PRESENT LAW AND RECENT GLOBAL DEVELOPMENTS RELATED TO CROSS-BORDER TAXATION

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HOUSE COMMITTEE ON WAYS AND MEANS
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Prepared by the Staff
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INTRODUCTION

The House Ways and Means Committee has scheduled a public hearing for February 24, 2016, on the global tax environment in 2016 and its implications for U.S. international tax reform. Parts I and II of this document,[1] prepared by the staff of the Joint Committee on Taxation, describe international principles of taxation and provide an overview of present law related to U.S. taxation of cross-border income. Part III examines selected issues that have arisen as policymakers deliberate U.S. international tax reform, including (1) the competitiveness of the U.S. tax system, (2) economic distortions arising from deferral, (3) shifting of income and business operations, (4) locating deductions in the United States, and (5) inversions. Part IV discusses the Base Erosion and Profit Shifting Project undertaken by the Organization for Economic Cooperation and Development at the request of the Group of Twenty ("OECD/G20 BEPS Project") and the recent European Commission State Aid investigations of certain tax rulings of Member States of the European Union ("EU"). The Appendix includes a press release the European Commission released on October 15, 2015, explaining the findings of its investigation of certain tax rulings issued by Luxembourg to Fiat Finance and Trade and by the Netherlands to Starbucks, as well as a January 16, 2016, European Commission press release explaining its findings in a case involving the Belgian "excess profits" tax regime.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Recent Global Developments Related to Cross-Border Taxation*, (JCX-8-16), February 23, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. INTERNATIONAL PRINCIPLES OF TAXATION

A. General Overview

A number of commonly accepted principles have developed to minimize the extent to which conflicts arise between countries as a result of extraterritorial or overlapping exercise of authority. 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 between conduct and the territory of the nation or it may be between a person (whether natural or juridical) and the status of that person in the view of the sovereign nation.[2] Normative limitations based on the reasonableness of such regulatory action have developed. In addition, most legal systems respect limits on the extent to which extraterritorial measures can be given effect. The broad acceptance of such norms extends to cross-border trade and economic dealings.

These two broad bases of jurisdiction, *i.e.*, territoriality and nationality of the person whose conduct is regulated, have been refined and, in varying combinations, form the bases of most systems of income taxation. Exercise of taxing authority based on a person's status as a national, resident, or domiciliary of a jurisdiction reaches worldwide activities of such persons and is the broadest assertion of taxing authority. A more limited exercise of taxation occurs when taxation is imposed only to the extent that activities occur, or property is located, in 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 limited basis of taxation is a territorial application.

Regardless of which basis of taxation is used by a jurisdiction, the identification of its tax base depends upon establishing rules for determining whether the income falls within its authority to tax. The source of income and its related expenses are governed by source rules that specify the treatment of income derived from a broad range of activities. Those rules sometimes turn on residency, leading to another set of rules that determine how to identify which persons have sufficient contact with a jurisdiction to be considered resident. For individuals, the test may depend solely 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. Such rules generally reflect a policy decision about the requisite level of activity within a geographic location that warrants assertion of taxing jurisdiction.

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, as well as to permit limited mutual administrative assistance between jurisdictions.[3] For example, asymmetry between different standards adopted in two

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

[3] 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,

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.

In addition to bilateral treaties, countries work with multilateral organizations to develop common principles for adoption by its members and to identify emerging issues and possible solutions, chief among them the OECD.

Restatement (Third) of Foreign Relations Law of the United States, sec. 483, (1987). To the extent that the revenue rule is abrogated, it is done so in bilateral treaties, to ensure reciprocity.

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

The United States has adopted a Code that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)[4] on all income, whether derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether the 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.

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation's conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This taxpayer-favorable result is circumscribed by the anti-deferral regimes of the Code, described in Part II., below.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability, and the mechanism by which it is taxed (either by gross-basis withholding or on a net basis through tax return filing).

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. These and other source rules are described in more detail below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. 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, the source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. 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.

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[4] Sec. 7701(a)(30) 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. Whether a noncitizen is a resident is determined under rules in section 7701(b).

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. 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. 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.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions or aggressive intercompany pricing practices with respect to intangible property.

