BACKGROUND AND SELECTED POLICY ISSUES ON INTERNATIONAL TAX REFORM

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on October 3, 2017

Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on October 3, 2017, titled "International Tax Reform." This document,[1] prepared by the staff of the Joint Committee on Taxation, covers a number of topics related to the U.S. taxation of cross-border income. Part I of this document describes general international principles of taxation and how they are applied in the United States under present law. Part II discusses selected issues that have been of particular interest to policymakers as they evaluate the U.S. international tax system, including the competitiveness of the U.S. tax system; the economic distortions arising from deferral; the shifting of income and business operations away from the United States; the tax incentive to locate deductions in the United States; inversions; and the Base Erosion and Profit Shifting Project undertaken by the Organization for Economic Cooperation and Development ("OECD") at the request of the Group of Twenty[2] ("OECD/G20 BEPS Project"). Part III contains background data on cross-border income flows and economic activity, including mergers and acquisitions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-45-17), September 28, 2017. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[2] Group of Twenty ("G20") is a forum for international economic cooperation among 19 member countries and the European Union. The OECD and G20 Ministers of Finance work on a range of issues including agriculture, employment, energy, social policy, taxation, trade and investment.

I. PRESENT LAW AND BACKGROUND

A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be based on nationality of the actor, *i.e.*, a nexus between said conduct and a person (whether natural or juridical) with a connection to the sovereign nation, or it may be territorial, *i.e.*, a nexus between the conduct to be regulated and the territory where the conduct occurs.[3] For example, most legal systems respect limits on the extent to which their measures may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

The exercise of sovereign jurisdiction is usually based on either nationality of the person whose conduct is regulated and or the territory in which the conduct or activity occurs. These concepts have been refined and, in varying combinations, adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to impose a tax. The elements of nexus and the nomenclature of the principles may differ based on the type of tax in question. Taxes are categorized as either direct taxes or indirect taxes. The former category generally refers to those taxes that are imposed directly on a person ("capitation tax"), property, or income from property and that cannot be shifted to another person by the taxpayer. In contrast, indirect taxes are taxes on consumption or production of goods or services, for which a taxpayer may shift responsibility to another person. Such taxes include sales or use taxes, value-added taxes, or customs duties.[4]

Although governments have imposed direct taxes on property and indirect taxes and duties on specific transactions since ancient times, the history of direct taxes in the form of an income tax is relatively recent.[5] When determining how to allocate the right to tax a particular item of income, most jurisdictions consider principles based on either source (territory or situs of

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[3] American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, secs. 402 and 403, (1987).

[4] Maria S. Cox, Fritz Neumark, et al., "Taxation" *Encyclopedia Britannica*, https://www.britannica.com/topic/taxation/Classes-of-taxes, accessed May 16, 2017. Whether a tax is considered a direct tax or indirect tax has varied over time, and no single definition is used. For a review of the significance of these terms in Federal tax history, see Alan O. Dixler, "Direct Taxes Under the Constitution: A Review of the Precedents," *Tax History Project, Tax Analysts*, available at http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA8525730800067017?OpenDocument, accessed May 17, 2017.

[5] The earliest western income tax system is traceable to the British Tax Act of 1798, enacted in 1799 to raise funds needed to prosecute the Napoleonic wars, and rescinded in 1816. See, A.M. Bardopoulos, *eCommerce and the Effects of Technology on Taxation*, Law, Governance and Technology Series 22, DOI 10.1007/978-3-319-15449-7_2, (Springer 2015), at Section 2.2. "History of Tax," pp. 23-24. See also, http://www.parliament.uk/about/living-heritage/transformingsociety/private-lives/taxation/overview/incometax/.

the income) or residence (nationality of the taxpayer).[6] By contrast, when the authority to collect indirect taxes in the form of sales taxes or value added taxes is under consideration, jurisdictions analyze the taxing rights in terms of the origin principle or destination principle. The balance of this Part I.A describes the principles in more detail and how jurisdictions resolve claims of overlapping jurisdiction.

1. Origin and destination principles

Indirect taxes that are imposed based on the place where production of goods or services occur, irrespective of the location of the persons who own the means of production, and where the goods and services go after being produced, are examples of origin-based taxes. If, instead, authority to tax a transaction or service is dependent on the location of use or consumption of the goods or services, the tax system is an example of a destination-based tax. The most common form of a destination-based tax is the destination-based value-added tax ("VAT"). Over 160 countries have adopted a VAT,[7] which is generally a tax imposed and collected on the "value added" at every stage in the production and distribution of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added can generally be thought of as the difference between the value of sales (outputs) and purchases (inputs) of a business.[8] The United States does not have a VAT, nor is there a Federal sales or use tax.

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[6] Reuven Avi-Yonah, "International Tax as International Law," 57 *Tax Law Review* 483 (2003-2004).

[7] Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, Cambridge University Press, 2015. Consistent with the OECD *International VAT/GST Guidelines, supra,* the term VAT is used to refer to all broad-based final consumption taxes, regardless of the acronym used to identify. Thus, many countries that denominate their national consumption tax as a GST (general sales tax) are included in the estimate of the number of countries with a VAT.

[8] Nearly all countries use the credit-invoice method of calculating value added to determine VAT liability. Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax is generally disclosed on the sales invoice. A business credit is provided for all VAT levied on purchases of taxable goods and services (*i.e.*, "inputs") used in the seller's business. The ultimate consumer (*i.e.*, a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (*i.e.*, a "cascading" of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

In order to receive an input credit with respect to any purchase, a business purchaser is generally required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

However, the majority of the States have enacted sales or use taxes, including both origin-based taxes and destination-based taxes.[9]

With respect to cross-border transactions, the OECD has recommended that the destination principle be adopted for all indirect taxes, in part to conform to the treatment of such transactions for purposes of customs duties. The OECD defines the destination principle as "the principle whereby, for consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption."[10] A jurisdiction may determine the place of use or consumption by adopting the convention that the place of business or residence of a customer is the place of consumption. Use of such proxies are needed to determine the location of businesses that are juridical entities, which are more able than natural persons to move the location of use of goods, services or intangibles in response to imposition of tax.

2. Source and residence principles

Exercise of taxing authority based on a person's residence may be based on status as a national, resident, or domiciliary of a jurisdiction and may reach worldwide activities of such persons. As such, it is the broadest assertion of taxing authority. For individuals, the test for residence may depend upon nationality, or a physical presence test, or some combination. For all other persons, determining residency may require more complex consideration of the level of activities within a jurisdiction, management, control or place of incorporation. Such rules generally reflect a policy decision about the requisite level of activity within, or contact with, a jurisdiction by a person that is sufficient to warrant assertion of taxing jurisdiction.

Source-based exercise of taxing authority taxes income from activities that occur, or property that is located, within the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting taxation may require allocation and apportionment of expenses attributable to the activity in order to ensure that only the portion of profits that have the required nexus with the territory are subject to tax. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories such as compensation for services, dividends, interest, royalties and gains.

Regardless of which of these two bases of taxing authority is chosen by a jurisdiction, a jurisdiction's determination of whether a transaction, activity or person is subject to tax requires that the jurisdiction establish the limits on its assertion of authority to tax.

[9] EY, *Worldwide VAT, GST and Sales Tax Guide 2015*, p. 1021, available at http://www.ey.com/Publication/vwLUAssets/Worldwide-VAT-GST-and-sales-tax-guide-2015/$FILE/Worldwide%20VAT,%20GST%20and%20Sales%20Tax%20Guide%202015.pdf.

[10] See, OECD, "Recommendation of the Council on the application of value added tax/goods and services tax to the international trade in services and intangibles as approved on September 27, 2016," [C(2016)120], appendix, page 3, reproduced in the appendix, OECD, *International VAT/GST Guidelines, (2017), (2017) the OECD Publishing, Paris.*

3. Resolving overlapping or conflicting jurisdiction to tax

Countries have developed norms about what constitutes a reasonable regulatory action by a sovereign state that will be respected by other sovereign states. Consensus on what constitutes a reasonable limit on the extent of one state's jurisdiction helps to minimize the risk of conflicts arising as a result of extraterritorial action by a state or overlapping exercise of authority by states. Mechanisms to eliminate double taxation have developed to address those situations in which the source and residency determinations of the respective jurisdictions result in duplicative assertion of taxing authority. For example, asymmetry between different standards adopted in two countries for determining residency of persons, source of income, or other basis for taxation may result in income that is subject to taxation in both jurisdictions.

When the rules of two or more countries overlap, potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction. The United States is a partner in numerous bilateral agreements that have as their objective the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. The United States Model Income Tax Convention ("U.S. Model Treaty of 2016") with an accompanying Preamble by the Department of Treasury, reflects the most recent comprehensive statement of U.S. negotiating position with respect to tax treaties.[11] Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.[12]

In addition to entering into bilateral treaties, countries have worked in multilateral organizations to develop common principles to alleviate double taxation. Those principles are generally reflected in the provisions of the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (the "OECD Model treaty"),[13] a

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[11] The current U.S. Model treaty was published February 17, 2016, and is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf; the Preamble is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf. The U.S. Model treaty is updated periodically to reflect developments in the negotiating position of the United States. Such changes include provisions that were successfully included in bilateral treaties concluded by the United States, as well as new proposed measures not yet included in a bilateral agreement.

[12] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law "revenue rule" in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B.1775). American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, sec. 483, (1987). The rule retains vitality in U.S. case law. *Pasquantino v. United States,* 544 U.S. 349; 125 S. Ct. 1766; 161 L. Ed. 2d 619 (2005) (a conviction for criminal wire fraud arising from an intent to defraud Canadian tax authorities was found not to conflict "with any well-established revenue rule principle[,]" and thus was not in derogation of the revenue rule). To the extent it is abrogated, it is done so in bilateral treaties, to ensure reciprocity. At present, the United States has such agreements in force with five jurisdictions: Canada; Denmark; France; Netherlands; and Sweden.

[13] OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing. http://dx.doi.org/10.1787//mtc_cond-2014-en. The multinational organization was first established in

precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.[14] As a consensus document, the OECD Model treaty is intended to serve as a model for countries to use in negotiating a bilateral treaty that would settle issues of double taxation as well as to avoid inappropriate double nontaxation. The provisions have developed over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.[15]

1961 by the United States, Canada and 18 European countries, dedicated to global development, and has since expanded to 35 members.

[14] "Report by the Experts on Double Taxation," League of Nation Document E.F.S. 73\F19 (1923), a report commissioned by the League at its second assembly. See also, Lara Friedlander and Scott Wilkie, "Policy Forum: The History of Tax Treaty Provisions--And Why It Is Important to Know About It," 54 *Canadian Tax Journal* No. 4 (2006).

[15] For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

B. International Principles as Applied in the U.S. System

The United States has adopted a Code[16] that combines residence-based taxation of all U.S. persons on all income, whether derived in the United States or abroad, with source-based taxation of income of nonresident aliens and foreign entities. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities, although certain rules are common to both inbound and outbound activities.

1. Rules applicable to both inbound and outbound activities

Although the U.S. tax rules differ depending on whether the activity in question is inbound or outbound, certain concepts apply to both inbound and outbound investment. Such areas include the classification and residence of persons, determination of source, intercompany pricing, anti-base erosion rules intended to prevent reduction of the U.S. tax base and foreign tax credits.

Residence

U.S. persons are subject to tax on their worldwide income. The Code defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts.[17] The term "resident" is defined only with respect to natural persons. Noncitizens who are lawfully admitted as permanent residents of the United States in accordance with immigration laws (colloquially referred to as green card holders) are treated as residents for tax purposes. In addition, noncitizens who meet a substantial presence test and are not otherwise exempt from U.S. taxation are also taxable as U.S. residents.[18]

For legal entities, the Code determines whether an entity is subject to U.S. taxation on its worldwide income on the basis of its place of organization. For purposes of U.S. tax law, a corporation or partnership is treated as domestic if it is organized or created under the laws of the United States or of any State, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[19] All other partnerships and corporations (that is, those organized under the laws of foreign countries) are treated as foreign.[20] In contrast, place of organization is not

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[16] Unless otherwise stated, all references to the Code are to the Internal Revenue Code of 1986, as amended.

[17] Sec. 7701(a)(30).

[18] Sec. 7701(b).

[19] Sec. 7701(a)(4).

[20] Secs. 7701(a)(5) and 7701(a)(9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

determinative of residence under other taxing jurisdictions that use factors such as situs, management and control are used to determine residence. As a result, legal entities may have more than one tax residence, or, in some case, no residence.[21]

Certain entities are eligible to elect their classification for Federal tax purposes under the "check-the-box" regulations adopted in 1997.[22] Those regulations simplified the entity classification process for both taxpayers and the Internal Revenue Service ("IRS") by making the entity classification of unincorporated entities explicitly elective in most instances.[23] Whether an entity is eligible for the election and the breadth of its choices depends upon whether it is a "per se corporation" and its number of beneficial owners. Foreign as well as domestic entities may make the election. As a result, it is possible for an entity that operates across countries to be treated as hybrid entities, which are entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes. For "reverse hybrid entities," the opposite is true. Hybrid and reverse hybrid entities can affect whether income is currently includible in income or whether a taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States.

Foreign tax credits

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes.[24] The foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[25] The amount of the credit is limited to the U.S. tax in the same proportion that foreign source taxable income bears to the taxpayer's worldwide taxable income. As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source,

[21] "The notion of corporate residence is an important touchstone of taxation, however, in many foreign income tax systems[,]" with the result that the bilateral treaties are often relied upon to resolve conflicting claims of taxing jurisdiction. Joseph Isenbergh, Vol. 1 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 7.1 (Fourth Ed. 2016).

[22] Treas. Reg. sec. 301.7701-1, *et seq*.

[23] The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies ("LLCs") under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

[24] In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes are allowed as deductions under section 164(a)(3).

[25] Secs. 901, 902, 960, and 1291(g).

the source of income remains a critical factor to the extent that it determines the limitation on the amount of credit available for foreign taxes paid. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories, commonly referred to as the "general basket" and the "passive basket." Consequently, the expense allocation rules primarily affect taxpayers that may not be able to fully use their foreign tax credits because of the foreign tax credit limitation. In addition to the statutory relief afforded by the credit, the network of bilateral treaties to which the United States is a party provides a system for elimination of double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

Present law also provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. The expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation.

Rules for determining source of income and expenses

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used.

The Code specifies rules for determining the source of income derived from the following items: interest; dividends; royalties; rents; personal property; personal services; amounts received with respect to guarantees of indebtedness; and insurance.[26] Special rules are provided for income from international transportation, communications and space and ocean activities.[27] To determine whether items are derived from United States sources, various factors are relevant, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of any assets that generate the income.

To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment.[28] However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes

[26] Secs. 861-863.

[27] Sec. 864.

[28] Sec. 7805 (general authority to prescribe rules and regulations needed to enforce the Code, subject to restrictions on retroactive rule-making); *Home Concrete & Supply, LLC. v. United States*, 132 S. Ct. 1836; 182 L. Ed. 2d 746 (2012).

resulting in non-taxation of income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[29]

Anti-base erosion measures

U.S. tax law includes several statutory rules intended to prevent reduction of the U.S. tax base by placing deductions in the United States, as discussed below in part II.D, or by outbound transactions that result in locating income abroad, as discussed in parts II.C and E. Such rules limit the earnings stripping potential of excessive borrowing in the United States by denying deductions of interest in certain circumstances.[30] Outbound transfers of intangible property may trigger recognition of any unrecognized appreciation[31] or result in reallocation of income to ensure that intercompany pricing with respect to the transfer is commensurate with the income attributable to the intangible.[32]

Tax benefits otherwise available to a domestic corporation that migrates its tax home from the United States to foreign jurisdiction may be denied to such corporation, which continues to be treated as a domestic corporation for ten years following the inversion.[33] These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic 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 domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, 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.[34] The Treasury Department has promulgated detailed guidance addressing these requirements under section 7874.[35]

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[29] See, *e.g.*, *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[30] Sec. 163(j).

[31] Sec. 367(d).

[32] Sec. 482 and Treas. Reg. sec. 1.482-4, 1.482-7.

[33] Sec. 7874.

[34] Section 7874(a). In addition, an excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Section 4985.

[35] On November 19, 2015, Treasury and the IRS issued Notice 2015-79, 2015 I.R.B. LEXIS 583 (Nov. 19, 2015), which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. On April 4, 2016, Treasury and the IRS issued proposed and temporary regulations (T.D. 9761) that incorporate the rules previously announced in Notice 2014-52 and Notice 2015-79 and

2. Rules applicable to foreign activities of U.S. persons

In general, income earned directly by a U.S. person from the conduct of a foreign business is taxed on a current basis,[36] but income earned indirectly from a separate legal entity operating the foreign business is not. Instead, active foreign business income earned by a U.S. person indirectly through an interest in a foreign corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. Certain anti-deferral regimes may cause the U.S. owner to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by the foreign corporation regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes that provide such exceptions are the controlled foreign corporation ("CFC") rules of subpart F[37] and the passive foreign investment company ("PFIC") rules.[38]

Subpart F regime

The anti-deferral regime known as subpart F departs from the general rules by requiring that certain shareholders' proportionate shares of the earnings of CFCs be subject to U.S. income tax on a current basis, even if the earnings are not distributed to the shareholders. A CFC is generally a foreign corporation in which more than 50 percent of the corporation's stock (measured by vote or value) is owned by U.S. persons (directly, indirectly, or constructively) who own at least 10 percent of the stock (measured by vote only).[39] Only a U.S. person who owns at least 10 percent of the stock of a foreign corporation is a United States shareholder within the meaning of subpart F. A United States shareholder is subject to current U.S. taxation on its pro rata share of E & P of the CFC that constitute either subpart F income or includible investments in U.S. property.[40] Where the foreign country in which the CFC is tax-resident for foreign tax purposes imposes an income tax on the income of the CFC, a foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source

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a new multiple domestic entity acquisition rule. On January 13, 2017, Treasury and the IRS issued final and temporary regulations under section 7874 (T.D. 9812), which adopt, with few changes, prior temporary and proposed regulations, which identify certain stock of an acquiring foreign corporation that is disregarded in calculating the ownership of the foreign corporation for purposes of section 7874.

[36] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

[37] Secs. 951-964.

[38] Secs. 1291-1298.

[39] Secs. 951(b), 957, and 958.

[40] Sec. 951(a).

income,[41] in which case the net U.S. tax owed is, in broad terms, the difference between the U.S. tax otherwise applicable to the income and the foreign tax imposed on the income.

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another and consists of foreign base company income,[42] insurance income,[43] and certain income relating to international boycotts and other violations of public policy.[44] Several exceptions to the broad definition of subpart F income permit continued deferral for certain transactions, dividends, interest and certain rents and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[45] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception from foreign base company income and insurance income is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[46] A third exception, the provision colloquially referred to as the "CFC look-through" rule, excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[47] The application of the look-through rule applies to taxable years of foreign corporations beginning before January 1, 2020, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.[48]

In addition to the above exceptions, there are also exceptions from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business

[41] Secs. 901, 902, and 960.

[42] Sec. 954. Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

[43] Sec. 953.

[44] Sec. 952(a)(3)-(5).

[45] Sec. 954(c)(3).