II. PRESENT LAW

A. Principles Common to Inbound and Outbound Taxation

Although the U.S. tax rules differ depending on whether the activity in question is inbound or outbound, there are certain concepts that apply to both inbound and outbound investment. Such areas include the transfer pricing rules, entity classification, the rules for determination of source, and whether a corporation is foreign or domestic.

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[5] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[6] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[7] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with

[5] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

[6] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[7] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[8]

Entity classification

A business entity is generally eligible to choose how it is classified for Federal tax law purposes, under the "check-the-box" regulations adopted in 1997.[9] 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.[10] Whether an entity is eligible and the breadth of its choices depends upon whether it is a "per se corporation" and the number of beneficial owners.

Certain entities are treated as "per se corporations" for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as per se corporations. These entities are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.[11]

An eligible entity with two or more members may elect, however, to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic entity with multiple members is treated as a partnership. A foreign entity with multiple members is treated as a partnership, if at least one member does not have limited liability, but is treated as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded

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[8] H.R. Rep. No. 99-426, p. 423.

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

[10] 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.

[11] For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions as *per se* corporations.

entity is treated in the same manner as a branch or division. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment depends upon whether the single-member entity has limited liability. If it does, the foreign entity is treated as a corporation; otherwise, its default treatment is that of a disregarded entity.

The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. As a result, it is possible for an entity that operates across countries to elect into a hybrid status. "Hybrid entities" refers to 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. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

<u>Source of income rules</u>

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, 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 the assets that generate the income. If a payor or recipient is an entity that is eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other. To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations, sometimes resulting in non-taxation of the 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.[12]

<u>Interest</u>

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[13] Special rules apply to treat as foreign-source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial

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

[13] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

institutions.[14] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[15]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[16] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[17]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[18] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[19] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[20] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[21] while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a

[14] Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution. This results in the payment being treated as a withholdable payment. Sec. 1473(1)(C).

[15] Sec. 884(f)(1).

[16] Secs. 861(a)(2), 862(a)(2).

[17] Sec. 861(a)(2)(B).

[18] Sec. 861(a)(4).

[19] *Ibid.*

[20] Sec. 865(a).

[21] Sec. 865(g)(1)(B).

foreign country or a nonresident alien with a tax home in the United States.[22] As a result, nonresident includes any foreign corporation.[23]

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[24] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as U.S.-source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[25] Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States is treated as partly U.S.-source and partly foreign-source.[26]

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which income derived is effectively connected with that U.S. business. To the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.[27]

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[22] Sec. 865(g)(1)(A).

[23] Sec. 865(g).

[24] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

[25] Sec. 865(e)(2).

[26] Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.- or foreign-source: (1) 50-50 method under which 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) IFP method under which, in certain circumstances, an independent factory price ("IFP") may be established by the taxpayer to determine income from production activities; (3) books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

[27] Rev. Rul. 91-32, 1991-1 C.B. 107.

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[28] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[29]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[30] Compensation for services performed both within and without the United States is allocated between U.S.-and foreign-source.[31]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[32]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[33] Fifty percent of other income attributable to transportation that begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income.[34] With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States, in which case the international communications income attributable to such

[28] Sec. 865(c).

[29] Sec. 865(d).

[30] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[31] Treas. Reg. sec. 1.861-4(b).

[32] Sec. 861(a)(7).

[33] Sec. 863(c).

[34] Sec. 863(d).

fixed place of business is treated as U.S.-source income.[35] For U.S. persons, all income from space or ocean activities and 50 percent of international communications is treated as U.S.-source income.

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[36] This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S.-source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

Corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[37] All other corporations (that is, those incorporated under the laws of foreign countries) are treated as foreign.[38] Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of substantive factors that might be thought to bear on a corporation's residence, considerations

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[35] Sec. 863(e).

[36] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. 122 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011), in which the Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

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

[38] Sec. 7701(a)(5).

such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources; the exchange or exchanges on which the corporation's stock is traded; or the country or countries of residence of the corporation's owners. Only domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

To the extent the U.S. tax rules impose a greater burden on a domestic multinational corporation than on a similarly situated foreign multinational corporation, the domestic multinational company may have an incentive to undertake a restructuring, merger, or acquisition that has the consequence of replacing the domestic parent company of the multinational group with a foreign parent company. This sort of transaction, in which a foreign corporation replaces a domestic corporation as the parent company of a multinational group, has been commonly referred to as an inversion. Subject to the Code's anti-inversion rules (described below) and other provisions related to, for example, outbound transfers of stock and property, the deductibility of related party interest payments, and a foreign subsidiary's investment in U.S. property, an inversion transaction might be motivated by various tax considerations, including the removal of a group's foreign operations from the U.S. taxing jurisdiction and the potential for reduction of U.S. tax on U.S.-source income through, for example, large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent company.