[46] Sec. 954(b)(4).

[47] Sec. 954(c)(6).

[48] See section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114-113), H.R. 2029 (114th Cong.) ["the PATH Act of 2015"], which extended section 954(c)(6) for five years. The House agreed to amendments to the Senate amendment on December 17, and December 18, 2015, and the bill, as amended, passed the House on December 18, 2015. The Senate agreed to the House amendments on December 18, 2015. The President signed the bill on December 18, 2015. Congress has previously extended the application of section 954(c)(6) several times, most recently in the Tax Increase Prevention Act of 2014, Pub. L. No. 113-295; Pub. L. No. 107-147, sec. 614, 2002; Pub. L. No. 106-170, sec. 503, 1999; Pub. L. No. 105-277, 1998.

("active financing income"), and for certain income of a qualifying insurance company.[49] Often referred to as the active finance exception, the exception applies to income derived in the active conduct of a banking, financing, or insurance business.[50] The exception requires, among other things, that the CFC be predominantly engaged in such business and conduct substantial activity with respect to such business.

Other inclusions under subpart F: investments in U.S. property

To stop taxpayers from avoiding U.S. tax by repatriating untaxed CFC earnings through non-dividend payments such as loans to the U.S. parent company, subpart F also requires that U.S. shareholders of a CFC include in income their pro rata shares of a CFC's untaxed earnings invested in certain items of U.S. property.[51] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[52] Exceptions to the definition of U.S. property, include U.S. bank deposits, certain export property, and certain trade or business obligations.[53]

Adjustment of tax attributes to reflect subpart F inclusions

Subpart F includes rules for the computation of earnings and profits ("E & P") and for basis adjustments to avoid taxing earnings that have been previously taxed under subpart F. Ordering rules provide that distributions from a CFC are treated as coming first out of E & P of the CFC that have been previously taxed under section 956 as investments in U.S. property, then from earnings that have been previously taxed under subpart F, and then out of other E & P.[54] Other rules ensure that previously taxed E & P are not taxed again when actually distributed to a United States shareholder of a CFC, whether the previous exclusion was based on subpart F income or as a result of increased investments in U.S. property.[55] A U.S. shareholder's basis in the stock of a CFC is increased by the amount of the shareholder's subpart F inclusions in

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[49] Secs. 953 and 954(h). Section 128 of the PATH Act of 2015 made the temporary active financing and insurance exceptions permanent, after multiple extensions. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b); Pub. L. No. 111-312, sec. 750(a), 2010; Pub. L. No. 110-343, div. C, sec. 303(b), 2008; Pub. L. No. 109-222, sec. 103(a)(2), 2006; Pub. L. No. 107-147, sec. 614, 2002; Pub. L. No. 106-170, sec. 503, 1999.

[50] Sec. 954(h), (i).

[51] Secs. 951(a)(1)(B) and 956.

[52] Sec. 956(c)(1).

[53] Sec. 956(c)(2).

[54] Sec. 959(c).

[55] Sec. 959(a)(2).

respect of the CFC stock and is decreased by the amount of any distributions received from the CFC that are excluded from the shareholder's income as previously taxed income.[56]

Financial reporting requirements applicable to CFC earnings

Under Generally Accepted Accounting Principles ("GAAP") principles, the earnings of a foreign subsidiary are generally required to be included in the consolidated financial statements of the U.S. parent during the period in which they are earned, even though tax is deferred for earnings that are not distributed to the U.S. parent or otherwise includible, such as under subpart F. These undistributed earnings of a foreign subsidiary that are included in financial statement consolidated income but which are deferred from U.S. taxation represent a temporary difference for which a tax liability and associated tax expense is currently accrued, unless the relevant tax laws provide a means by which the investment in the subsidiary can be recovered tax-free.[57] It is generally presumed for U.S. GAAP purposes that all undistributed earnings of a foreign subsidiary will be repatriated to the U.S. parent entity. A firm may overcome that presumption by satisfying the "indefinite reversal criteria."[58] When a parent entity makes an assertion regarding its intent to indefinitely reinvest foreign earnings, and has demonstrated its ability to do so, it is required to disclose the gross amount of foreign earnings in the footnotes of its financial statements. The parent entity is also required to disclose the nature of events that would give rise to taxation of the earnings in the parent jurisdiction, as well as to provide either an estimate of the tax liability associated with the foreign earnings or a statement that it is impractical to provide a reasonable estimate of the tax liability.

Passive foreign investment companies

The Tax Reform Act of 1986[59] established the PFIC anti-deferral regime. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[60] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax,

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[56] Secs. 961(a) and 961(b).

[57] Accounting Standards Codification ("ASC") 740-30-25-3, *Income Taxes, Other Considerations or Special Areas, Recognition of Undistributed Earnings of Subsidiaries and Corporate Joint Ventures*.

[58] ASC 740-30-25-17, *Income Taxes, Other Considerations or Special Areas, Recognition, Exceptions to Comprehensive Recognition of Deferred Income Taxes*. These criteria require that the company provide evidence of specific plans for reinvestment of the undistributed earnings that demonstrate that remittance of the earnings will be postponed indefinitely and demonstrate that the U.S. parent company has adequate cash flows from other sources and will not require remittances from the foreign subsidiary.

[59] Pub. L. No. 99-514.

[60] Sec. 1297.

subject to an interest charge, on income not currently received.[61] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[62] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[63]

3. Rules applicable to U.S. activities of foreign persons

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: (1) U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") and (2) income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI").

FDAP income

FDAP income generally is subject to a 30-percent rate of tax that is collected by withholding at the source of payment and is limited to income that is not effectively connected with the conduct of a U.S. trade or business.[64] The items enumerated in defining FDAP income are illustrative; the common characteristic of various types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.[65]

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.[66] Capital gains received by nonresident aliens present in the United States for fewer

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[61] Secs. 1293-1295.

[62] Sec. 1291.

[63] Sec. 1296.

[64] Secs. 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.

[65] *Commissioner v. Wodehouse*, 337 U.S. 369, 388-89 (1949). After reviewing legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, *i.e.*, subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.

[66] Although insurance premiums paid to a foreign insurer or reinsurer are FDAP income (secs. 871(a)(1)(A), 881(a)(1)(A), they are exempt from withholding under Treas. Reg. sec. 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under section 4371. Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2).

than 183 days are generally treated as income derived from foreign sources that is not subject to U.S. tax unless the gains are effectively connected with a U.S. trade or business, while capital gains received by nonresident aliens present in the United States for 183 days or more[67] are treated as U.S.-source and subject to gross-basis taxation.[68] In contrast, U.S-source gains from the sale or exchange of intangibles that are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business are subject to the gross basis tax withheld at the source.[69]

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations and certain amounts held by insurance companies are U.S. source but are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[70] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[71] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[72] Additionally, information reporting may not be required with respect to payments of such amounts.[73]

The 30-percent tax on FDAP income is generally collected by means of withholding.[74] Withholding on FDAP payments to foreign payees is required unless the withholding agent[75]

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[67] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[68] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980, discussed *infra* at part II.B.3.

[69] Secs. 871(a)(1)(D), 881(a)(4).

[70] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[71] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[72] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[73] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and 1.6049-8. The IRS has published a list of the countries whose residents are subject to the reporting requirements, and a list of those countries with respect to which the reported information will be automatically exchanged. Rev. Proc. 2016-56, I.R.B. 2016-52 (December 27, 2016).

[74] Secs. 1441 and 1442.

[75] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[76] The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest.[77]

Income effectively connected with the conduct of a U.S. trade or business

Income from the conduct of a U.S. trade or business is taxed on a net basis if such income is effectively connected with the conduct of that trade or business. The determination of whether a foreign person is engaged in a U.S. trade or business is factual and considers whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[78]

Specific statutory rules govern whether income is ECI.[79] A foreign person engaged in a U.S. trade or business may have both U.S.-source and foreign-source income that is ECI. In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[80]

The extent to which a foreign person who is engaged in a U.S. trade or business may have foreign-source income that is considered to be ECI is limited in the Code to circumstances in which a threshold level of activities is met.[81] Foreign-source income generally is considered to be ECI only if the person has an office or other fixed place of business within the United

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[76] Secs. 871, 881, 1441, and 1442; Treas. Reg. sec. 1.1441-1(b).

[77] Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person. Sec. 871(h)(2). A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. Sec. 1441(b). In addition to statutory exemptions, the 30-percent withholding tax with respect to interest, dividends or royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

[78] Sec. 875.

[79] Sec. 864(c).

[80] Sec. 864(c)(2).

[81] Under tax treaties to which the United States is a party, the ability to tax business profits is further limited, because the threshold level of activities required to find that a foreign person has a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business.

States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.[82] Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.[83]

Deductions associated with gross ECI are permitted in determining taxable ECI, which is then taxed at the same graduated rates applicable to U.S. persons. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

4. Interaction of U.S. hybrid tax system with and U.S. nontax international obligations

Since 1939, the U.S. tax system has had a series of special tax regimes intended to provide incentives for foreign trade and to ameliorate disadvantages of U.S. multinational enterprises face in competing with entities based in jurisdictions with territorial tax systems.[84] Under the current Code, both the foreign sales corporation ("FSC") regime[85] and the

[82] Sec. 864(c)(4)(B).

[83] Sec. 864(c)(4)(D)(i).

[84] An overview of the history of the special tax regimes is provided in Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 81. (Fourth Ed. 2016). Prior to the Internal Revenue Act of 1986, such efforts included the special rules and benefits for China Trade Corporations and Western Hemisphere Corporations under the Code of 1939, and the partial deferral for certain domestic international sales corporations ("DISCs") under the Internal Revenue Code of 1954.

[85] Secs. 921- 927.

extraterritorial income systems (“ETI regime”)[86] were challenged on the ground that it provided an export subsidy of a direct tax in violation of international trade agreements.

The FSC regime was enacted in 1984 in response to concerns that the partial deferral for income of DISCs[87] violated the General Agreement on Tariffs and Trade (“GATT”). A FSC was a foreign corporation managed outside the United States and entitled to exempt from tax a portion of its foreign trade income from services and sales of goods manufactured in the United States. In 1999, the World Trade Organization (“WTO”), in response to EU complaints, held that the FSC regime constituted an illegal export subsidy under the relevant WTO agreements. In 2000, the United States repealed the FSC regime and replaced it with the ETI regime. The ETI regime permitted domestic corporations and electing foreign corporations to exclude a portion of income as qualifying foreign trade income.[88] The EU immediately challenged the ETI regime in the WTO. In January 2002, a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.[89]

[86] Secs. 941- 943

[87] Secs. 991 through 997.

[88] “FSC Repeal and Extraterritorial Income Exclusion Act of 2000,” Pub. L. No. 106-519.

[89] For a detailed report of the FSC/ETI dispute, see Raymond J. Ahearn, “European Trade Retaliation: The FSC-ETI Case,” Congressional Research Service RS21742 (July 26, 2006). See also, *Joint Committee on Taxation, The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations* (JCX-67-03), July 3, 2003.

II. POLICY ISSUES

A. Competitiveness

1. Economic objectives

Overview

U.S. policymakers are often concerned with promoting economic growth and the general economic well-being of the U.S. population, both of which are influenced significantly by the level of investment and employment in the United States. The meaning of "competitiveness" in U.S. tax policy discussions is broad, but generally reflects these policy concerns. The competitiveness of the U.S. tax system refers in large part to how effectively it promotes domestic investment and employment, and U.S. economic growth in general.

Domestic investment and employment arises from a number of sources, including the activities of U.S. multinationals and other U.S. businesses as well as foreign multinationals. In turn, their investment decisions in the United States may be based on a number of factors, including: the quality of the U.S. workforce and the cost of labor; their expected sales growth both in the United States and abroad (*i.e.*, the demand for their goods and services); the location of both their customers and their input suppliers; taxes; and the economic benefits of locating activities in particular areas, such as a geographic region (*e.g.*, Silicon Valley), because, for example, of existing research networks and proximity to universities.

In the cross-border context, concerns about the competitiveness of the U.S. tax system have centered on policy objectives that include: (1) fostering the growth of U.S. multinationals abroad; (2) encouraging domestic investment by U.S. and foreign businesses; and (3) promoting U.S. ownership, as opposed to foreign ownership, of U.S. and foreign assets. These particular policy objectives may be important to policymakers for a number of economic reasons, described below.

Growth of U.S. multinationals abroad

When U.S. multinationals grow overseas, as measured by increased sales abroad, that growth may lead to greater domestic investment and employment.[90] For example, a company may increase employment at a manufacturing plant or build new facilities if sales of its U.S.-made goods increase abroad. Likewise, an opportunity to expand into a new foreign market may increase the resources that a company puts into its U.S.-based marketing and management activities as it aims to gain a foothold in that market. To the extent that a U.S. company relies on its domestic operations to service foreign markets, increased sales overseas should increase domestic investment and employment. In addition, an increase in earnings may increase the value of the U.S. company, the benefits of which could accrue primarily to U.S. shareholders given the documented "home bias" in portfolio investments (*i.e.*, the disproportionate share of

[90] This particular claim concerns sales and is distinct from the claim that foreign investment and employment is a substitute for, or complement to, domestic investment and employment.

local equities that investors hold in their portfolio relative to what theories of the benefits of international diversification would predict).[91]

However, if growth of U.S. sales abroad is accompanied by increased foreign investment and employment, that may result in lower U.S. investment and employment. For example, a company may decide to move its U.S.-based manufacturing and marketing operations overseas, which reduces domestic investment and employment. However, it may also be the case that foreign investment and employment complements domestic investment and employment. For example, the successful expansion of a company's overseas operations may provide the company with funds to make more domestic investments and increase its domestic workforce.

The evidence on whether foreign investment and employment complements, or substitutes for, domestic investment and employment has been inconclusive. One study finds that expansion of a company's domestic economic activity is associated with expansion in the activity of its foreign affiliates.[92] However, this can occur if a company develops a new product and expands its sales force both in the United States and overseas.[93] In this case, domestic investment and employment growth coincides with, but is not caused by, foreign investment and employment growth. Another study finds that, on average, increases in domestic employment by U.S. multinationals are associated with increases in employment of their foreign affiliates.[94] However, this result holds only for affiliates in high-income countries. For affiliates in low-income countries, where labor costs may be lower than in the United States, the authors found that foreign employment growth is associated with reductions in U.S. employment.

Domestic investment by U.S. and foreign businesses

Higher levels of domestic investment by U.S. and foreign businesses may contribute to U.S. economic growth and job creation. For example, when a U.S. business makes a new investment, such as constructing a new factory or research facility, it may need to hire workers as part of the investment. The investments they make may also increase the productivity of the operations of the U.S. business which may promote overall economic growth in the United States and potentially raise wages (to the extent that workers' wages rise as their productivity rises). These same economic effects are not restricted to domestic investments by U.S. businesses and could be brought about by domestic investments made by foreign businesses.

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[91] For a review of the literature on home bias in portfolio holdings, see Nicolas Coeurdacier and Hélène Rey, "Home Bias in Open Economy Financial Macroeconomics," *Journal of Economic Literature*, vol. 51, no. 1, March 2013, pp. 63-115.

[92] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, vol. 1, no. 1, February 2009, pp. 181-203.

[93] The authors of the study recognize this problem and attempt to correct for it in their analysis.

[94] Ann E. Harrison, Margaret S. McMillan, and Clair Null, "U.S. Multinational Activity Abroad and U.S. Jobs: Substitutes or Complements," *Industrial Relations*, vol. 46, no. 2, April 2007, pp. 347-365.

U.S. ownership of U.S. and foreign assets

Some policymakers may prefer that ownership of U.S. and foreign assets is held by U.S. persons instead of foreign persons. With regards to foreign assets, U.S. ownership may confer a number of benefits on the U.S. economy. Foreign assets may serve as a platform for overseas expansion and growth, potentially increasing domestic employment and investment. In addition, when a U.S. company acquires a foreign company, it may also be acquiring intangibles (such as intellectual property and managerial know-how) that may complement its existing U.S. operations and enhance their effectiveness.

Compared to situations involving U.S. ownership of a foreign asset, it is less clear how, as a general matter, U.S. ownership of a U.S. asset benefits the U.S. economy more than foreign ownership of a U.S. asset. The effects may vary depending on the particular circumstances.

For example, when a foreign company acquires a U.S. company, the headquarters operations of the U.S. company may move outside the United States. This may result in direct employment losses in the United States as well as some of the local economic benefits that accompany headquarters operations, including involvement in philanthropic activities.[95]

When a foreign company starts a new venture in the United States by making new investments ("greenfield investments") instead of acquiring an existing company that may benefit the U.S. economy by increasing employment and investment. This positive economic impact may come at the expense of U.S. businesses, though. For example, the foreign company's U.S. venture may be competing directly with a U.S. company for control of a market for a particular product. If the foreign company's U.S. venture succeeds in controlling the market at the expense of its U.S.-based competitor because its products are more attractive (which benefits U.S. consumers) and the company is managed more efficiently, for example, net investment and employment in the United States may still increase. However, what could have been a U.S.-headquartered company controlling a market segment is now a foreign-headquartered company. If policymakers are concerned about this scenario, though, that concern may be in conflict with the goal of encouraging U.S. investment by foreign corporations.

The U.S. economic impact in the second hypothetical example—where a foreign person makes a new investment in the United States—contrasts with that of the first hypothetical example, where a foreign company acquired an existing U.S. company. In both cases, a foreign-headquartered company owns a U.S. asset that could have been owned by a U.S.-headquartered company. However, there was a positive U.S. economic impact in the example where a foreign company made a new investment, while there was a negative U.S. economic impact in the example where a foreign company acquired an existing U.S. company and moved its headquarters overseas. These examples, and the U.S. economic impact described, are hypothetical, but they illustrate that the distinction between foreign ownership of an existing U.S. asset versus a new U.S. asset may be important for the economic analysis. However, there is little empirical evidence on the extent to which these hypothetical examples reflect existing

[95] David Card, Kevin F. Hallock, and Enrico Moretti, "The Geography of Giving: The Effect of Corporate Headquarters on Local Charities," *Journal of Public Economics*, vol. 94, nos. 3-4, April 2010, pp. 222-234.

investment patterns, and if so, whether, on balance, U.S. ownership of U.S. assets provides greater economic benefits than foreign ownership of U.S. assets.

A general consideration to take into account is whether a U.S. asset is more productive under foreign ownership than U.S. ownership for purely economic reasons. A foreign company, for example, may have a stronger overseas presence (in the relevant markets) than prospective U.S. acquirers of a U.S. company, and may facilitate the global expansion of the U.S. company more effectively. The economic case for promoting U.S. ownership of the U.S. company in this situation is unclear. However, if the U.S. company is more productive under U.S. ownership, but for tax reasons is more valuable in the hands of a foreign owner, there may be a stronger case for designing tax rules to promote U.S. ownership of these assets.