Until enactment of the American Jobs Creation Act of 2004 ("AJCA"),[39] the Code included no rules specifically addressed to inversion transactions. Consequently, until AJCA a domestic corporation could re-domicile in another country with insignificant or no adverse U.S. tax consequences to the corporation or its shareholders even if nothing related to the ownership, management, or operations of the corporation changed in connection with the re-domiciliation.[40]

AJCA included provisions intended to curtail inversion transactions. Among other things, the general anti-inversion rules (the "toll charge rules") provide that during the 10-year period following the inversion transaction corporate-level gain recognized in connection with the

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[39] Pub. L. No. 108-357.

[40] Shareholders of the re-domiciled parent company who were U.S. persons generally would be subject to U.S. tax on the appreciation in the value of their stock of the U.S. company unless a number of conditions were satisfied, including that U.S. persons who were shareholders of the U.S. company received 50 percent or less of the total voting power and total value of the stock of the new foreign parent company in the transaction. See section 367(a)(1); Treas. Reg. sec. 1.367(a)-3(c)(1). The IRS promulgated these greater-than-50-percent rules after becoming aware of tax-motivated inversion transactions, including the publicly traded Helen of Troy cosmetic company's re-domiciliation in Bermuda. See Notice 94-46, 1994-1 C.B. 356 (April 18, 1994); T.D. 8638 (December 26, 1995). Shareholder taxation under section 367 as a result of inversion transactions remains largely the same after enactment of AJCA.

If an inversion transaction was effectuated by means of an asset acquisition, corporate-level gain generally would have been recognized under section 367(a).

For a fuller description of the possible tax consequences of a reincorporation transaction before AJCA, see Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, p. 4.

inversion generally may not be offset by tax attributes such as net operating losses or foreign tax credits. 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.[41]

If a transaction otherwise satisfies the requirements for applicability of the anti-inversion rules and the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction, the anti-inversion rules entirely deny the tax benefits of the inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes.[42]

Similar rules apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.[43]

The Treasury Department has promulgated detailed guidance under section 7874. In 2014 and 2015, the IRS and Treasury Department issued notices intended to address avoidance of section 7874, to restrict or eliminate certain tax benefits facilitated by inversion transactions, and to describe regulations that will be issued.[44]

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[41] Section 7874(a). AJCA also imposes an excise tax on certain stock compensation of some executives of companies that undertake inversion transactions. Section 4985.

[42] Sec. 7874(b).

[43] Sec. 7874(a)(2)(B)(i).

[44] Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014). Among other things, the notice describes regulations that the Treasury Department and IRS intend to issue (1) addressing some taxpayer planning to keep the percentage of the new foreign parent company stock that is held by former owners of the inverted domestic parent company (by reason of owning stock of the domestic parent) below the 80 or 60 percent threshold; (2) restricting the tax-free post-inversion use of untaxed foreign subsidiary earnings to make loans to or stock purchases from certain foreign affiliates, and (3) preventing taxpayers from avoiding U.S. taxation of pre-inversion earnings of foreign subsidiaries by engaging in post-inversion transactions that would end the controlled foreign corporation status of those subsidiaries. Notice 2015-79, I.R.B. 2015-49 (December 7, 2015), (describing regulations that the Treasury Department and IRS intend to issue to address, among other things, "third-country" inversions; transactions structured to stay below the 60 percent ownership threshold; post-inversion transfers or licenses of property; and post-inversion exchanges of CFC stock).

B. U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code[45] or a bilateral income tax treaty.[46]

1. Gross-basis taxation of U.S.-source income

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.[47] The items enumerated in defining FDAP income are illustrative; the common characteristic of 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.[48] The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the

[45] *E.g.*, the portfolio interest exception in section 871(h) (discussed below).

[46] The United States has set forth its negotiating position on withholding rates and other provisions in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model Treaty"). Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties.