2. Assessing the competitiveness of the U.S. tax system in a global economy

The United States is part of a global economy in which some governments have adopted policies intended attract investment and promote the overseas growth of their home-country multinationals. Over the past decade, there have been a number of policy developments around the world, and in OECD countries in particular, that have led policymakers to question whether the U.S. tax system is competitive, including the decline in statutory corporate income tax rates and the adoption of tax rules that exempt active foreign-source income from home-country taxation.[96]

Global trends in corporate tax rates and adoption of exemption systems

Global trends in corporate tax rates

Table 1, below, presents the top combined statutory corporate income tax rates in countries in the Organization for Economic Cooperation and Development ("OECD") from 2007 to 2017 and reflects tax rates set by central governments as well as sub-central governments and accounts for some (but not always all) surtaxes and deductions.[97] For each year, the cell corresponding to the country with the highest tax rate is shaded pink, while the cell associated with the country with the lowest tax rate is shaded blue. For most OECD countries, top combined statutory income tax rates have declined over the last decade. The rate in 2017 was lower than in 2007 for 21 of the 35 OECD countries. Rates were higher in 2017 for only six

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[96] A third recent development that may result in tax competition, discussed in Parts II.C and II.F of this document, is the enactment of preferential tax regimes for income derived from intellectual property.

[97] See OECD, *OECD Tax Database Explanatory Annex Part II: Taxation of Corporate and Capital Income*, April 2017, available http://www.oecd.org/ctp/tax-policy/corporate-and-capital-income-tax-explanatory-annex.pdf. For the United States in 2017, the combined statutory corporate tax rate of 38.9 percent equals the (top) Federal corporate income tax rate of 35 percent minus 2.1 percent (to account for the section 199 deduction for domestic production activities and the deductibility of State corporate income taxes) plus a weighted average State corporate income tax rate of 6.01 percent. The weighted average tax rate equals the sum of the top corporate tax rate for each State multiplied by the State's share in total personal income. The OECD weighting methodology is not consistent across countries.

countries. From 2007 to 2012, the United States had the second highest combined statutory corporate income tax rate among OECD countries, and had the highest rate from 2013 to 2017.[98]

Table 1.−Top Combined Statutory Corporate Income Tax Rates in the OECD (Central and Sub-Central Governments): 2007-2017

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Austria	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Belgium	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Canada	34.0	31.4	30.9	29.4	27.7	26.1	26.2	26.2	26.7	26.7	26.7
Chile	17.0	17.0	17.0	17.0	20.0	20.0	20.0	21.0	22.5	24.0	25.0
Czech Republic	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Denmark	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5	23.5	22.0	22.0
Estonia	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	20.0	20.0	20.0
Finland	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0	20.0	20.0	20.0
France	34.4	34.4	34.4	34.4	36.1	36.1	38.0	38.0	38.0	34.4	34.4
Germany	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0	26.0	29.0	29.0
Hungary	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	9.0
Iceland	18.0	15.0	15.0	18.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Israel	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5	26.5	25.0	24.0
Italy	37.3	31.4	31.4	31.4	31.4	31.3	31.3	31.3	31.3	31.3	27.8
Japan	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0	32.1	30.0	30.0
Korea	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2	24.2	24.2	24.2
Latvia	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Luxembourg	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2	29.2	29.2	27.1
Mexico	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Netherlands	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0	25.0	25.0	25.0
New Zealand	33.0	30.0	30.0	30.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.0	27.0	25.0	24.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5	29.5	29.5	29.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0	22.0	22.0	21.0
Slovenia	23.0	22.0	21.0	20.0	20.0	18.0	17.0	17.0	17.0	17.0	19.0
Spain	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0	28.0	25.0	25.0
Sweden	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0	22.0	22.0	22.0
Switzerland	21.3	21.2	21.2	21.2	21.2	21.2	21.2	21.2	21.2	21.2	21.2
Turkey	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0	20.0	20.0	19.0
United States	39.3	39.3	39.2	39.2	39.2	39.1	39.1	39.1	39.0	38.9	38.9

Source: OECD Tax Database.

[98] For estimates of average and effective corporate tax rates across the Group of Twenty ("G20") countries for 2012, see Congressional Budget Office, *International Comparisons of Corporate Tax Rates*, March 2017. Average and effective corporate tax rates account for features of tax systems besides statutory corporate tax rates, such as cost recovery provisions and investment incentives. The Congressional Budget Office estimates, for the United States in 2012, an average corporate tax rate of 29.0 percent and an effective corporate tax rate of 18.6 percent, which were among the highest in the G20.

Adoption of exemption systems

Since 2000, there has been an increase in the number of OECD countries that have adopted some form of exemption system for the taxation of foreign-source income. According to one report, of the 35 countries that make up the OECD, 29 have some form of an exemption system, which is more than double the number of countries that had one at the start of 2000.[99]

Implications for the competitiveness of the U.S. tax system

Growth of U.S. multinationals abroad

In foreign markets, U.S. corporations may have more limited options for growth than some of their foreign competitors in that market. For example, consider a U.S. corporation and foreign corporation that both require an after-tax rate of return of 10 percent on the investments they pursue in a given market outside their home country, which is assumed to have a tax rate of 20 percent. If the earnings of the foreign corporation are exempt from home-country tax, this means that it will pursue investments that yield a required pre-tax rate of return of 12.5 percent.[100] In contrast, the U.S. corporation's required pre-tax rate of return may be greater than 12.5 percent, even though it can defer paying residual U.S. tax on its earnings, because it cannot reduce the present value of its U.S. residual tax liability below zero in the absence of cross-crediting. Therefore, the U.S. corporation may forgo investments—such as expansion of its manufacturing facilities or acquisitions of local companies—that it would have pursued if its returns were not subject to U.S. taxation. This may make it more difficult for the U.S. corporation to gain market share relative to the foreign corporation, and also may have an indirect, negative effect on employment and economic growth in the United States to the extent that a U.S. company's success overseas translates into increased domestic investment and employment. However, if the U.S. corporation is able to fully offset the residual U.S. tax liability on its earnings with credits allowed for income taxes paid in another jurisdiction, it would not be at a competitive tax disadvantage relative to the foreign corporation. Moreover, the ability of a U.S. corporation to defer paying residual U.S. tax on its earnings may limit its competitive tax disadvantage because its cash flow would not be immediately reduced by its U.S. tax liability.

Domestic investment by U.S. and foreign businesses

The economics literature has found that the location of foreign direct investment is sensitive to both the statutory tax rates and effective marginal tax rates, which is the effective

[99] See PricewaterhouseCoopers, "Evolution of Territorial Tax Systems in the OECD," April 2, 2013, and Deloitte, "International Tax: Latvia Highlights 2017," available at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-latviahighlights-2017.pdf.

[100] In equation form, $0.10/(1 - 0.8) = 0.125$. To see how this equation was arrived at, note that a pre-tax rate of return of 12.5 percent multiplied by 1 minus the foreign tax rate of 20 percent equals an after-tax rate of return of 10 percent. Therefore, to arrive at the required pre-tax rate of return for a given tax rate and after-tax rate of return, one divides the after-tax rate of return (in this case, 10 percent or 0.10) by 1 minus the foreign tax rate (in this case, 80 percent or 0.80).

rate of tax (accounting for all features of the tax system such as tax incentives and methods of cost recovery) on a marginal investment.[101] Therefore, the United States may be at a competitive tax disadvantage, relative to other countries, in attracting domestic investment by U.S. and foreign businesses, to the extent that the other countries have corporate tax rates lower than that of the United States. This scenario may have grown increasingly likely over the last decade as statutory corporate tax rates in other OECD countries have gradually declined, as illustrated above in Table 1. However, the United States may be able to offset some or all of its competitive disadvantage by offering tax incentives, such as the section 199 domestic production activities deduction and accelerated cost recovery methods, that lower the effective marginal tax rate on income earned by foreign (and domestic) businesses.

<u>Ownership of assets</u>

Policymakers may be concerned that the U.S. system of worldwide taxation may put U.S. multinationals at a competitive disadvantage, relative to foreign multinationals, in acquiring U.S. and foreign assets. With respect to U.S. assets, since foreign multinationals may have more opportunities to grow overseas if they are based in countries that exempt active foreign income from home-country tax, a U.S. asset may be more valuable under foreign ownership than under U.S. ownership. For example, the U.S. asset may be a U.S. company that has opportunities to expand its global presence. If it can achieve greater success overseas under foreign ownership, that may allow foreign corporations to offer higher bids than U.S. corporations when acquiring the company.

However, it could be the case that the company is more valuable under U.S. ownership despite the U.S. system of worldwide taxation. For example, a particular U.S. corporation may manage the company more effectively, and integrate it more successfully into the corporation's overall business operations, than any foreign corporation could. The company would then be less valuable to any foreign corporation than it is to the U.S. corporation, so the U.S. corporation may submit a higher bid than any foreign corporation, and as a result acquire the company. The geographic pattern of the ownership of assets by owners' country of residence, then, can reflect a number of economic considerations unrelated to tax. Moreover, for any given U.S. company, the proposition that it can expand more successfully under an exemption system, versus a worldwide tax system with deferral, may not be true. That will depend on a number of factors, including the line of business the company is engaged in, its capital needs in the United States, and the type of growth opportunities it is interested in pursuing.

[101] This research is surveyed in Ruud A. De Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance*, vol. 10, no. 6, November 2003, pp. 673-693. Studies do, however, find that foreign direct investment is more responsive to effective marginal tax rates than statutory tax rates.

B. Economic Distortions Arising from Deferral

1. Deferral and the initial choice between foreign and domestic investment

U.S. policymakers may be concerned that the ability of U.S. corporations to defer U.S. tax on foreign earnings may discourage investment in the United States. As the following example illustrates, a U.S. corporation may prefer a foreign investment opportunity to a domestic investment opportunity if the returns on the domestic investment are subject to current taxation, even if both investments yield the same pre-tax rate of return.

Suppose that a U.S. taxpayer in the 35-percent tax bracket is considering whether to make an investment in an active enterprise in the United States or in an equivalent investment opportunity in a country in which the income tax rate is zero. Assume the U.S. taxpayer chooses to make the investment in the foreign country through a CFC that earns $100 of active income today, and the U.S. taxpayer defers tax on that income for five years by reinvesting the income in the CFC. Assume further that the CFC can invest the money and earn a 10-percent return per year, and the income earned is not subject to foreign tax or current U.S. taxation under subpart F. After five years, the taxpayer will have earned $161.05 of income and will pay tax of $56.37 on repatriation, for an after-tax income of $104.68.

If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, income from such an investment will not be eligible for deferral. As a result, the taxpayer receives $100 in income today, pays tax of $35, and has only $65 to reinvest. The taxpayer invests that amount at an after-tax rate of 6.5 percent (this is a 10-percent pre-tax rate less 35 percent tax on the earnings each year). At the end of five years, this taxpayer has after-tax income of only $89.06, as compared to the foreign investment option which generates after-tax income of $104.68. The result is that the foreign investment option to defer tax on the income for five years leaves the taxpayer with $15.62 more in profits than the domestic investment option that requires the taxpayer to pay tax on the income immediately, even though the pre-tax rate of return (10 percent) is the same for both investments. As a result, the foreign investment is the preferred choice (all else being equal).

2. The "lockout effect" and the choice between repatriating or reinvesting foreign earnings

Policymakers may also be concerned that U.S. tax rules may create a "lockout effect," which is a colloquial reference to the possibility that the overseas earnings of U.S. corporations are being "locked out" and not reinvested in the United States because U.S. corporations have a tax incentive, created by deferral, to reinvest foreign earnings abroad rather than repatriate them. This may occur if corporations choose to make foreign investments, rather than domestic investments, because the ability to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. The lockout effect disappears if repatriation of overseas earnings has no tax consequence, as would be the case either if foreign earnings were exempt from U.S. tax on repatriation or if those earnings were subject to current U.S. taxation when earned.

Figure 1, below, shows that an increasing amount, and share, of earnings from U.S. direct investment abroad has been reinvested overseas over the past two decades. From 1999 to 2016, earnings from U.S. direct investment abroad grew from $126.8 billion to $419.5 billion, while the amount of those earnings that was reinvested overseas increased from $64.2 billion to $298.6 billion. Therefore, the share of earnings reinvested abroad, as a percentage of earnings from U.S. direct investment abroad, rose from 38.4 percent to 71.1 percent. The amount of earnings that was distributed annually (*i.e.*, dividends and withdrawals) rose from $62.5 billion in 1999 to $120.9 billion in 2016.[102] Although a significant amount of foreign earnings was reinvested abroad and not distributed, that does not necessarily mean that the lockout effect is significant. Such reinvestment may be the most economically productive use of a corporation's funds if the pre-tax rate of return on its foreign investment exceeds the domestic investment opportunities available to it. Because most growth by U.S. multinational enterprises ("MNEs") is occurring in foreign markets, companies may be making productive investment decisions by reinvesting a large portion of their foreign earnings to support their expansion overseas.

[102] The large increase in distributed earnings, and corresponding decrease in earnings reinvested abroad, in 2004 and 2005 was due largely to the enactment of the section 965 repatriation holiday.

Figure 1.−Earnings from U.S. Direct Investment Abroad: 2007-2016

Source: JCT Staff calculations based on Bureau of Economic Analysis ("BEA"), International Transactions Table 4.2, "U.S. International Transactions in Primary Income on Direct Investment," and Table 6.1, "U.S. International Transactions for Direct Investment." U.S. direct investment abroad is defined as ownership by a U.S. investor of at least 10 percent of a foreign business. Primary income consists of income from direct investment, portfolio investment, and labor income.

However, one study finds a negative relationship between the amount of tax-induced foreign cash holdings (*i.e.*, locked-out cash) of a U.S. MNE and stock market reactions to acquisitions made by the U.S. MNE of existing foreign-based (but not domestic) businesses, suggesting that U.S. MNEs may make more productive use of their funds if there were no residual U.S. tax liability when earnings are repatriated.[103] Another study reaches a similar conclusion, and estimates that the burden of residual U.S. tax liability on repatriated earnings distorts a corporation's decision concerning how much to repatriate (and from which foreign subsidiaries), and that the economic cost of this distortion—which could cause U.S. corporations to incur more debt, or invest less in the United States, than they would if they had no residual

[103] Michelle Hanlon, Rebecca Lester, and Rodrigo Vedi, "The Effect of Repatriation Tax Costs on U.S. Multinational Investment," *Journal of Financial Economics*, vol. 116, no 1, April 2015, pp. 179-196.

U.S. tax liability on their foreign earnings—can be significant.[104] Some economists find that the cost of this distortion increases as the accumulated stock of deferred income increases.[105]

3. Distortions in shareholder payouts

Deferral may affect or alter how U.S. corporations manage shareholder payouts and debt. For example, deferral may provide U.S. corporations with a tax incentive to reinvest foreign earnings rather than repatriate the earnings and distribute the proceeds to shareholders in the form of dividends or share buybacks, leading to reduced shareholder payouts. Moreover, U.S. corporations may have larger levels of U.S. debt than they otherwise would because they are not repatriating foreign earnings to reduce their debt load, or because they choose to fund shareholder payouts through borrowing rather than out of repatriated foreign earnings.

[104] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Repatriation Taxes and Dividend Distortions," *National Tax Journal*, vol. 54, no. 4, December 2001, pp. 829-851.

[105] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3, September 2013, pp. 671-712.

C. Shifting Income or Business Operations and Governmental Responses

Since 1962, the number and size of U.S. firms have grown as a result of both the growth of the U.S. market and their expansion into foreign markets.[106] As they increased their cross-border business transactions, multinational corporations (both U.S.-based and foreign-based) have been able to determine where and when income will be subject to tax, if any. In contemplating reform of the U.S. rules of international taxation, U.S. policymakers face a challenge of balancing the calls for reform from a range of U.S. multinational corporations against concerns that many multinational corporations have shifted income to low-tax jurisdictions as a result of aggressive tax planning or deficiencies in present law.[107] They face this challenge against the backdrop of the impact of the OECD/G20 BEPS Project. This section provides general background on several commonly used tax-planning structures and governmental tax practices that gave rise to that project.

1. Structures and tax planning that facilitate shifting income

Multinational corporations engage in foreign direct investment as they acquire or create assets abroad to manufacture or sell the corporation's goods and services. Tax burden is a factor that may motivate foreign direct investment by U.S. multinational corporations, in addition to many nontax business factors such as trade barriers, transportation costs, physical proximity to customers, lower operating costs by exploiting less expensive (or more skilled) foreign labor and less expensive access to raw materials or components from suppliers, or a less burdensome regulatory environment. The phrase "to shift income" is used herein to refer to the broad range of tax-planning techniques that minimize tax liability by migrating income or items of income from a high-tax jurisdiction to a jurisdiction with a low- or zero-tax rate. Such migration may be achieved through the restructuring of a business and its supply chain, the transfer or sharing of ownership rights to intangible property, and use of the asymmetries between U.S. law and that of another jurisdiction in order to avoid income recognition under subpart F and ensure deferral. Depending on how migration is achieved, actual business operations may migrate as well, in whole or in part.

Principal Model of Business Structure

It is generally not possible for a taxpayer to structure its operations to avoid high-tax jurisdictions entirely. Companies may have distribution channels and customer support activities located where customers are located, or products may be difficult or expensive to ship, requiring manufacturing to take place where the product is ultimately used. Nevertheless, an integrated value chain may be structured in a way that achieves both business and tax objectives. Such

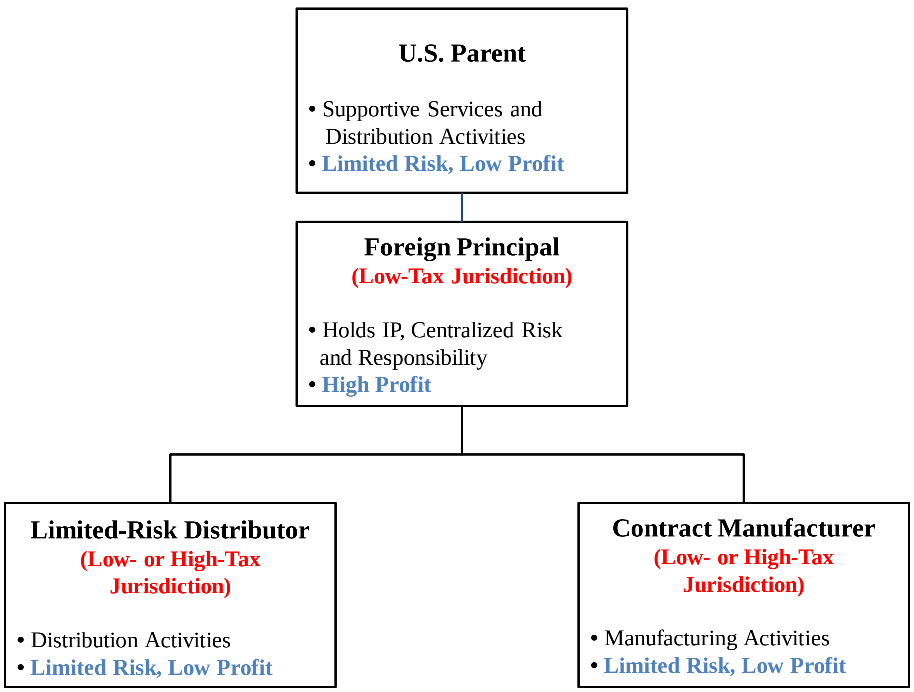
[106] The expansion of foreign markets has benefitted the growth of foreign corporations in those markets as well. Compare, for example, the number of Chinese corporations included in the Global 500 published by Fortune magazine in 1995 to number included in the Global 500 for 2017. In 1995, three Chinese corporations were included; in 2017, three Chinese corporations are in the top ten. See, www.fortune.com/global500.

[107] For case studies and analysis of how U.S. multinational corporations may shift income to low-tax jurisdictions, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

structures would typically follow the principal model (described below) and limit contractual risks of certain entities.[108] Using the principal model, a multinational corporation may devise a rational structure for the activities and entities that make up its global value chain while concentrating its more profitable functions in foreign jurisdictions where the average tax rate is lower and limiting the functions and risks in jurisdictions where the average tax rate is higher.

The following diagram illustrates the principal model:

Principal Model of Business Structure



[108] Contractual limitation of risk may also be accomplished using existing entities within a group and need not include the creation or reorganization of entities.

Companies that follow the principal model establish an entity as a foreign principal, typically located in a foreign jurisdiction where the principal is subject to low average corporate income tax rates because the jurisdiction has a low statutory tax rates on business income or as a result of specially negotiated tax rates. The principal owns intangible property rights and may have contractual responsibility for high value functions associated with such property, such as the continued development of intangible property, as well as the general management and control of business operations. In contrast, lower value functions such as contract manufacturing or limited risk distributor functions may continue to be performed in locations dictated by nontax business needs or historical precedent. For example, proximity to suppliers and ultimate customers and an experienced workforce may require that manufacturing or a distribution center remain in a jurisdiction despite its high tax rate. In that case, those functions are performed by a contract manufacturer or other limited risk contractor. Although those contractors recognize positive taxable income based on the compensation required under their arrangements with the principal, such income is limited to a routine return because the contractors do not share the entrepreneurial risk that would entitle them to a profit potential of the business activities.

The tax objectives of the structure are met only if the tax authorities of both the United States and the foreign jurisdiction respect the chosen structure and allocation of entrepreneurial risk under the contractual arrangements. Risk allocation may be reviewed as part of several issues that could arise in tax examination. For example, questions about the compensation paid to a principal for its services or for the use of its intangible property rights may arise in transfer-pricing inquiries. Similarly, a party claiming treaty benefits with respect to an item of income may face questions about whether it has sufficient nexus with a jurisdiction in order to satisfy the limitations of benefits article in the treaty. Such questions may include inquiry into the substantiality of functions actually performed in the treaty jurisdiction.

Exploitation of intangible property rights

The taxation of income attributable to intangible property is a particularly difficult area for policymakers. A number of studies show that the location of intangible property—and the income derived from their exploitation—is highly sensitive to tax rates.[109] Some economists have found that income derived from intangible property accounts for a significant share of the income shifted from high-tax to low-tax jurisdictions by U.S. corporations.[110] One study reports that income shifting, driven in large part by locating the ownership of intangible property in low-tax jurisdictions, can generate significant reductions in U.S. tax revenue.[111]

[109] Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets Within Multinational Firms," *Journal of Public Economics*, vol. 95, no. 7-8, August 2011, pp. 691-707.

[110] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, vol. 56, no. 1, March 2003, pp. 221-242.

[111] Kimberly Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4, December 2009, pp. 703-725.

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways: an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction (for example, a tax-free capital contribution of the intangible property to a corporate affiliate,[112] or an exchange made pursuant to a plan of reorganization that is entitled to non-recognition treatment with respect to any built in gain,[113]); provision of services using the intangible property; a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate;[114] and qualified cost-sharing arrangements.

All licenses or sales of intangible property and provision of services that use intangible property, are generally required to meet the arm's length standard under the transfer-pricing rules. A cost sharing arrangement is a particular form of intercompany cross-border transfer and sharing of intangible property rights that is defined and governed by the transfer pricing regulations.[115] Such an arrangement allows related parties to share costs and risks of developing intangibles in proportion to their reasonably anticipated benefits. Cost-sharing arrangements are not recognized as separate entities for purposes of the Code, nor are they governed by the rules applicable to partnerships between unrelated parties.[116]

Under the terms of a cost-sharing arrangement, a U.S. owner of existing intangible property rights agrees to make the rights available to one or more of its foreign affiliates in return for other resources and funds to be applied in the joint development of a new marketable product or service. Specified rights to existing intangible property can be transferred to other cost-sharing participants either through a sale or a license. In return, the U.S. owner receives a payment from the other cost-sharing participants for the initial contribution to the cost sharing agreement of any resource, capability or rights that provide the platform for the intangible development. In addition to the compensation for its initial contribution, the U.S. owner receives compensation for a portion of the costs of research and development that it performs on a contractual basis for the cost sharing arrangement.[117] As a result of the arrangement, the other

[112] Sec. 351.

[113] Sec. 361.

[114] The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

[115] Treas. Reg. sec. 1.482-7.

[116] Treas. Reg. sec. 301.7701-1(c).

[117] Treas. Reg. secs. 1.482-7(c)(1) and 1.482-7(b)(1)(ii). The payment for this contribution may offset the benefit of expense deductions for research and development previously performed in the United States; amounts received in excess of previously deducted research and development expenses incurred should represent the present value of the intangible property transferred, discounted for the risk assumed by the transferee. The ongoing cost-sharing payments offset deductions that the recipient of such payment takes for post-buy-in research and development activities. Such ongoing cost-sharing does not, however, include compensation for the return on any products that may result from that research and development.

cost-sharing participants own some or all of the rights to the new technology developed under the arrangement, from the outset. These rights typically include the right to develop such technology further. The other participants may have been formed specifically for their roles in the arrangement, and received the funding necessary to satisfy their financial obligations under the arrangement from the U.S. parent. Such arrangements were widely used throughout the late 1990's and earlier this century to achieve the off-shoring of intangible property rights.

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferoror of intangible property must recognize gain from the transfer as though he had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[118] The appropriate amounts of those imputed payments are determined using transfer-pricing principles.[119]

Subpart F rules and disregarded entities.

Taxpayers seek to defer U.S. Federal income tax on a substantial percentage of their foreign earnings by effectively managing their exposure to the antideferral rules. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax only when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred, unless the income is within certain categories of passive or highly mobile income earned by foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation under the CFC rules of subpart F[120] and the PFIC rules.[121] As the discussion of the lockout effect in section II.B., above, demonstrates, the application of subpart F rules may distort decisions about whether to distribute foreign earnings and incur the residual U.S. tax on the previously deferred earnings. The initial deferral of the earnings can be structured by use of the principal model in conjunction with statutory or regulatory exceptions to avoid current taxation of foreign earnings, *i.e.*, by avoiding characterization of earnings as subpart F income. An example of a statutory exception is the look-through treatment for dividends between controlled foreign corporations, while contract manufacturing rules are an example of a regulatory exception. Additionally, transactions are

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[118] Sec. 367(d).

[119] Final regulations eliminate an exception under Treas. Reg. 1.367(d)-1T(b) for outbound transfers of foreign goodwill and going concern value after September 14, 2015, and any transfers occurring before that date resulting from entity classification elections filed on or after September 15, 2015. See, T.D. 9803 (December 17, 2016). Treas. Reg. sec. 1.367(d)-1(b) Property subject to section 367(d), now provides that the rules of section 367(d) apply to transfers of intangible property as defined under Treas. Sec. 1.367(a)-1(d)(5).

[120] Secs. 951-964.

[121] Secs. 1291-1298.

structured to result in royalties and other payments from higher-tax jurisdictions to entities in lower-tax jurisdictions.[122]

Taxation of income earned from foreign operations may depend upon the classification of the foreign entity conducting the foreign operations. The existence of hybrid and reverse hybrid entities[123] can affect whether income is currently includible under subpart F. In selecting a jurisdiction in which to locate a foreign principal, relevant considerations include not only the favorable tax rate, but also the extent to which a company would be able to locate employees and business operations in that country. If the desired tax rate is not available in a jurisdiction in which activities can be realistically located, the principal may nevertheless be able to avail itself of the favorable rate by use of a hybrid or fiscally transparent entity that is organized immediately below the principal, and the activities and related profits of which are attributed to the principal under U.S. tax principles. Cross-border payments may be structured to flow between disregarded entities, resulting in disregard of the payments and avoidance of foreign personal holding company income.[124]

2. Special tax regimes

Asymmetries in tax rules applicable to cross-border transactions are sometimes accentuated by one jurisdiction in an attempt to attract foreign investment. Such regimes may be designed to deter base erosion or to attract certain types of investments in furtherance of job creation and encouraging trade.[125]

Preferential tax regimes for income derived from intellectual property

Innovation is an important determinant of economic growth, and a number of countries, including the United States, have made it a priority to promote domestic investment in the research and development that generates innovation. The U.S. tax system subsidizes research

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[122] See discussion below, in section II.D., describing how taxpayers may manage payment flows to ensure that deductions are taken in high-tax jurisdictions, with the income inclusion in a lower-tax jurisdiction.

[123] A hybrid entity is disregarded for U.S. tax purposes but is respected in its country of origin. Conversely, a reverse hybrid is fiscally transparent (that is, it is not respected and looked-through) by its home jurisdiction but is recognized by the U.S tax authorities.

[124] For examples of the flexibility with which a multinational corporation may determine whether it recognizes subpart F income under the antideferral rules, see the discussion of "Managing Subpart F Exposure" in the case studies of Bravo, Echo, Delta and Foxtrot corporations, at pages 122 through 127, in Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010. In particular, see Figures 8 and 13, at pages 63 and 71, respectively, and accompanying discussion of Bravo Company. For an example of the ability to use the asymmetry of foreign and U.S. law on corporate residency, see U.S. Senate Permanent Subcommittee on Investigations, *"Memorandum: Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.),"* May 21, 2013, available at http://www.hsgac.senate.gov/download/?id=CDE3652B-DA4E-4EE1-B841-AEAD48177DC4.

[125] The former FSC and ETI regimes in the United States are examples of the former type of special tax regime, as described above in Part I.B.4.

activities by offering a credit for certain qualified research expenditures and allowing research expenditures to be expensed instead of amortized over time.[126]

Other countries have supported investment in research within their borders by establishing special tax regimes for exploitation of intellectual property (or "patent boxes"). These regimes offer preferential tax treatment on income attributable to intellectual property. Countries that have enacted such regimes since 2000 include Belgium, Cyprus, France, Hungary, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Spain, Turkey and the United Kingdom.

Some commentators have argued that the United States should also adopt an intellectual property regime,[127] on the assumption that the adoption of such regimes by other countries may attract research activity away from the United States.

There are three key design features of the patent boxes: a definition of the type of intellectual property that qualifies for the regime; the required nexus between the intellectual property and the country offering the regime; and a description of income that qualifies for the regime and the preferential tax treatment available. The manner in which these design features are implemented is not uniform among the jurisdictions. While patents qualify for the benefits of the regime in all the countries, some countries offer benefits to non-patented property, including trademarks, copyrights, and business secrets. Some countries only require that the intellectual property be owned by the resident company, while others may require that the intellectual property be developed or improved on by the resident company.

Excess profits tax in United Kingdom

In addition to the special tax regimes described above, which can be viewed as incentives to encourage companies to relocate significant activities to a jurisdiction, governments have also imposed surtaxes on taxpayers whose activities within the jurisdiction appear to outstrip the amount of income reported to that jurisdiction. Such taxes include the diverted profits tax in the United Kingdom[128] to address taxpayers conducting activities within the jurisdiction but whose reported taxable income appears not to match the level of activity within the jurisdiction. In the United Kingdom, a diverted profits tax of 25-percent (compared to the basic corporate rate of 20-percent) is imposed based on the excess profits resulting from either the lack of economic substance of a transaction or party to the transaction or a "contrived arrangement" to avoid status

[126] For more detail on federal tax benefits for research activities, see Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012.

[127] For example, see Robert Atkinson and Scott Andes, "Patent Boxes: Innovation in Tax Policy for Innovation," The Information Technology and Innovation Foundation, October 2011, available at http://www.itif.org/files/2011-patent-box-final.pdf.

[128] Finance Act 2015, Secs. 80 et seq. An earlier version of the diverted profits tax ostensibly was limited to structures that exploit intellectual property, but guidance issued in 2016 makes clear that the legislation is not limited to such structures.

as a permanent establishment and tax presence in the United Kingdom.[129] Nonresident companies are potentially subject to the diverted profits tax on either basis; resident companies are potentially liable for the tax only on the basis of lack of economic substance.

[129] Part Three, Finance Act 2015, sections 80 *et seq*.

D. Locating Deductions in the United States

Deductions are one of the central elements in the determination of federal income tax liability, among other elements such as gross income and tax rates, and have been a fundamental part of the U.S. income tax system since its enactment in 1913.[130] The concept of allowing deductions to reduce gross income in the income tax liability computation had its beginnings with the first Civil War Income Tax Act of 1861.[131] Conceptually, amounts that are deductible represent a decrease in the taxpayer's wealth and are a component in determining net income. Today, ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business generally are deductible,[132] with exceptions for certain allowances or disallowances provided by the Code.[133]

<u>Deductions related to cross-border activity: General background</u>

Certain features of the U.S. tax system provide incentives to multinational enterprises to maximize tax deductions by U.S. affiliates as a trade-off for higher income earned, or lower deductions incurred, by their foreign affiliates. First, the higher the top marginal tax rate is, the more valuable the deduction that reduces income otherwise taxable at that rate. Top marginal U.S. tax rates may be higher than top marginal tax rates in other countries where a multinational firm may choose to operate and to locate deductions.[134] As such, a tax deduction in the United States is generally more valuable than a tax deduction in other OECD jurisdictions. Second, the worldwide system of taxation coupled with deferral of eligible income from current U.S. taxation provides additional incentive to locate deductions in the United States.

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. Rather, in the case of expenses incurred by a domestic corporation, they apply principally for purposes of determining the foreign tax credit limitation, which is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income

[130] Act of October 3, 1913, c. 16, Pub. L. No. 16, 63rd Cong., 1st Sess.

[131] Even though the bill expressly allowed deductions only of taxes assessed on the property generating the income, the Presiding Officer, in response to a concern expressed on the floor of the Senate that the bill might be interpreted as levying tax on gross rather than net income, replied that "…nobody can mistake the word income…it is the net profits…for the year, and the Secretary of the Treasury will provide all the ways and means to ascertain it." Cong. Globe, 37th Cong., 1st Sess. Page 315 (1861).

[132] Sec. 162.

[133] See, for example, allowance for depreciation and partial disallowance for meals and entertainment, under secs. 167 and 274, respectively.

[134] Combined statutory corporate income tax rate reflect taxes levied by U.S. State and local jurisdictions; see also Table 1 in Section II.A, describing the top combined statutory corporate income tax rates in the OECD (Central and Sub-Central Governments): 2007-2017.

in each of two limitation categories.[135] Consequently, those rules primarily affect taxpayers that claim the foreign tax credit, and among that group, only those that may not be able to fully utilize their foreign tax credits because of this limitation. A domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. The resulting mismatch between the timing of income recognition and the deductibility of expenses may provide incentive to taxpayers to make tax-deferred investments offshore.[136]

A U.S. corporation may deduct the interest expense[137] incurred on borrowings made for purposes of funding its operations. Because money is fungible, it is very difficult, if not impossible, to determine whether the borrowed funds were in fact used for the stated purpose of any particular borrowing. For the same reason, a U.S. multinational can choose to locate its borrowing in the country where the interest expense deduction will produce the highest tax benefit, *i.e.*, the country with the highest tax rate and the fewest restrictions on deductibility. The fact that a U.S.-based multinational can claim a current U.S. tax deduction for borrowing to invest in low-taxed countries increases the after-tax return of those investments and may encourage some investments that would not otherwise be made.

In contrast, a U.S. corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible interest (or other deductible amounts, such as royalties, management or service fees, rents, and reinsurance premiums) to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[138] Structuring tax deductions in this manner, when motivated by U.S.-income tax avoidance, is known as "earnings stripping" and described in greater detail below. Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax is commonly reduced or eliminated under an applicable income tax treaty.

In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the payment, *i.e.*, the amount of U.S. deduction

[135] Secs. 901 and 904. 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.

[136] There have been several proposals in recent years for tax reform with respect to deductibility of foreign related expenses by U.S.-parented multinational groups. While the scope as to application to specific expense categories of the various proposals has differed, the underlying policy was to defer deductions for expenses of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax.

[137] Sec. 163.

[138] It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

times the applicable U.S. tax rate, less the U.S. withholding tax levied at a percentage as provided under the relevant income tax treaty.

Similarly, the Code allows a U.S. taxpayer a deduction or credit for expenditures in relation to research and experimentation activities.[139] A U.S. corporation may undertake research and experimentation activities in the United States and claim associated deductions and credits against its U.S gross income. The deductibility of these expenditures encourages taxpayers to perform research and experimentation activities in the United States. However, once the research activities yield the discovery of innovative techniques, processes, or formulas, the U.S. corporation may undertake a transfer of the resulting intellectual property to a foreign affiliate through a variety of techniques as discussed above in Section II.C.3. Following transfer of the intellectual property, the profits may accumulate in a low tax environment offshore in a manner in which it is shielded from current U.S. taxation. Such transactions illustrate the effect of incentives of the United States' relatively high statutory rate coupled with deferral of U.S. tax on certain income earned offshore.

Debt financing and earnings stripping

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through debt, equity, or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing. For example, debt financing may allow a business to raise funds at a lower cost, where the return to debt investors may be lower because such investment is less risky than an equity investment in the same business, and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing facilitates a lower effective rate of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation's overall tax rate on its worldwide operations. Debt may also be a tax-advantaged source of financing because debt principal may be repaid on a tax-free basis, while redemption of equity held by a foreign parent is generally treated as a dividend distribution to the extent of the corporation's earnings and profits.[140]

Payment of deductible interest arguably is the most widely used form of earnings stripping.[141] However, as mentioned above in Section I.B.1, present law limits the ability of foreign corporations to reduce U.S. tax on income derived from their U.S. subsidiaries' operations through earnings stripping interest payments. However, the tax law generally

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[139] Secs. 41 and 174.

[140] See secs. 301 and 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

[141] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 7. Although payments of other deductible amounts by a U.S. corporation to tax-exempt or partially exempt related parties also provide an opportunity to shift income out of a U.S. corporation, the use of related-party debt arguably is the most readily available method of shifting income out of U.S. corporation. *Id*.

contains no fixed definition of debt or equity.[142] Section 385 sets forth factors to be taken into account in making the determination of whether an instrument is debt or equity. Under section 385 of the Code, the Treasury Department is authorized to prescribe regulations to determine whether an interest in a corporation is to be treated for tax purposes as stock or debt (or as in part stock and in part debt).[143]

On April 4, 2016, Treasury and the IRS issued proposed regulations under section 385 (the "2016 Proposed Regulations").[144] The 2016 Proposed Regulations contain four sections: (1) providing that the IRS on exam may bifurcate a single financial instrument issued between related parties into a combination of debt and equity, (2) providing new contemporaneous documentation requirements for related party debt, (3) generally treating related-party debt issued in three particular types of related party transactions as stock, and (4) providing operating rules for the treatment of instruments that begin or cease to be between members of the same U.S. consolidated group.[145]

On October 13, 2016, Treasury and the IRS issued final and temporary regulations under Section 385 (the "2016 Final and Temporary Regulations").[146] The scope of the 2016 Final and Temporary Regulations is significantly narrower than the 2016 Proposed Regulations, as the final and temporary regulations apply only to "expanded group instruments" and debt instruments issued by domestic corporations. Furthermore, on July 28, 2017, Treasury and the IRS issued Notice 2017-36,[147] announcing a one-year delay in the application of the documentation requirements contained in the Final and Temporary Section 385 Regulations.[148]

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[142] For further background, see Joint Committee on Taxation, *Overview of the Tax Treatment of Corporate Debt and Equity* (JCX-45-16), May 20, 2016, and Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

[143] Proposed regulations under section 385 had been initially issued in 1980 and 1981, but were withdrawn in 1983 without ever having taken effect. T.D. 7929, 48 F.R. 50711.