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

[48] *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.

purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.[49]

Types of FDAP income

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.[50] Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more[51] that are treated as U.S.-source are subject to gross-basis taxation.[52] In contrast, U.S-source gains from the sale or exchange of intangibles are subject to tax, and subject to withholding if they are contingent upon productivity of the property sold and are not effectively connected with a U.S. trade or business.[53]

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.[54] 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).[55] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to

[49] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[50] Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, 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).

[51] 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).

[52] 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.

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

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

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

a foreign person.[56] Additionally, there is generally no information reporting required with respect to payments of such amounts.[57]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30 percent withholding tax. 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.[58] For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.[59] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[60] certain contingent interest,[61] interest received by a controlled foreign corporation from a related person,[62] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[63]

Imposition of gross-basis tax and reporting by U.S. withholding agents

The 30-percent tax on FDAP income is generally collected by means of withholding.[64] Withholding on FDAP payments to foreign payees is required unless the withholding agent,[65]

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

[57] 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 84 countries whose residents are subject to the reporting requirements, and a list of countries with respect to which the reported information will be automatically exchanged naming 18 countries. Rev. Proc. 2014-64, I.R. B. 2014-53 (December 29, 2014), available at http://www.irs.gov/pub/irs-irbs/irb14-53.pdf.

[58] Sec. 871(h)(2).

[59] Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

[60] Sec. 871(h)(3).

[61] Sec. 871(h)(4).

[62] Sec. 881(c)(3)(C).

[63] Sec. 881(c)(3)(A).

[64] Secs. 1441, 1442.

[65] 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).

i.e., the person making the payment to the foreign person receiving the income, 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.[66] The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, and portfolio interest, described above.[67]

In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No U.S. Federal income tax return from the foreign recipient is required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient (unless the foreign recipients files for a refund).

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.[68] The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[69]

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.[70] If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

<u>Excise tax on foreign reinsurance premiums</u>

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[71] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance

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

[67] 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.

[68] Treas. Reg. sec. 1.1461-1(b), (c).

[69] See Treas. Reg. sec. 1.1441-7(a) (definition of withholding agent includes foreign persons).

[70] Sec. 1462.

[71] Secs. 4371-4374.

premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Many U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Japan, Switzerland, and the United Kingdom.[72] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[73]

2. Net-basis taxation of U.S.-source income

Income from a U.S. business

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States.[74] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[75]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. 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.[76]

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[72] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

[73] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the revenue ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the revenue ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[74] Secs. 871(b), 882.

[75] Secs. 871(b)(2), 882(a)(2).

[76] Sec. 875.

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include 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.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[77] If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.[78] Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[79] A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with the business. Specific statutory rules govern whether income is ECI.[80]

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

[77] Sec. 864(b).

[78] Sec. 864(b)(1).

[79] Sec. 864(b)(2).

[80] Sec. 864(c).

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).[81] Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.[82]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[83] Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's 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 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, trade-marks, 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.[84] 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.[85]

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.[86] If a foreign person has a

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

[82] Sec. 864(c)(3).

[83] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. Sec. 906.

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

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

[86] Sec. 864(c)(5)(A).

U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[87]

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.[88]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[89] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[90] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.[91]

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. 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

[87] Sec. 864(c)(5)(B).

[88] Sec. 864(c)(4)(C).

[89] Sec. 864(c)(1)(B).

[90] Sec. 864(c)(6).

[91] Sec. 864(c)(7).

and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

3. Special rules

FIRPTA

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[92] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[93] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI ("FIRPTA income") is generally required to withhold U.S. tax from the payment. Withholding is generally 15 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust ("REIT") or regulated investment company ("RIC").[94] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

Branch profits taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. withholding tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign

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[92] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

[93] Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[94] Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduce the 35-percent withholding on distributions to 20-percent withholding during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.[95]

Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount."[96] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.[97] Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.[98]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[99] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).[100] Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.[101] For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

Earnings stripping

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions involving interest payments.

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[95] See Treas. Reg. sec. 1.884-1(g), -5.

[96] Sec. 884(a).

[97] Sec. 884(b).

[98] See sec. 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of U.S. real property interests described in section 897 (discussed below)).

[99] Sec. 884(b).

[100] Sec. 884(f)(1)(A).

[101] Sec. 884(f)(1)(B).

If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense.[102] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[103] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's net interest expense (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its adjusted taxable income (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

[102] Sec. 163(j).

[103] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In general

The United States has a worldwide tax system under which U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The U.S. does not impose an income tax on foreign corporations on income earned from foreign operations, whether or not some or all its shareholders are U.S. persons. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax 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. U.S. shareholders of foreign corporations are taxed by the U.S. when the foreign corporation distributes its earnings as dividends or when a U.S. shareholder sells it stock at a gain. Thus, the U.S. tax on foreign earnings of foreign corporations is "deferred" until distributed to a U.S. shareholder or a U.S. shareholder recognizes gain on its stock.

However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the CFC rules of subpart F[104] and the PFIC rules.[105] A 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.[106]

2. Anti-deferral regimes

Subpart F

Subpart F,[107] applicable to CFCs and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[108] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on

[104] Secs. 951-964.

[105] Secs. 1291-1298.

[106] Secs. 901, 902, 960, 1293(f).

[107] Secs. 951-964.

[108] Secs. 951(b), 957, 958.

their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[109] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income.

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[110] insurance income,[111] and certain income relating to international boycotts and other violations of public policy.[112]

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.[113]

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. Temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign

[109] Sec. 951(a).

[110] Sec. 954.

[111] Sec. 953.

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

[113] Sec. 954.

statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Special rules apply under subpart F with respect to related person insurance income.[114] Enacted in 1986, these rules address the concern that "the related person insurance income of many offshore 'captive' insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company's U.S. ownership was relatively dispersed."[115] For purposes of these rules, the U.S. ownership threshold for CFC status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a CFC, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[116] 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.[117] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[118] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Subpart F exceptions

A provision colloquially referred to as the "CFC look-through" rule excludes from foreign personal holding company income dividends, interest, rents, and royalties received or

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[114] Sec. 953(c).

[115] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 968.

[116] Secs. 951(a)(1)(B), 956.

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

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

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.[119] 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.[120]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business ("active financing income"), which is applies to all taxable years of the foreign corporation beginning after December 31, 2014, and for taxable years of the shareholders that end during or within such taxable years of the corporation.[121] With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

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

[120] See section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114-113), H.R. 2029 ["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; 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; Pub. L. No. 105-277, 1998.

[121] Sec. 954(h). See section 128 of the PATH Act of 2015, which made the active financing exception permanent.

Income is treated as active financing income only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. Certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[122] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized.[123] These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income 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).[124]

<u>Exclusion of previously taxed earnings and profits</u>

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[125] Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income when such earnings are ultimately distributed.[126] Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[127]

<u>Basis adjustments</u>

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the

[122] Sec. 954(h)(3)(E).

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

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

[125] Sec. 959(a)(1).

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

[127] Sec. 959(c).

10-percent U.S. shareholder's income under subpart F.[128] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[129]

Passive foreign investment companies

The Tax Reform Act of 1986[130] 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.[131] 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, subject to an interest charge, on income not currently received.[132] 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.[133] 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."[134]

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[135] and the personal holding company rules.

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For

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[128] Sec. 961(a).

[129] Sec. 961(b).

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

[131] Sec. 1297.

[132] Secs. 1293-1295.

[133] Sec. 1291.

[134] Sec. 1296.

[135] Secs. 531-537.

example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[136]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[137] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[138]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[139] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[140] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[141]

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

[137] Secs. 901, 904.

[138] Sec. 904(c).

[139] Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

[140] Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

[141] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[142] These rules exclude foreign corporations from an affiliated group.[143] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[144] The effective date of the modified rules has been delayed to January 1, 2021.[145] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive category income and to general category income.[146] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or

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[142] Secs. 864(e)(5), 1504.

[143] Sec. 1504(b)(3).

[144] AJCA sec. 401.

[145] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

[146] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, *e.g.*, secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

other payments were made.[147] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[148]

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[149]

[147] Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

[148] Sec. 904(d)(4).

[149] Sec. 909.

III. POLICY ISSUES

A. Competitiveness

1. Economic benefits of competitiveness

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 depend heavily on 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. That is, 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. multinational enterprises ("MNEs"), purely domestic U.S. businesses, and the U.S. activities of foreign MNEs. In turn, business investment and employment decisions may be based on a number of factors, including: the quality of the U.S. workforce and the cost of labor; expected sales growth both in the United States and abroad *(i.e.*, the demand for their goods and services); the location of both customers and 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. Therefore, the economic rationale behind business investment and employment decisions may be multifaceted—only some aspects of which policymakers may influence—and tax policy is only one component of a larger set of instruments that policymakers may choose to employ in order to promote U.S. economic activity and growth. The importance of tax policy within this larger set of instruments depends at least in part on the type of economic activity policymakers seek to promote.