[144] IRS REG-108060-15, 2016-17 I.R.B, 636 (April 25, 2016).

[145] The three types of transactions are: (1) distributions of debt instruments by corporations to their related corporate shareholders, (2) issuances of debt instruments in exchange for stock of an affiliate, and (3) certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization. The rules also generally characterize certain loans to related entities as an equity investment if such a loan is issued within a 72-month period centered on the date that the issuer of the loan (1) distributes a dividend, (2) acquires equity in a related entity, or (3) distributes boot in an asset reorganization.

[146] T.D. 9790, 81 F.R. 72858.

[147] Notice 2017-38, 2017-30 I.R.B. 1 (July 7, 2017).

[148] Notice 2017-38 announced Treasury's and the IRS's intent to amend the documentation rules to apply only to interests issued or deemed issued on or after January 1, 2019 and was released in response to Executive Order 13789, which required additional review of significant regulations.

Other deductible expenses

As mentioned, the potential for earnings stripping is also associated with transactions involving the payment of other deductible amounts such as royalties, management or service fees, rents, premiums and similar types of payments to related foreign entities. For example, the U.S. corporation may enter into a licensing or distribution agreement with its foreign parent with respect to exploitation of intellectual property in the U.S. market in exchange for fixed or variable royalty payments from the U.S. corporation. The royalty payments have the effect of eroding the U.S. tax base, particularly when the payments are excessive in relation to the benefit derived. Alternatively, the U.S. corporation may transfer performance or other risks to a foreign parent or affiliate in exchange for service or similar fees, leaving a small profit margin in the United States reflecting the local market distribution activities. Although the generation of earnings stripping payments other than interest, such as royalties, may require a real movement of tangible or intangible assets or a change in business operations of the corporation, firms may engage in this tax planning to improve the after-tax return on investment.

E. Inversions

The preceding sections have described policy issues related to the U.S. taxation of cross-border business operations and identified ways in which the U.S. international tax rules, alone and in combination with the international tax rules of other countries, affect cross-border investment and business operations and the location of reported tax profits. Among other effects, the U.S. international tax rules may alter cross-border merger and acquisition activity. For example, if foreign corporations can derive higher after-tax returns from ownership of particular assets than U.S. corporations could derive from ownership of the same assets even though the pre-tax returns to foreign owners would be the same as the pre-tax returns to U.S. owners, the tax rules may create an incentive for foreign corporations to acquire assets from U.S. owners. One form of tax-motivated cross-border acquisitions colloquially referred to as inversions. This section gives an overview of possible tax motivations for inversions and describes policy concerns related to, and possible responses to, inversions.

<u>Tax motivations for inversions</u>

In a typical inversion transaction after the 2004 enactment of the section 7874 anti-inversion rules, described previously, a domestic corporation acquires a smaller foreign corporation, and the parent company of the combined group is a foreign corporation for U.S. tax purposes. In this transaction, the sanctions of section 7874 either do not apply or are sufficiently insignificant that they do not stop the transaction.[149] From 1983 through 2015, at least 60 companies completed or announced inversion transactions.[150] Furthermore, at least six inversion transactions were completed in 2016.[151] While statistical data suggests a decline in inversions from 2015 to 2016, which could be attributable to the abovementioned regulations and notices, certain companies indicate that deals are on hold generally while tax reform is being considered.[152]

Inversions may be motivated by tax considerations. To the extent U.S. tax considerations encourage mergers and acquisitions that create foreign-parented groups, a broad reason for this tax incentive is the disparity between the U.S. taxation of U.S. parented groups and the U.S. taxation of foreign-parented groups. The Code imposes potentially greater taxation on both the

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[149] A domestic parented multinational company might become foreign parented by means of an internal restructuring, rather than by combining with a foreign company, if, as one possibility, the newly foreign-parented company has substantial business activities in its new country of organization, in which case section 7874 does not apply.

[150] Congressional Budget Office, *An Analysis of Corporate Inversions,* September 2017, p. 5.

[151] *Ibid*. at p. 8.

[152] Donald J. Marples and Jane G. Gravelle, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," *CRS Report* R43568, August 17, 2017, p. 14 and Stephanie Cumings, Pfizer CEO Says Big Deals Delayed by Tax Reform, *Tax Notes,* August 7, 2017, pp. 685-686. *See also* Murphy, Tom, "Experts Expect Corporate Tax Inversions to Survive New Rules," *Chicago Tribune*, April 7, 2016.

foreign and U.S. earnings of U.S. parented groups than it does on the foreign and U.S. earnings of foreign-parented groups. For foreign earnings of multinational companies, the Code taxes foreign earnings of foreign branches of U.S. parented groups in the year of the earnings; taxes foreign business earnings of foreign subsidiaries of U.S. parent companies when the earnings are repatriated to the United States as dividends; and generally does not tax foreign earnings of foreign-parented groups (unless the foreign earnings are earned by a foreign subsidiary of a U.S. subsidiary of the foreign parent company). Consistent with this structure, the Code creates U.S. taxation when a foreign subsidiary of a U.S. company makes a loan to or an equity investment in a U.S. shareholder.[153] Because many U.S. multinational companies have large amounts of untaxed, unrepatriated earnings in their foreign subsidiaries, they have large potential U.S. tax liabilities if they are considering repatriating those earnings to, or otherwise accessing those earnings in, the United States. If they remain U.S. parented, these multinational companies also face potential U.S. taxation on future foreign earnings. And if a U.S. parented company undertakes a merger with a foreign-parented company and the combined group has a domestic rather than foreign parent, the foreign earnings of the foreign merger partner are brought into the U.S. taxing jurisdiction.

As for U.S. earnings of multinational companies, multinational companies that are foreign parented may be able to reduce U.S. tax on U.S. earnings more readily than can multinational companies that are U.S. parented. For example, subject to the section 163(j) limitations on the deductibility of interest payments on related-party loans, a foreign parent company or its foreign affiliate may loan funds to a U.S. subsidiary so that the U.S. subsidiary can reduce its U.S. earnings with deductible interest payments on the loan. If, by contrast, a multinational company has a U.S. parent company with foreign subsidiaries, and one of the foreign subsidiaries makes a loan to its U.S. parent, the U.S. parent generally cannot use deductible interest payments to reduce its U.S. earnings because the loan generally is considered an investment in U.S. property and thereby triggers an income inclusion to the U.S. parent company under section 956, and the interest on the loan is subpart F income, includible to the U.S. parent company, when received by the foreign subsidiary. As a business matter, a foreign-parented multinational company may be better positioned than a U.S. parented multinational company to locate functions performed for the multinational group, such as oversight and managerial functions, outside the United States and thereby generate deductible payments for those functions for U.S. members of the group.

Policy concerns and possible policy responses

There are several policy concerns related to cross-border acquisitions generally and to inversions in particular. Different policy goals may be in tension with one another and may therefore argue for different policy responses.

[153] Sec. 956. Furthermore, prior to the release of Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 22, 2014) and Notice 2015-79, 2015-49 I.R.B. 775 (Nov. 19, 2015) and the issuance of final and temporary regulations formalizing the rules contained in Notice 2014-52 and Notice 2015-79, there was no U.S. taxation when a foreign subsidiary of a U.S. company made a loan or an equity investment in a foreign affiliate, including a new foreign parent company following a cross-border acquisition.

One policy concern is that cross-border acquisitions, specifically inversions, may erode the U.S. tax base. A recent Congressional Budget Office ("CBO") publication provides empirical support for this concern.[154] The CBO has forecast that corporate income tax receipts will decline from 1.7 percent of gross domestic product in fiscal year 2017 to 1.6 percent of gross domestic product in fiscal year 2027.[155] According to the CBO, inversions account for part of this decline and CBO expects an:

> Increase in the use of certain strategies that many businesses and investors employ to reduce their tax liabilities, […] including increasing the amount of income that is shifted out of the United States through a combination of methods such as setting more aggressive transfer prices, increasing the use of intercompany loans, undertaking corporate inversions, and using other techniques.[156]

Protecting the U.S. tax base may be in tension with other possible policy goals related to cross-border mergers and acquisitions. One tax policy goal might be complete neutrality toward cross-border transactions – in other words, that the U.S. tax rules would have no effect on cross-border transactions. Given the complexities of cross-border business activities and the variations among tax systems of countries around the world, achieving full U.S. tax neutrality toward cross-border transactions is likely not realistic.

A related goal is minimizing the extent to which the U.S. tax rules affect cross-border transactions in ways that reduce investment or employment in the United States. In the context of inversions, a question is whether inversions have adverse effects on economic activity in the United States. Inversions might meaningfully reduce U.S. economic activity if the location of a multinational company's tax residence is positively correlated with the location of its capital and labor. On the other hand, cross-border acquisitions involving U.S. companies might have the overall effect of increasing rather than decreasing investment and employment in the United States if new management operates the company more effectively. An article surveying the relevant literature and describing case studies involving recent inversions concludes that the effects of inversions on meaningful economic activity in the initial home country of the inverting company are uncertain and are dependent on the particular circumstances of the relevant companies.[157] Notwithstanding the uncertain evidence related to the economic effects of

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[154] Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, p. 21. CBO further estimates that if current policy does not change, new actions by multinational corporations to reduce their worldwide tax liabilities through inversions and certain other strategies will reduce U.S. corporate tax receipts by approximately 2.5 percent in 2027 ($12 billion in nominal dollars). According to CBO, the projected 2.5 percent reduction in U.S. corporate tax receipts in 2027 relative to receipts that year if additional shifting did not occur is the cumulative effect of such new tax-minimization activities undertaken by multinational corporations from 2017 through 2027. *Ibid.* at p. 15.

[155] *Ibid. at 21.*

[156] *Ibid. at p. 22.*

[157] Omri Marian, "Home-Country Effects of Corporate Inversions," *Washington Law Review*, vol. 90, 2015.

inversions, some commentators have made the broader argument that policy makers should reduce the U.S. tax burden on cross-border income of U.S.-domiciled companies. Under this argument, reducing the tax burden on foreign profits of U.S.-headed firms will promote portfolio investment in the United States and will encourage U.S.-parented firms to remain U.S. parented and start-up firms to organize themselves in the United States, thereby making it more likely that firms will locate headquarters and other activities in the United States.[158]

These varying policy concerns may argue for contrasting responses to inversions. If a goal is to protect the U.S. tax base, a response may be to impose stricter U.S. tax rules related to inversions, either by broadening the scope of transactions to which the sanctions of section 7874 apply or by eliminating tax benefits of inversion transactions. Since section 7874 was enacted in 2004, Treasury and the IRS have consistently sought to expand its reach or eliminate tax benefits of inversion transactions, through regulations as well as several notices. For example, Notice 2014-52 announced Treasury's and the IRS's intention to issue regulations and took a two-pronged approached. First, it addressed the treatment of cross-border combination transactions themselves. Second, it addressed post-transaction steps that taxpayers may undertake with respect to US-owned foreign subsidiaries making it more difficult to access foreign earnings without incurring added U.S. tax. On November 19, 2015, Treasury and the IRS issued Notice 2015-79, which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. On April 4, 2016, Treasury and the IRS issued proposed and temporary regulations (T.D. 9761) that incorporate the rules previously announced in Notice 2014-52 and Notice 2015-79 and a new multiple domestic entity acquisition rule.[159]

Imposing stricter rules related to inversions may not further, and may in fact run counter to, the goal of maximizing long-term investment and employment in the United States. On the other hand, there is no clear answer to the question of what sort of tax rules related to cross-border investment and business operations might maximize long-term domestic investment and employment, particularly under the overall residence-based structure of the current U.S. corporate tax. Because capital is mobile across borders (and because laborers also may move) and because some large countries have significantly reduced the tax burden on home-country businesses, one question in this context is the extent to which the United States can collect any corporate tax revenue on foreign business income under the current structure of the U.S. corporate tax if the main policy goal is to maximize domestic investment and employment.

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[158] E.g., John M. Samuels, "John Samuels Addresses Inversions and Tax Reform," *Tax Notes,* Feb. 9, 2015, pp. 815-18.

[159] *See also* the discussion of the regulations under section 385 in Section II.D. above, which were also issued on April 4, 2016 and limit the tax benefits of inversion transactions On January 13, 2017, Treasury and the IRS issued final and temporary regulations under section 7874 (T.D. 9812), which adopt, with few changes, prior temporary and proposed regulations, which identify certain stock of an acquiring foreign corporation that is disregarded in calculating the ownership of the foreign corporation for purposes of section 7874.

F. The OECD/G20 BEPS Project

This section describes the OECD/G20 BEPS Project, its final reports and how the findings have influenced the competitive tax environment, including responses by the United States and the European Union.[160]

1. Background

Since its formation in 1960, the OECD has been charged by its members with working on agriculture, employment, energy, and social policy, taxation, trade and investment.[161] The OECD, through its members as well as with other international organizations, works to develop the normative tax principles, as reflected in the OECD Model treaty. It does so by examining information about the tax regimes and business practices of members and nonmembers, including the operation of their treaty networks, and the ability of tax authorities to gain access to information about cross-border activities. With respect to the access to tax information and transparency, the OECD published standards for transparency which have been endorsed by the G20 Ministers of Finance.[162] In the course of working toward greater transparency in tax administration, OECD and G20 heard from various policymakers who voiced concerns about the operation and effects of tax on cross-border activities, resulting in a perceived increase in base erosion and profit shifting. At the G20 Leaders' Summit in June 2012, world leaders spoke of the "need to prevent base erosion and profit shifting" and expressed support for the work being done in that area by the OECD.[163]

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[160] For a more complete description of the OECD operations as well as more detailed description of the final reports, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[161] Convention on the Organization for Economic Cooperation and Development, signed December 14, 1960 at Paris, (entered into force on September 30, 1961) ("OECD Convention"). In its preamble, the OECD Convention explains that the signatories to the treaty recognize the increasing interdependence of their economies, the need for cooperation, the necessity of economic strength and prosperity for preservation of individual liberty and improved general well-being, and the role that the members could play in contributing to the improvement of international economics, including the economies of nonmember countries.

[162] Overview of the OECD's Work on International Tax Evasion (A note by the OECD Secretariat), p. 3 (March 23, 2009) ("2009 OECD Overview"). See, OECD, *Update to Article 26 of the OECD Model Tax Convention and Its Commentary*, (July 12, 2012), available at http://www.oecd.org/ctp/exchange-of-tax-information/120718_Article%2026-ENG_no%20cover%282%29.pdf. Adherents to the standards (which are binding on OECD members) agree to respect requests to exchange information where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of the treaty partner requesting the information, and would not restrict exchange due to bank secrecy or domestic tax interest requirements, while respecting both taxpayer rights and strict confidentiality of information exchanged.

[163] G20 Leaders Declaration, Los Cabos, Mexico, June 19, 2012, at paragraph 48. Available at http://www.treasury.gov/resource-center/international/g7-g20/Documents/Washington%20Nov%20Leaders%20Declaration.pdf. See also the G20 Ministers Communique, Mexico City, Mexico, November 5, 2012.

In response to concerns raised by the G20, and the desire to provide an internationally coordinated approach, the OECD released a report on February 12, 2013, *Addressing Base Erosion and Profit Shifting.*[164] The BEPS Report presented an overview of data and global business models, discussed issues potentially related to base erosion and profit shifting, and concluded that it is often the interaction of various principles and the asymmetries among tax regimes of multiple jurisdictions with which a taxpayer has contact that allows base erosion and profit shifting to occur. It proposed an action plan with 15 action items, to be completed within two years.

Asymmetric application of basic principles of taxation may contribute to base erosion or profit shifting, with the result that profits from some transactions are not taxed anywhere. For example, asymmetric rules for determining jurisdiction to tax are frequently modified by the treaty concept of permanent establishment that refers not only to a substantial physical presence in the country, but also to a situation in which a non-resident carries on business through a dependent agent. As a result, according to the BEPS Report, "… it is possible to be heavily involved in the economic life of another country, *e.g.* by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent)."[165] Similarly, the arm's-length principle for determining intercompany transfer pricing contributes to incentives to shift functions, assets and risks in order to achieve a more favorable result, [166] while the broad variety of rules for distinguishing between debt and equity for tax and other purposes can encourage the creation of hybrid entities or hybrid transactions. [167]

Finally, the BEPS Report noted that countries have adopted a variety of anti-avoidance strategies to ensure the fairness and effectiveness of their corporate tax system. These strategies include adoption of statutory general anti-avoidance rules ("GAAR"), judicial doctrines limiting or denying the availability of undue tax benefits, strengthening CFC rules, enactment of thin-capitalization rules or other rules limiting interest deductions, anti-hybrid rules linking the domestic tax treatment with the tax treatment in the foreign country, and anti-base-erosion rules that impose higher withholding taxes or deny the deductibility of certain payments. The variety and complexity of these rules lead in turn to a variety of strategies pursued by taxpayers in order to avoid the application of anti-avoidance rules, including channeling financing through an

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[164] OECD Publishing, *Addressing Base Erosion and Profit Shifting*, 2013, available at http://dx.doi.org/10.1787/9789264192744-en ("BEPS Report").

[165] *Ibid.*, pp. 35-36. The traditional bases of jurisdiction to tax (residence of the taxpayer or activity or connection within a country) The BEPS Report states that questions arise as to whether the current rules ensure a fair allocation of taxing right, especially where the profits from some transactions are not taxed anywhere.

[166] *Ibid.*, p.42.

[167] *Ibid.*, p.37.

independent third party to avoid thin-capitalization rules, inversions, or the use of hybrid entities to make income "disappear" for purposes of avoiding application of the CFC rules.[168]

The OECD/G20 BEPS Action Plan ("BEPS Action Plan")[169] was approved by the G20 leaders at the St. Petersburg summit in September 2013.[170] The BEPS Action Plan reiterated the need for new international standards and identified 15 action items ("BEPS Actions").

2. BEPS final reports

The final reports on each of the 15 action items identified in the BEPS Action Plan were delivered to the G20 leaders, who subsequently endorsed the reports at the Antayla Summit,[171] and asked the OECD to develop an inclusive framework by early 2016 to assist the implementation of the recommendations in not only OECD member states but also in interested non-G20 countries and jurisdictions, including many developing economies.[172] In doing so, the G20 countries agreed to four minimum standards that were agreed upon by participants in the BEPS project. Although most of the findings of the reports on the action items were in the form of recommendations for development of new domestic statutes in member states, sometimes including alternatives to choose among, the minimum standards impose binding obligations on the states that participated in the project. The four minimum standards that members must meet reflects the consensus of all participants from the project and encompass the final reports of all 15 action items, although they are principally based on BEPS Actions 5, 6 13 and 14.