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. MNEs 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-sited assets. These particular policy objectives may be important to policymakers for a number of economic reasons described below, and may at times be in conflict with each other. In addition, these policy goals are not necessarily the same as the goals described at the outset of this overview—of promoting economic growth and general economic well-being—and may be in conflict with them in some instances.

Fostering the growth of U.S. MNEs abroad

The overseas growth of U.S. MNEs may be measured along a number of dimensions, including (1) sales to foreign markets and (2) overseas investment and employment. Policymakers may be interested in promoting the growth of U.S. MNEs because of the positive impact this may have on domestic investment and employment. However, the channel through which increased foreign sales impacts domestic investment and employment may differ from the channel through which increased foreign investment and employment affects the U.S. operations of a U.S. MNE. Therefore, their effects may differ and it may be useful to analyze the effects separately.

An increase in overseas sales made by a U.S. MNE, unaccompanied by changes in foreign investment and employment, may lead to greater domestic investment and employment.[150] Even if a U.S. MNE produces its goods and services abroad, an opportunity to expand in a foreign market may increase the resources that a company puts into its U.S.-based marketing and management activities to increase sales in that foreign market. To the extent that a U.S. company relies on its domestic operations to serve foreign markets, increased sales overseas should increase domestic investment and employment. For example, a company may increase employment at a U.S. manufacturing plant, or build new U.S. facilities, if sales of its U.S.-made goods increase abroad. In addition, an increase in earnings may increase the value of the U.S. MNE, 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 local equities that investors hold in their portfolio relative to what theories of the benefits of international diversification would predict).[151] Income gains by U.S. shareholders may be important to the extent that a goal of U.S. policymakers is to improve the standard of living in the United States. Therefore, to the extent that U.S. individuals own shares in foreign MNEs, growth of foreign MNEs may benefit U.S. shareholders economically even if the foreign MNE has no presence in the United States.

In contrast to overseas sales growth, it is less clear whether increased foreign investment and employment, by themselves, have a positive impact on domestic investment and employment. For example, a U.S. MNE may move its U.S.-based manufacturing operations overseas to take advantage of lower labor costs, thereby reducing domestic investment and employment. U.S. shareholders may still benefit in this case if the earnings (and value) of the U.S. MNE have increased. However, the welfare loss from reduced domestic employment and investment may exceed whatever welfare gain accrues to U.S. shareholders. It may also be the case that foreign investment and employment complements domestic investment and employment. For example, increased foreign investment and employment may be a precursor to increased overseas sales and profits, which may provide a U.S. MNE with funds to make more domestic investments and expand its domestic workforce. As another example, expanding operations in a foreign market may require greater managerial or "back office" (*e.g.*, accounting) support from U.S. headquarters, although with greater global dispersion of production activities it may be the case that headquarters activities grow at foreign affiliates instead of in the United States.

The evidence on whether foreign investment and employment complements, or substitutes for, domestic investment and employment has been inconclusive. One study finds

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[150] 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.

[151] The degree of home bias in developed countries has been declining over time. 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.

that expansion of a company's domestic economic activity is associated with expansion in the activity of its foreign affiliates.[152] However, this finding is also consistent with a scenario in which a company develops a new product and expands its sales force both in the United States and overseas.[153] 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. MNEs are associated with increases in employment of their foreign affiliates.[154] However, this result holds only for foreign affiliates in high-income countries. For foreign 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. The findings of this study suggest that if the domestic effect of increasing foreign investment and employment in a given country depends on some characteristic of that country (*e.g.*, its per-capita income), and if policymakers aim to encourage domestic investment and employment, the tax treatment of foreign-source income should depend on the country in which that income is earned, and that an exemption system that applies uniformly across countries may promote domestic employment and investment less effectively (if at all) than an exemption system whose application varies by country in some way. For example, if it is the case that foreign employment and investment in high-income, but not low-income, countries complement domestic employment and investment, and high-income countries tend to have higher effective tax rates on business income, then proposals that exempt income earned in high-tax countries may be better targeted at increasing domestic employment and investment than proposals that exempt income earned in both high-tax and low-tax countries.

One should note that whether growth of U.S. MNEs provides greater economic benefits than growth of foreign MNEs with U.S. operations may depend on the particular characteristics and business operations of the MNEs being compared. For example, compare a foreign MNE that manufactures or develops a specific product ("Product A") only in the United States with a U.S. MNE that manufactures or develops a particular product ("Product B") outside the United States; these companies may operate in different industries. It may be the case that the success of Product A confers greater economic benefits than the success of Product B, even though Product A is produced by a foreign MNE while Product B is produced by a U.S. MNE. In this case, greater sales of Product A lead to greater investment and employment in the United States than increased sales of Product B, since the U.S. MNE has a smaller economic presence and relies less on its U.S. operations to serve foreign markets. This is a hypothetical example, but illustrates how the relationship between the growth of U.S. MNEs and their level of economic activity in the United States has become less difficult to identify as U.S. MNEs have dispersed their production activities globally.

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[152] 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.

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

[154] 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.

Encouraging domestic investment by U.S. businesses 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.

However, domestic investment by foreign businesses may result in lower levels of investment of U.S. businesses, to the extent that a given foreign business is competing with a U.S. business. Foreign competition may make the U.S. business more productive, which may be economically beneficial to the United States as a whole. However, if the U.S. affiliates of foreign MNEs can lower their U.S. tax liability through means unavailable to U.S. businesses (such as through earnings stripping),[155] it may be the case that increased investment by U.S. affiliates of a foreign MNE may come at the expense of investment by U.S. businesses for tax reasons and not for more fundamental non-tax economic reasons. To the extent that this fact pattern, and claim about the competitive tax advantage of U.S. affiliates of foreign MNEs, is accurate or prevalent, U.S. policymakers may wish to explore policies that make the tax system more neutral with respect to the tax residence of the ultimate parent company that is making the investment (*i.e.*, a U.S.-parented company or foreign-parented company).

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

Some policymakers may prefer that ownership of U.S. and foreign assets (*e.g.*, businesses, tangible property, intangible property, *etc*.) is held by U.S. persons instead of foreign persons.[156] 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. Moreover, earnings of the foreign company may support the U.S. income tax base.

Relative 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. To understand the economic consequences of foreign ownership of

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[155] This claim is discussed and evaluated more thoroughly in Part III.D. of this document.

[156] This section focuses on the economic benefits of U.S., versus foreign, ownership of U.S. and foreign assets. There may be broader foreign policy concerns that make it more attractive for U.S. persons to own U.S. and foreign assets. For example, the growth of U.S. MNEs may help provide the United States with greater leverage on particular foreign policy issues, or may help the United States project its influence more effectively.

U.S. assets, it may be useful to consider two separate examples in which foreign persons make direct investments in the United States: one in which a foreign MNE acquires an existing U.S. business and another in which a foreign MNE starts a new U.S. venture. These are the two main channels through which foreign direct investors can make new investments in the United States, although almost all such investment results from acquisitions of existing U.S. businesses. (Foreign direct investors may also expand an existing foreign-owned business.) In 2014, out of a total of $241.3 billion in expenditures on new investment by foreign direct investors, $224.7 billion (93.1 percent) came in the form of acquisitions, while $13.8 billion (5.7 percent) was attributable to establishing a new U.S. business and $2.8 billion (1.1 percent) resulted from expanding an existing foreign-owned U.S. business.[157]

<u>Example 1: Acquisition of an existing U.S. company by a foreign MNE</u>

When a foreign MNE acquires an existing U.S. company, some may argue that the U.S. business may hire fewer U.S. workers, or invest less in the United States, than would be the case had that company remained under control of a U.S. parent. However, to the extent that the parent—U.S. or foreign—of the U.S. company is charged with maximizing shareholder value, it should make employment and investment decisions based on what maximizes profits, and without further regard to where those economic activities take place (at least to a first approximation). In other words, both the potential U.S. and foreign parents will hire the most qualified workers, and make the most productive investments, regardless of nationality or location. However, if the potential U.S. and foreign parents have operational differences, these differences could influence U.S. investment and employment. For example, when a foreign MNE acquires a U.S. company, the headquarters operations of the U.S. company may move outside the United States if operations are managed more effectively where the foreign parent's central management is located, which may often be outside the United States. The loss in U.S. headquarters jobs may be a policy concern because they may be highly compensated and may attract highly productive workers. In addition, policymakers may value whatever local economic benefits may accompany headquarters operations, such as involvement in philanthropic activities.[158] There is little research on the magnitude or existence of these local economic benefits, however.