The four standards and the BEPS Action most specifically implicated in each standard are as follows: Action to prevent treaty abuse, including forum-shopping (BEPS Action 6[173]); implementation of standardized country-by-country reporting in order to modernize and make consistent documentation, in order to provide tax administrations a better understanding of a multinational group's global activities (BEPS Action 13[174]); participation in revitalized peer

168 *Ibid.*, p.44.

169 OECD, *Action Plan on Base Erosion and Profit Shifting*, July 19, 2013, available at http://www.oecd.org/tax/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm.

170 The complete annex is available at http://www.oecd.org/g20/meetings/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf.

171 See, G20 Leaders Communique, Antalya Summit, 15-16 November 2015, paragraph 15. Available at http://www.consilium.europa.eu/en/meetings/international-summit/2015/11/15-16/.

172 OECD, *Background Brief -- Inclusive Framework on BEPS*, Paris, January 2017, available at http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf.

173 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm.

174 OECD, *Transfer Pricing Documentation and Country-by-Country Reporting Action 13: 2015 Final Report*, October 5, 2015, http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm.

review process to counter harmful tax practices effectively, taking into account transparency and substance (BEPS Action 5 [175]); and an agreement to secure more effective dispute resolution procedures (BEPS Action 14[176]).

Minimum standard 1. Action to prevent treaty abuse

The BEPS Final Report on Action 6 recommends a series of changes to bilateral tax treaties to reflect a consistent policy against treaty shopping, include specific limitation on benefits rules to address the interposition of third country entities in the bilateral framework of treaty partners and to revise the OECD Model treaty to include a general principal purpose test as an adjunct or an alternative to the limitations on benefits provisions. Countries involved have committed to ensure a minimum level of protection against treaty shopping ("minimum standard"). That commitment requires countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Countries will implement this common intention by including in their treaties: (i) both a limitations on benefits article and a principal purpose test rule; (ii) the principal purpose test alone; or (iii) the limitations on benefits rule accompanied by a mechanism to combat any remaining possibilities for conduit financing arrangements.

Minimum standard 2. Standardized country-by-country reporting

In its final report on Action 13, the OECD calls for enhanced transparency for tax administration of transfer pricing by adoption of a three-tiered standardized approach to transfer pricing documentation, including a requirement that multinational enterprises provide all relevant governments with needed information on their global allocation of income, their economic activity, and taxes paid among countries according to a common template of a country-by-country report. The required documentation is to take the form of three recommended documents (a master file, a local file, and the country-by-country report) in which taxpayers must articulate consistent transfer pricing positions. The reports are intended solely to be used by tax administrations to assess risks of noncompliance with tax laws, but not as the basis for computing tax liabilities. The country-by-country reporting requirements were to be implemented for fiscal years beginning on or after January 1, 2016, and applicable to multinational enterprises with annual consolidated group revenue equal to or exceeding 750 million euros (or approximately $800 million).

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[175] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm.

[176] OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14: 2015 Final Report*, October 5, 2015, http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241633-en.htm.

Minimum standard 3. Revitalized peer review process to address harmful tax practices

Under this standard, member countries and nonmembers will be subject to monitoring and review with respect to their implementation of the minimum standards and recommendations under Actions 5, 6, 13 and 14. The reviews with respect to Action 14 on improving the effectiveness of dispute resolution processes have been scheduled, and the terms and methodology for peer reviews with respect to the transparency requirements for exchange of tax rulings of Action 5 have been published. The OECD has also released peer review documents that will be used in the monitoring of efforts to counter harmful tax practices of special tax regimes under Action 5 and of the documentation requirements of Action 13.[177]

Among the harmful tax practices identified in BEPS Action 5 for monitoring and review are the special tax regimes that offer preferential rates, preferential ruling processes and attempts to tax excess or diverted profits. Accordingly, peer review will address the preferential regimes as well as transparency of rulings granted to specific taxpayers. The identification of factors that may characterize a harmful practice was undertaken earlier by the OECD, and continued in BEPS Action 5, which focuses on securing "the integrity of tax systems by addressing the issues raised by regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services."[178] In its earlier work, the OECD identified factors to be used to determine whether a preferential regime is harmful,[179] including indices of transparency and a substantial activity test, based on whether the preferential regime encourages purely tax-driven arrangements. Special tax regimes in general (and patent boxes in particular) that do not require some physical nexus between the jurisdiction with authority to tax profits from intellectual property and the economic activities that helped produce that property present significant potential for distortions because a company may have flexibility in choosing the country where it initially locates the legal entitlements to intellectual property.

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[177] OECD released the peer review documents on January 2, 2017. See, http://www.oecd.org/tax/beps/oecd-releases-peer-review-documents-for-assessment-of-beps-minimum-standards-actions-5-and-13.htm.

[178] OECD, *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance*, September 16, 2014, p. 7.

[179] OECD, *Harmful Tax Competition: An Emerging Global Issue*, (1998) available at http://www.uniset.ca/microstates/oecd_44430243.pdf. The report characterized the factors as four key factors ((1) the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities; (2) the regime is ring-fenced from the domestic economy; (3) the regime lacks transparency; and (4) there is no effective exchange of information with respect to the regime) as well as eight other factors, consisting of (1) an artificial definition of the tax base; (2) failure to adhere to international transfer pricing principles; (3) exemption of foreign-source income from residence-country taxation; (4) negotiable tax rate or tax base; (5) existence of secrecy provisions; (6) access to a wide network of tax treaties; (7) the regime is promoted as a tax minimization vehicle; and (8) the regime encourages operations or arrangements that are purely tax-driven and involve no substantial activities.

Thus, the OECD included review of such regimes in its BEPS Action 5 on harmful tax practices.[180]

The final report to Action 5 emphasizes the substantial activity factor in the form of a nexus standard for determining eligibility for benefits under special tax regimes. The profits eligible for preferential tax treatment under a patent box or similar regime must be limited in proportion to the ratio of qualified expenditures incurred in the development of an intangible asset to the overall expenditures incurred to develop that asset. Regimes that are not compliant with the nexus approach may continue for five years or adopt rules to implement the limitations, including a bar on any new entrants to the regime after June 2016. Qualifying expenses are generally limited to those incurred directly by the taxpayer claiming the benefits of the regime, with up to an additional 30 percent of expenses for outsourcing and intellectual property acquisition cost to be included as qualifying expenditures. For these purposes, qualifying intellectual property assets that could qualify for the preferential regime are patents and functionally equivalent intellectual property assets that are legally protected and subject to approval and registration processes, where such processes are relevant. Marketing-related intellectual property assets such as trademarks are explicitly excluded.

Minimum standard 4. Make dispute resolution mechanisms more effective

Countries have agreed to strengthen the effectiveness and efficiency of the mutual agreement procedure process and adopted a minimum standard to be met with respect to the resolution of treaty-related disputes. The minimum standard requires countries to ensure the following objectives are met in their mutual agreement procedures: Treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that mutual agreement procedure cases are resolved in a timely manner; administrative processes promote the prevention and timely resolution of treaty-related disputes; and taxpayers eligible to invoke the procedures can in fact access the mutual agreement procedure. Measures required to meet the above objectives are included in the report and are intended to reflect best practices that may become part of a peer-based monitoring mechanism.

3. Reaction to BEPS minimum standards

The response of governments in the inclusive framework to conform to the minimum standards and address other aspects of the BEPS Final Reports can be seen in public actions of governments and will be the subject of monitoring and review by the OECD. The impact of the BEPS Final Reports on private companies has also been observed, at least anecdotally. In July, 2017, at the Hamburg Summit of the G20, the OECD reported that it has already observed indications that the minimum standards established by the OECD/G20 BEPS Project are having

[180] OECD/G20 Base Erosion and Profit Shifting Project, *Countering Harmful Tax Practices More Effectively, Taxing into Account Transparency and Substance*, 2013, available at http://www.oecd-ilibrary.org/docserver/download/2314271e.pdf?expires=1426166387&id=id&accname=guest&checksum=DCC77548D32DA7C88CD04F870ED76A59.

an effect on corporate decision making.[181] The effect on decisions about placement of business operations was summarized in a recent white paper by KPMG, in which the authors state "BEPS may significantly impact the way multinationals do business by requiring a much closer alignment between a company's value chain, operating model, and tax structure. As a result, BEPS is causing many multinationals to not just reevaluate tax planning, but also where and how they run their business operations."[182]

<u>U.S. BEPS-related actions</u>

The United States tax administration is generally consistent with each of the minimum standards.

U.S. Treaty policy revisions are consistent with standards that counter harmful tax practices, treaty-shopping and that improve dispute resolution standards (Minimum Standards 1 and 4)

The publication of the United States Model Treaty of 2016 reflects changes to the U.S. negotiating position on tax treaties that have evolved since the last revision to the U.S. Model Treaty in 2006. The changes include revisions that reflect provisions included in treaties concluded since 2006, including strengthened limitations on benefits article (Article 22), rules regarding payments to fiscally transparent entities (Article 1, paragraph 8), and inclusion of mandatory arbitration as part of the mutual agreement procedures (Article 25). These changes are generally consistent with recommendations throughout the final reports regarding bilateral treaties.

The U.S. Model Treaty of 2016 is not consistent with all of the OECD/G20 BEPS Project recommendations, in particular those regarding the threshold for a permanent establishment. It adopts the rules proposed to protect against contract abuses in the permanent establishment rules regarding building sites, construction or installation projects for the first time. In addition, several changes that are consistent with other recommendations are adopted for the first time, including a revised statement of the purpose of the treaty for use in a preamble to a negotiated treaty, to make clear that elimination of double taxation is to be accomplished without creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance. Holding period requirements for eligibility for a reduced withholding rate for direct dividends are also included.

[181] OECD, *OECD Secretary-General Tax Report to the G20 Finance Ministers,* Hamburg, Germany, July 2017, available at http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-july-2016.pdf?utm_source=Adestra&utm_medium=email&utm_content=%C2%BB%20Read%20the%20full%20report&utm_campaign=Tax%20News%20Alert%2025-07-2016&utm_term=demo.

[182] Brett Weaver, Jerry Thompson, "The BEPS Ripple Effect," KPMG TaxWatch, May 24, 2017.

Implementation of country-by-country reporting (Minimum Standard 2)

The United States published final regulations on June 30, 2016, implementing the country-by-country reporting standard.[183] The rules require the same scope of information and format for reporting that is recommended in the BEPS Final Report for Action 13, including the same model template provided in that report. Under the regulations, the ultimate parent entity of U.S. MNE with annual revenues above a threshold of $850,000 must file a country-by-country report, Form 8975, with the United States for its global operations.

The regulations anticipate that information collected under this reporting regime is eligible to be exchanged with foreign tax authorities only in compliance with an exchange of information agreement or treaty and the provisions of section 6103(k)(4). Accordingly, model competent authority agreements for exchange of the reporting information with other jurisdictions have been developed. The model agreements differ in form, depending on whether the exchange of information is pursuant to an article in a tax treaty or a Tax Information Exchange Agreement ("TIEA").[184]

The regulations are effective for taxable years beginning on or after the date of publication, i.e., June 30, 2016, although the minimum standard requires that the reporting regime apply to years beginning on or after January 1, 2016. The difference between the effective date of the regulations and effective date prescribed in the minimum standard presents the possibility that reporting for the U.S. MNE groups could begin one year later than for MNE groups with foreign parents with tax residence in jurisdictions that have fully and timely implemented the recommendations. That potential gap in implementation also raised concerns that a jurisdiction could treat the later effective date in U.S. regulations as a refusal to comply that would allow the jurisdiction to require a local subsidiary of the U.S. MNE to file the master file and country-by-country reports as well as the local reports, with a jurisdiction that has generally implemented the recommendations and in which the U.S. MNE has operations, even if the jurisdiction imposing the requirement is one with which the United States does not have a treaty or TIEA.

In order to avoid possible challenges to the adequacy of its implementation of the minimum standard, the United States announced that taxpayers may voluntarily file a country-by-country report with the United States for reporting periods starting before the periods to which the regulations apply.[185] Accordingly, as of September 1, 2017,[186] the United States has provided transitional relief to any U.S. MNE that may be subject to country-by-country reporting in another jurisdiction with respect to periods prior to the effective date of the U.S. regulations. In those cases, the U.S. MNE's ultimate parent may voluntarily submit a Form 8975 for an early

[183] Treas. Reg. sec. 1.6038-4; T.D. FR 4282.

[184] Examples of the model agreements are available at https://www.irs.gov/businesses/international-businesses/country-by-country-reporting-guidance.

[185] Preamble, T.D. 9773, 81 FR 42485.

[186] Rev. Proc. 2017-23, I.R.B. 2017-7, available at https://www.irs.gov/pub/irs-drop/rp-17-23.pdf.

short accounting period by including the form with a tax return (either original or amended return) for the taxable year that includes the early reporting period. The transitional relief is specifically approved in updated guidance from the OECD on implementation of the country-by-country standard.[187]

Compliance with efforts to counter harmful tax practices (minimum standard 3)

With respect to the third standard, the commitment to counter harmful tax practices by participating in the revitalized peer review process, the United States has indicated its cooperation by agreeing to be one of the first nations reviewed. To date, no provision of United States tax law or administrative practice has been identified as a harmful tax practice.

European Union response to BEPS minimum standards

As part of a broad anti-avoidance proposal, the European Commission[188] proposed a number of measures to address base erosion concerns similar to those that motivated the OECD/G20 BEPS project. These measures are intended to be consistent with BEPS recommendations, although they may go beyond minimum standards.[189] The proposals included adoption of anti-avoidance measures, a program to implement the changes to tax treaties consistent with BEPS, revisions to EU law on mutual assistance in tax administration, and development of a strategy for working with non-EU jurisdictions on BEPS.[190]

The first of the above proposals is now embodied in a Council Directive adopted in 2016 laying down rules against tax avoidance practices that affect the European internal market and known as the EU Anti-Tax Avoidance Directive or EU ATAD.[191] The EU ATAD imposes a legally binding requirement that member states must implement rules to counter tax avoidance

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[187] OECD, *Guidance on the Implementation of Country-by-Country Reporting--BEPS Action 13*, (Paris, September 2017), available at https://www.oecd.org/tax/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf.

[188] The European Commission is an executive arm of the EU, solely responsible for developing legislative proposals for adoption by the European Council and European Parliament. There are 28 commissioners, one from each EU member state.

[189] An EU official, Stephen Quest, described the measures as consistent with BEPS, and rejected the notion that governments could not take actions in areas in which final reports did not impose requirements, citing the BEPS Action 1, on the digital economy. Alex M. Parker, "U.S., European Reform Goals Similar: EU Official," *International Tax Monitor, BNA*, September 25, 2017.

[190] https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en.

[191] Council Directive (EU) 2016/1164, July 12, 2016, *OJ L* 193, 19.7.2016, p. 1–14; http://data.europa.eu/eli/dir/2016/1164/oj. This package is in addition to the recent update to the directive requiring mandatory automatic exchange of certain tax information among Member States by the end of 2016. See Commission Implementing Regulation (EU) 2015/2378 of 15 December 2015, laying down detailed rules for implementing certain provisions of Council Directive 2011/16/EU on administrative cooperation in the field of taxation and repealing Implementing Regulation (EU) No 1156/2012, at http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1456239966989&uri=CELEX:32015R2378.

practices by January 1, 2019. The rules to be adopted encompass strengthening CFC rules that would reattribute mobile passive income to its parent company; enacting a provision to impose a minimum tax on foreign profits, with a credit given for taxes paid with respect to such profits; enacting an exit or expatriation tax on companies that relocate; imposing limits on the deductibility of interest; and adopting a GAAR that would operate throughout the EU.

III. BACKGROUND DATA

Part III provides data on U.S. cross-border economic activity and income flows.

A. Exports and Imports[192]

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the economy's exports and imports. The United States has generally reported trade deficits since 1977. Also, since 1977, the United States has generally recorded net capital inflows from abroad. Capital inflows can take the form of foreign purchases of domestic physical (or "real") assets, or of domestic financial assets, such as equity interests or debt instruments.

These two phenomena, trade balances and capital inflows, are related to each other. More generally, trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the "national income and product accounts," which measure the flow of goods and services and income in the economy.[193]

The value of a country's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If a country consumes and invests more than it produces, the country must be a net importer of goods and services. If the imports are all consumption goods, in order to pay for those imports, the country must either sell some of its assets or borrow from foreigners. If the imports are investment goods, foreign persons must be the owners of, or lend money to the owners of, these investments. Thus, a

[192] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the "current account" is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that "capital account" transactions will be small in comparison to the current account and financial account.

[193] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross domestic product ("GDP"). Related to GDP is gross national product ("GNP"). GDP can be understood as the total annual value of goods and service produced in the United States, regardless of the nationality of the owners of the factors of production (land, labor, and capital) that are required to produce the goods and services. GNP, by contrast is the total annual value of goods and services produced anywhere in the world where the relevant factors of production are owned by U.S. persons. Thus, wages earned by a U.S. resident from temporary work abroad, or dividends received by a U.S. person from an investment in a foreign corporation, constitutes part of GNP but not GDP.

country that runs a trade deficit must experience foreign capital inflows, as foreign persons purchase domestic assets, make equity investments, or lend funds (purchase debt instruments).

In other words, if the country is a net importer, it must attract capital inflows to pay for those imports. If the country is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying U.S. goods or services with the dollars, they will use the dollars to purchase U.S. assets. (Another way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The connection between capital flows and the goods and services in the economy can also be understood by concentrating on the sources of funds for investment. Investment in the United States must come either from domestic saving (that is saving by U.S. persons) or from foreign investors. If domestic saving is less than investment in the United States, that difference must be attributable to net capital inflows from foreign persons. In government reporting, such net capital inflows from foreign persons are termed “net foreign borrowing” even though the capital inflows may take the form of either equity investments or loans.

Relation of Trade Deficits to Cross-Border Capital Flow

In formal terms, the connection between trade deficits and cross-border capital flows is as follows. In the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept.

One way to measure GNP is by expenditures on final product. By this measure,

(1) GNP = C + I + G + (X-M) + NI.

Equation (1) is an accounting identity which states that gross national product for a period equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income of U.S. persons received from abroad over investment income paid to foreign persons from investments located in the United States), denoted "NI" in equation (1).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product for a period equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

(3) I = S + (T - G) + (M - X) - NI

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income. An intuitive interpretation of equation (3) is that it requires dollars to make investments in the United States and equation (3) identifies the sources of investment dollars. Equation (3) identifies private saving by U.S. persons, S, as one source of dollars and government saving, T - G, as another source of dollars. The next two terms in equation (3) identify dollars that result from cross-border transactions as additional sources of potential investment dollars. If imports, M, exceed exports, X, then, on net, dollars are in the hands of foreign persons and available for investment in the United States. If the earnings of foreign persons from their investments in the United States exceeds the earning of U.S. persons on their investments abroad, then NI is negative and, on net, dollars are in the hands of foreign person and available for investment in the United States. If the opposite is the case, NI is positive, there are not additional dollars available for investment. (If net investment income is reinvested in the economy then that reinvestment of course is reflected as savings, S.)

These relationships can be summarized as follows:[194]

Net Foreign Borrowing = Investment - Saving

Net Foreign Borrowing = (Imports - Exports) - Net Investment Income

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.[195] The excess of imports over exports is called the "trade deficit" in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service previous net foreign borrowing.

If the investment in a country is larger than that country's domestic saving, the country must be running a trade deficit, or the country must be increasing foreign borrowing, or both. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by paying down (or reacquiring) previously acquired domestic assets or financial claims against the domestic economy held by foreign investors. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates or investment earnings, *i.e.*, the profitability of equity), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

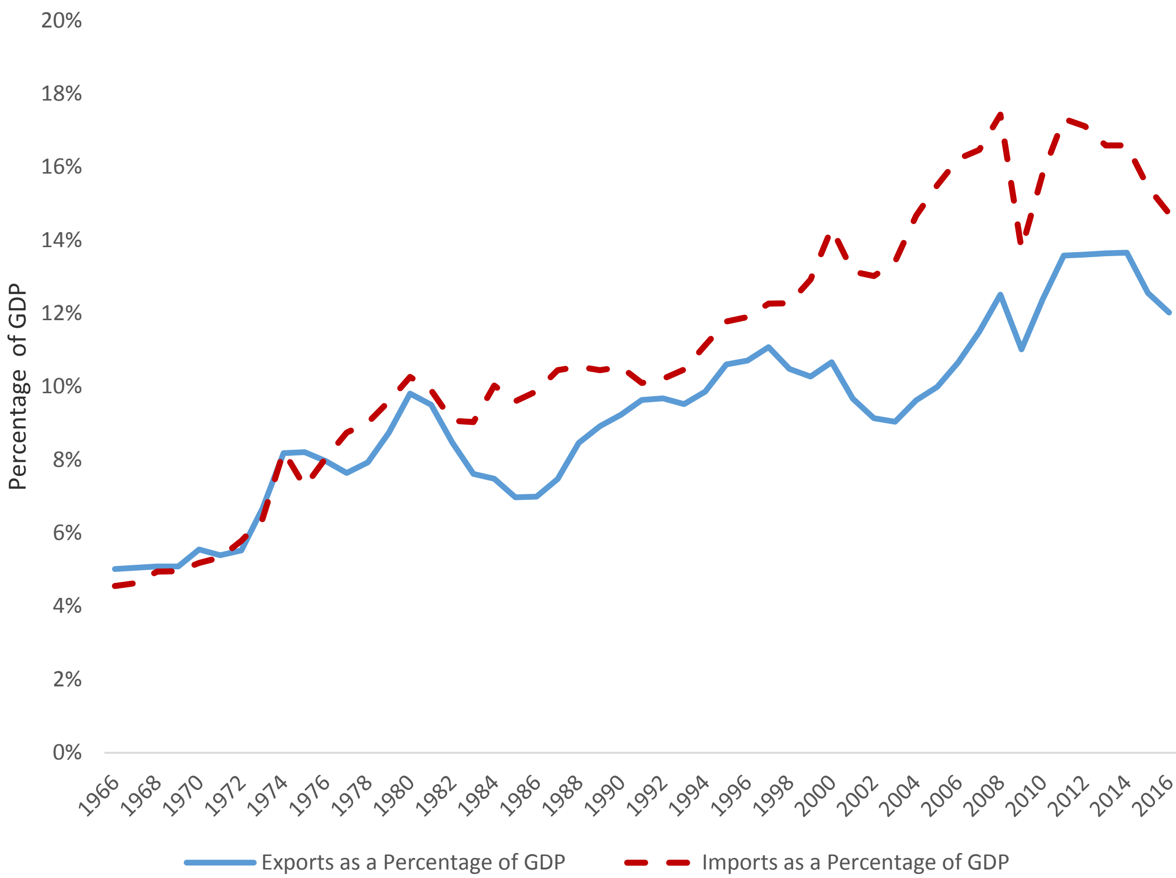
1. Trends in the U.S. current account

International trade in goods and services has increased as a share of the U.S. economy since the early 1960s. Figure 2, below, presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1966-2016. As depicted in Figure 2, exports and imports each have risen from approximately five percent of GDP in 1966 to at least 12 percent in 2016. Imports have consistently exceeded 13 percent of U.S. GDP since 2001. Figure 2 also shows that the United States was generally a net exporter of goods and services prior to 1977. Since that time, the United States has been a net importer of goods and services.

[194] The equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced).

[195] This equation in the text can be derived from equation (3) in the text box on trade deficits and cross-border capital flows, above, if the government budget is assumed to be balanced, that is, if $G = T$. It follows that if the government runs a deficit, that is, if $G>T$, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

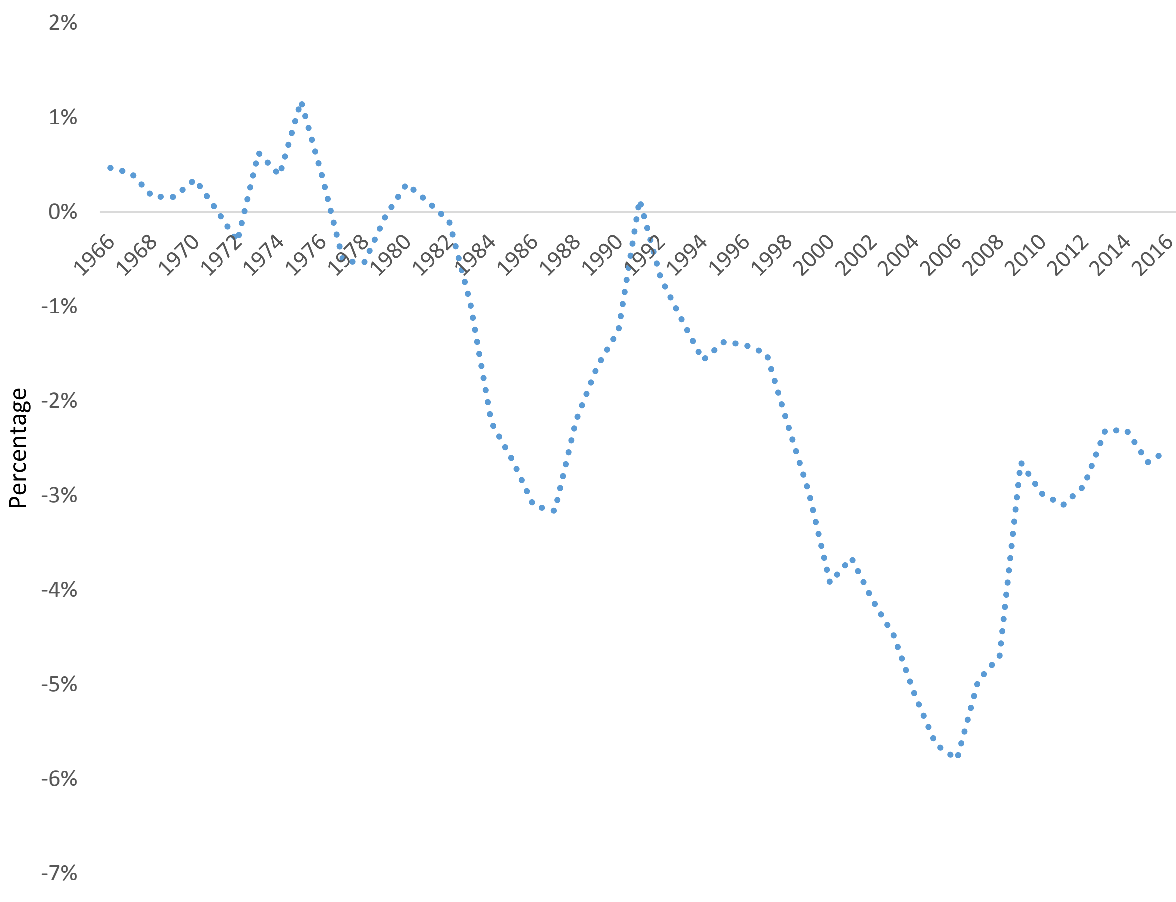
Figure 2.−Exports and Imports as a Percentage of U.S. GDP, 1966 − 2016



Source: JCT staff calculations based on data from the Bureau of Economic Analysis.

The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), was generally positive from 1966 through 1976, but generally has been in deficit since 1977. Figure 3 reports the current account balance of the United States for the period 1966 through 2016 as a percentage of GD.[196]

Figure 3.−United States Current Account Balance as a Percentage of GDP, 1962 − 2016



Source: JCT Staff calculations based on data from the Bureau of Economic Analysis.

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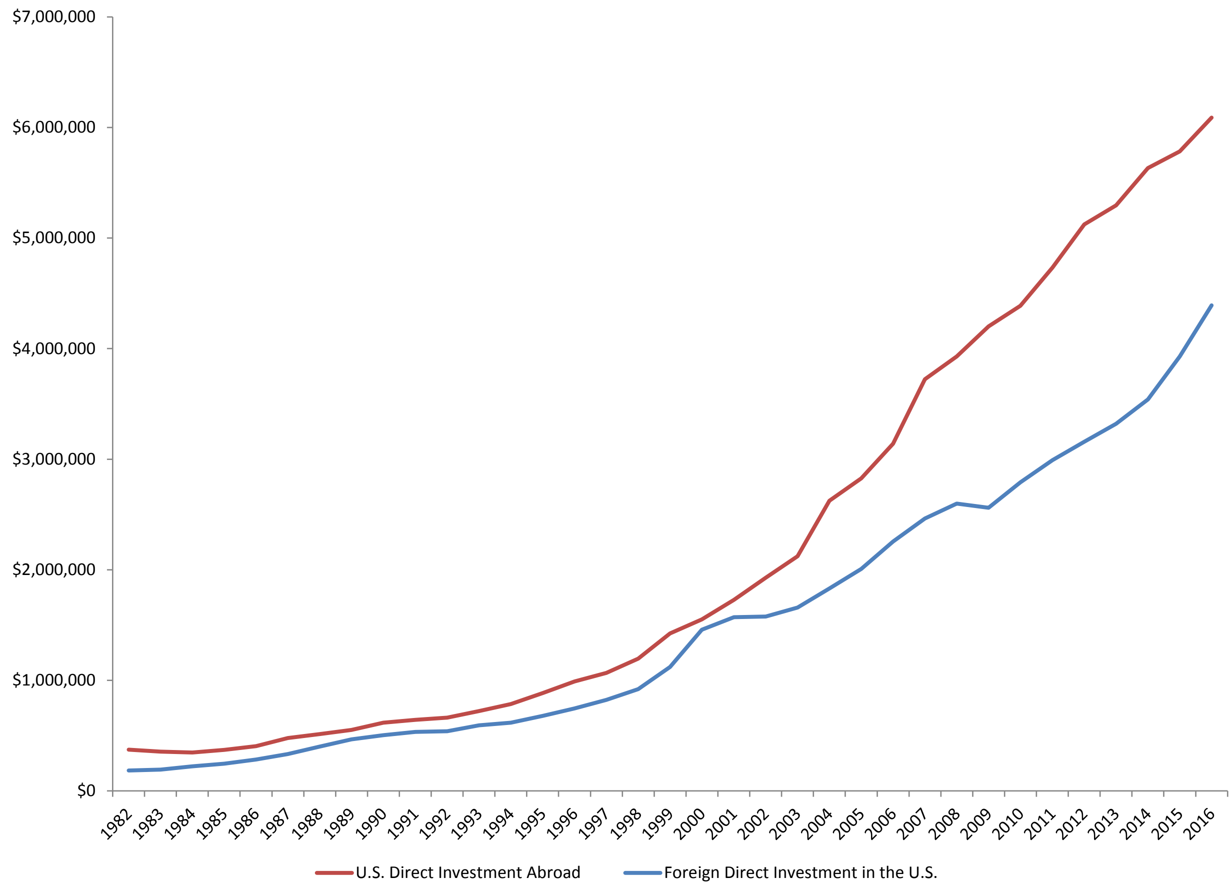
[196] Two issues merit mention. Figure 3 shows the relationship of the current account balance to GDP, rather than reporting the current account balance in dollar terms, because percentages of GDP, unlike nominal dollar amounts, are not affected by inflation. In addition, the current account balance generally reflects purely market activity. However, in 1992 the United States received substantial payments from certain foreign governments related to the prosecution of the Persian Gulf War. These payments are included in the computation of the current account balance and account for the substantial reduction in the current account deficit for that year, as one can see in Figure 3.

B. U.S. Direct Investment Abroad and Foreign Direct Investment in the United States

Figure 4, below, charts the growth in the stock of U.S. direct investment abroad, and foreign direct investment ("FDI") in the United States, from 1982 to 2016. In 2016, the stock of U.S. direct investment abroad totaled $6.1 trillion while the stock of FDI in the United States totaled $4.4 trillion (all valued on a current-cost basis). For context, the value of the stock of private fixed assets in the United States was $42.9 trillion (on a current-cost basis). From 2006 to 2016, the stock of U.S. direct investment abroad grew at annual rate of 6.8 percent, while the stock of FDI in the United States grew at an annual rate of 6.9 percent.

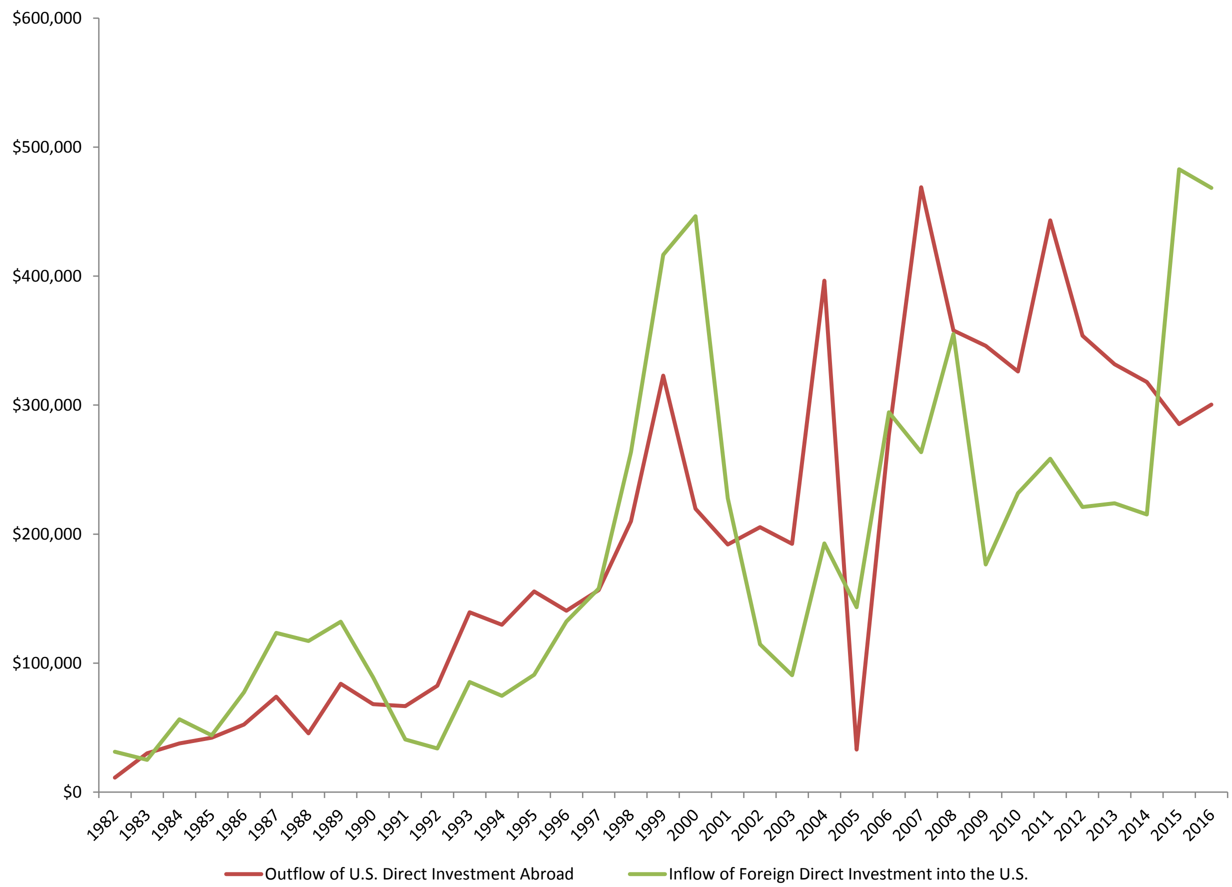
Figure 4.−Stock of Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, 1982-2016 (on current-cost basis, in millions)



Source: Department of Commerce (Bureau of Economic Analysis).

Figure 5, below, illustrates the outflow of U.S. direct investment abroad, and inflow of foreign direct investment to the United States, from 1982 to 2016. In 2016, the outflow of U.S. direct investment abroad was $300.5 billion, while the inflow of foreign direct investment to the United States was $468.3 billion (all in 2016 dollars).

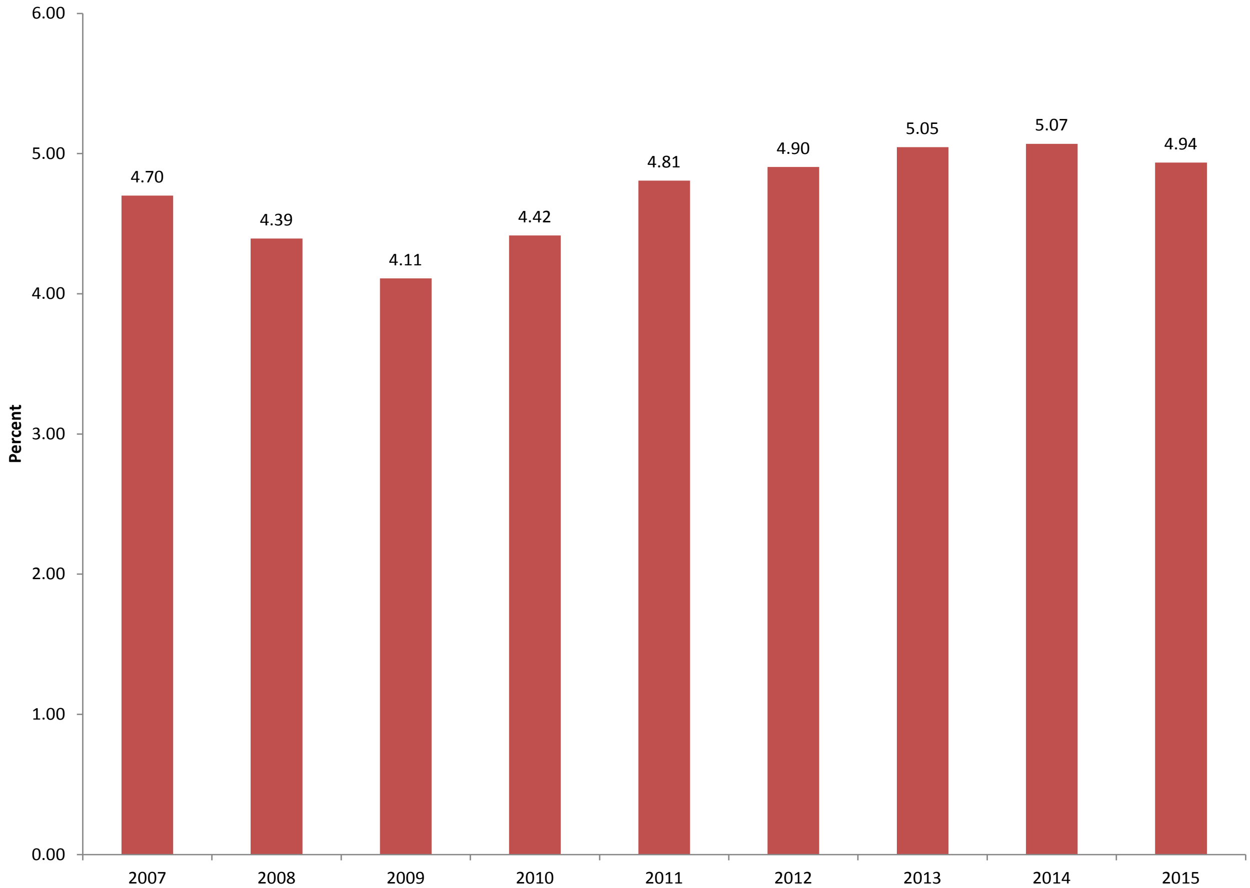
Figure 5.−Direct Investment Flows, 1982-2016
(in millions of 2016 dollars)



Source: JCT staff calculations based on data from Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

Figure 6, below, shows the contribution to GDP of foreign valued-added by majority-owned U.S. affiliates from 2007 to 2015. In 2015, foreign value-added by majority-owned U.S. affiliates was $894.5 billion (in 2016 dollars) and accounted for 4.94 percent of U.S. GDP.

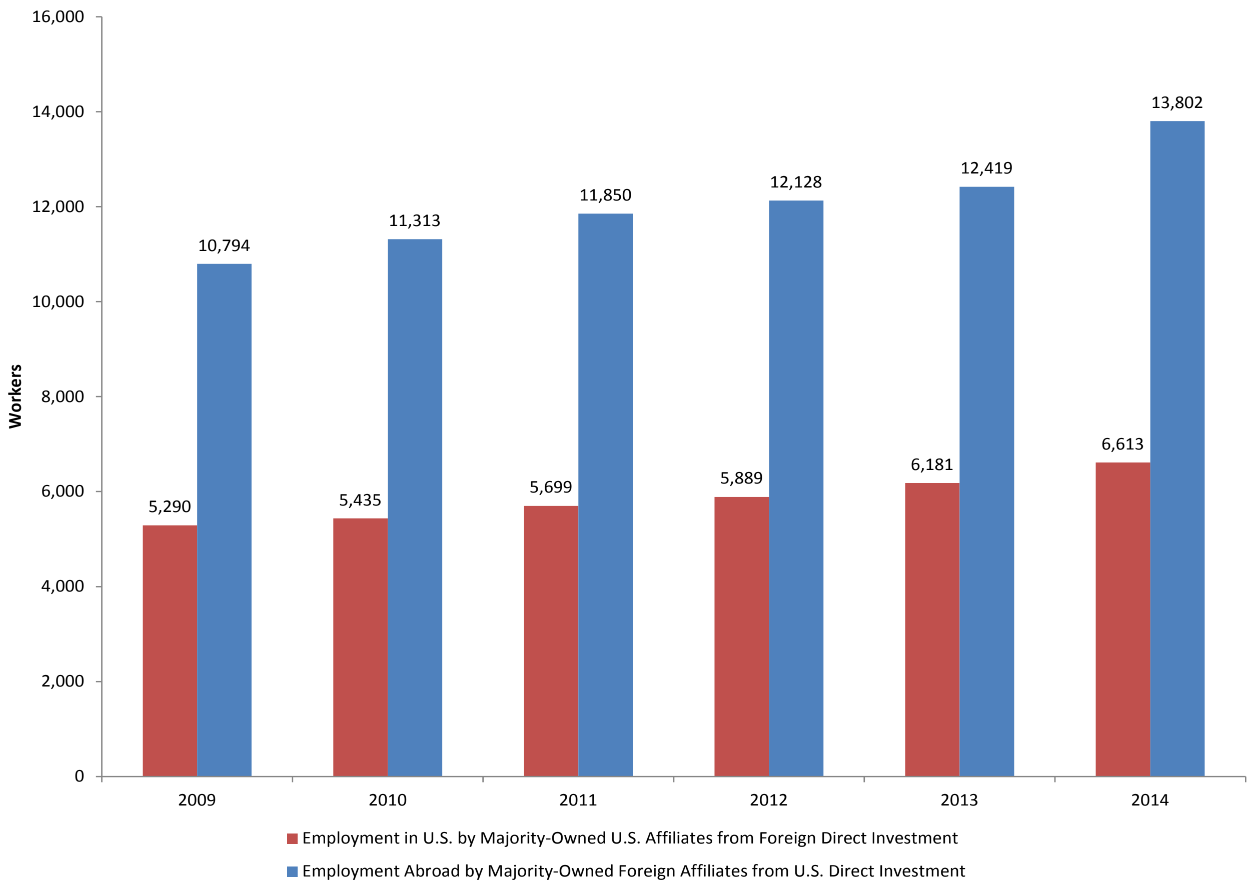
Figure 6.−Foreign Value-Added by Majority-Owned U.S. Affiliates, as Percentage of GDP, 2007-2015



Source: JCT staff calculations based on data from Department of Commerce (Bureau of Economic Analysis).

Figure 7, below, describes the level of employment, in majority-owned affiliates, arising from U.S. direct investment abroad and foreign direct investment in the United States. In 2014, overseas employment by majority-owned foreign affiliates of a U.S. parent was 13.8 million workers, while employment in the United States by majority-owned affiliates of a foreign parent was 6.6 million workers. To put these numbers in context, total private non-farm employment in the United States, as reported by the Bureau of Labor Statistics, was 117 million workers in 2014.[197]

Figure 7.−Employment from Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, Majority-Owned Affiliates, 2009-2014 (in thousands)

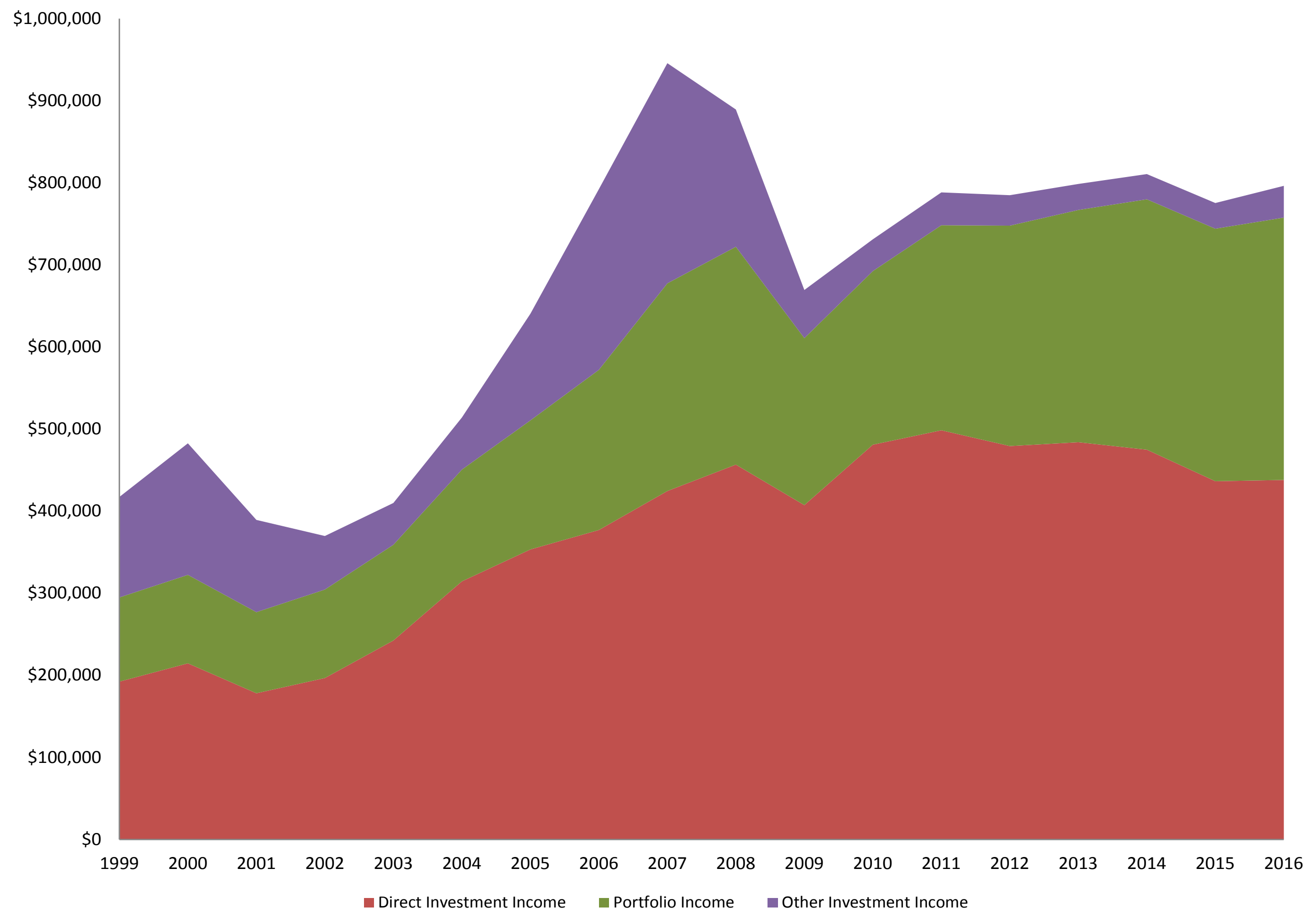


Source: Department of Commerce (Bureau of Economic Analysis).

[197] The data on employment arising U.S. direct investment abroad and FDI in the United States come from the Bureau of Economic Analysis. Those employment figures are not directly comparable to the employment figures reported by the Bureau of Labor Statistics because the data are collected from different surveys.

Figure 8, below, describes the amount of foreign investment income received by U.S. persons from foreign assets, broken down into three categories: direct investment income, portfolio income, and other investment income. In 2016, the total amount of foreign investment income received by U.S. persons was $796.2 billion.[198] Direct investment income was $437.9 billion (55 percent of the total), while portfolio income was $319.6 billion (40.1 percent) and other investment income was $38.7 billion (4.9 percent).

Figure 8.−Foreign Investment Income Received by U.S. Persons from Foreign Assets, 1999-2016 (in millions of 2016 dollars)

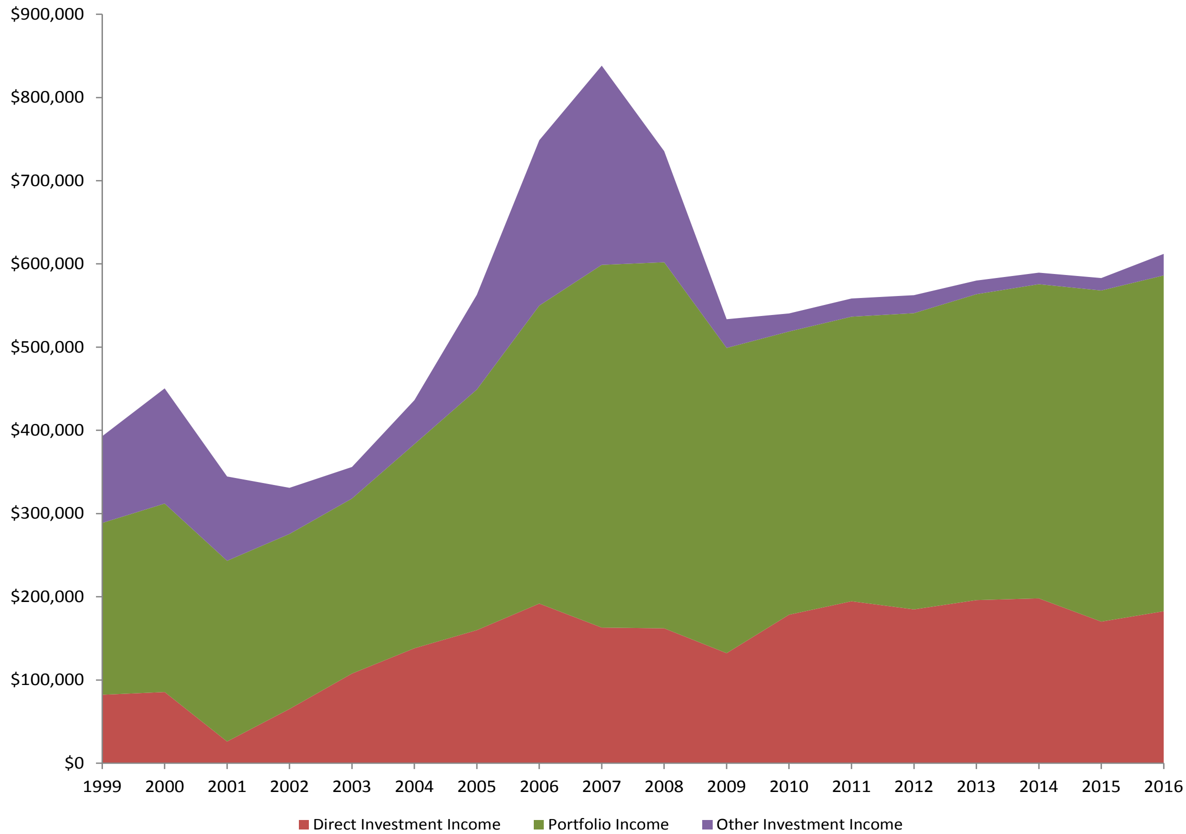


Source: JCT staff calculations based on data from the Department of Commerce (Bureau of Economic Analysis) and the Department of Labor (Bureau of Labor Statistics).

[198] Values for the amount of foreign investment income received by U.S. persons are expressed in 2016 dollars. The percentage totals do not sum to 100 percent because of rounding.

Figure 9, below, is similar to Figure 8, but reports the amount of U.S. investment income received by foreign persons from U.S. assets. In 2016, this figure totaled $612.1 billion.[199] Of this total, direct investment income received by foreign persons was $182.7 billion (29.8 percent of the total), while the amount of portfolio income received was $403.5 billion (65.9 percent) and the amount of other investment income received was $25.9 billion (4.2 percent).

Figure 9.−U.S. Investment Income Received by Foreign Persons from U.S. Assets, 1999-2016 (in millions of 2016 dollars)



Source: JCT staff calculations based on data from the Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

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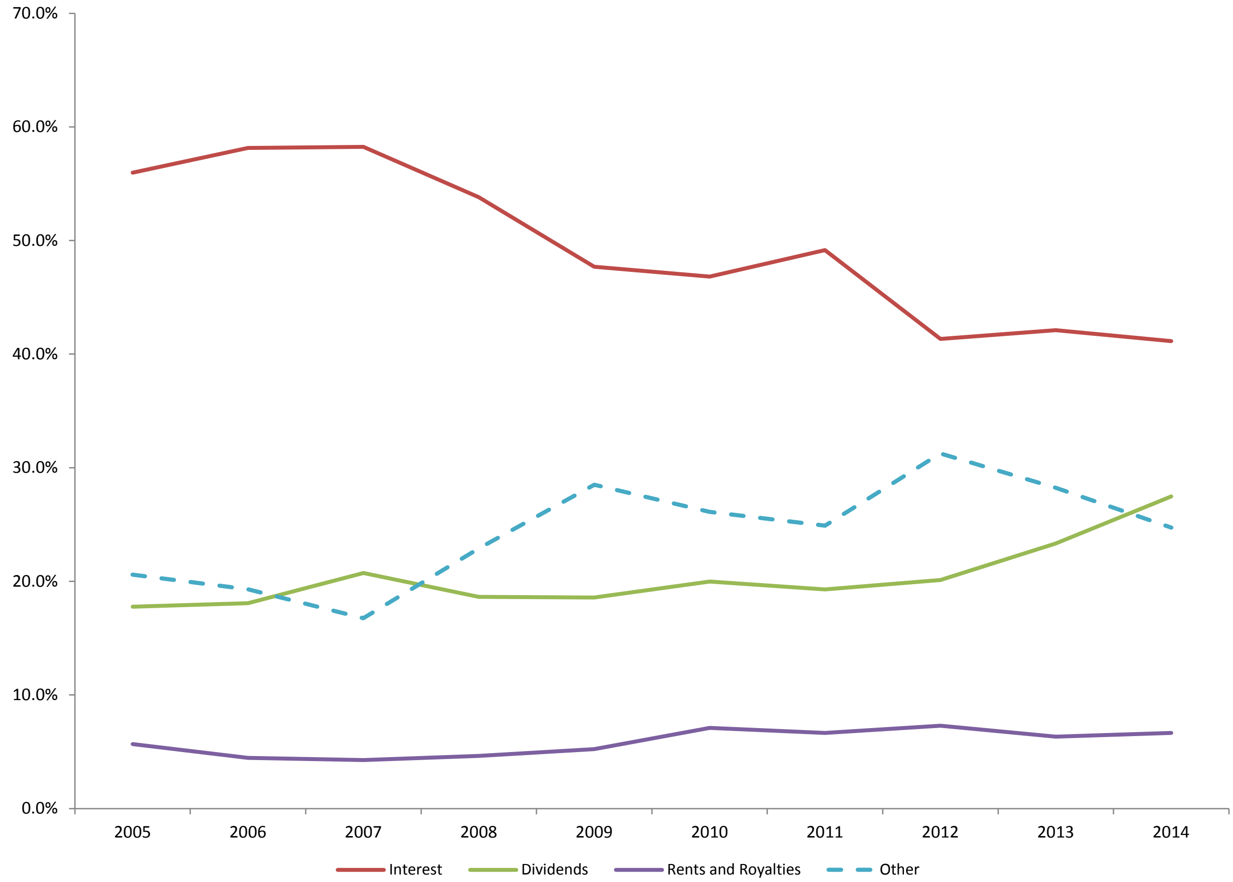
[199] Values for the amount of direct investment income received by U.S. persons are expressed in 2016 dollars.

Figure 10, below, illustrates the share of FDAP and similar income received by foreign persons, as reported on Form 1042-S ("Foreign Person's U.S. Source Income Subject to Withholding"), accounted for by particular items of income for tax year 2014. In 2012, a total of $728.2 billion of FDAP and similar income was reported by foreign persons on Form 1042-S, with 86.9 percent exempt from withholding and 13.1 percent subject to withholding. Interest income accounted for 41.2 percent of the FDAP and similar income received by foreign persons, while dividends and rents and royalties represented 27.5 percent and 6.7 percent, respectively. Other types of income accounted for the remaining 24.7 percent.[200] The amounts of interest, dividends, and rents and royalties received by foreign persons in 2014 were $299.7 billion, $200.0 billion, and $48.4 billion, respectively.

Figure 10.−Share of FDAP and Similar Income Received by U.S. Persons by Item of Income, 2005-2014



Source: JCT staff calculations based on data from the Internal Revenue Service (Statistics of Income Division).

[200] Other types of income include Social Security and Railroad Retirement payments, personal services income, and notional principal contract income