<u>Example 2: Start of a new U.S. venture by a foreign MNE</u>

In a different example, reflecting a less common fact pattern than Example 1, above, consider a foreign MNE that starts a new venture in the United States by making new investments ("greenfield investments") instead of acquiring an existing company. The foreign MNE may increase U.S. investment and employment to support its new venture. However, the success of the foreign MNE's U.S. venture may come at the expense of U.S. businesses. For example, the foreign company's U.S. venture may be competing directly with a U.S. company

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[157] Thomas W. Anderson, "Expenditures for New Foreign Direct Investment in the United States in 2014, *Survey of Current Business*, Bureau of Economic Analysis, January 2016, pp. 1-8.

[158] 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.

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 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.

Comparison of examples

The U.S. economic impact in Example 2—where a foreign MNE makes a new investment in the United States—contrasts with that of Example 1, where a foreign MNE acquires 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 is a positive U.S. economic impact in the example where a foreign company makes a new investment, while there is a negative U.S. economic impact in the example where a foreign company acquires an existing U.S. company and moves 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 understanding the mechanism through which foreign ownership of U.S. assets may impact the U.S. economy: foreign acquisition of a U.S. company may result in a relocation of economic activity, while the creation of a new U.S. company by a foreign MNE may result in new economic activity (although such activity may displace the activity of other U.S. companies, whether they are headquartered in the United States or abroad).

These examples ignore a number of important details. For instance, the examples ignore whether a U.S. asset is more productive under foreign ownership than U.S. ownership for purely economic reasons. A foreign MNE, 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. In this case, the advantage of the foreign MNE may mean that the domestic economic benefits conferred by foreign ownership outweighs the domestic economic benefits of U.S. ownership, although there may be other reasons that may make U.S. ownership more beneficial (*e.g.*, a U.S. acquirer may locate more production or management activities in the United States than the foreign acquirer) . 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 other governments may have also adopted policies intended to attract investment and promote the overseas growth of their home-country MNEs. 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: (1) the decline in statutory corporate income tax rates, (2) the adoption of tax systems that exempt active foreign-source income from home-country taxation; and (3) the expansion of preferential tax regimes for income derived from intellectual property.

Decline in statutory corporate income tax rates

The gradual decline in statutory corporate income tax rates throughout the OECD is illustrated in Table 1, below, which details the top combined statutory corporate income tax rates in the OECD from 2005 to 2015 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.[159]

[159] See OECD, *OECD Tax Database Explanatory Annex Part II: Taxation of Corporate and Capital Income*, September 2015, available at http://www.oecd.org/ctp/tax-policy/Corporate-and-Capital-Income-Tax-Rates-Explanatory-Annex-Sept-2015.pdf. For the United States, the combined statutory corporate tax rate of 39.0 percent equals the (top) federal corporate income tax rate of 35.0 percent minus 2.15 percent (to account for the section 199 and the deductibility of state corporate income taxes) plus a weighted average state corporate income tax rate of 6.15 percent. The weighted average rate equals the sum of the top corporate income tax rate for each state multiplied by the state's share in personal income. The OECD weighting methodology is not consistent across countries.

Table 1.−Top Combined Statutory Corporate Income Tax Rates in the OECD (Central and Sub-Central Governments): 2005-2015

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
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	34.2	33.9	34.0	31.4	31.0	29.4	27.6	26.1	26.3	26.3	26.3
Chile	17.0	17.0	17.0	17.0	17.0	17.0	20.0	20.0	20.0	20.0	22.5
Czech Republic	26.0	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0
Denmark	28.0	28.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5	23.5
Estonia	24.0	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	20.0
Finland	26.0	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0	20.0
France	35.0	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4
Germany	38.9	38.9	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	32.0	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0	26.0
Hungary	16.0	17.3	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0
Iceland	18.0	18.0	18.0	15.0	15.0	18.0	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	34.0	31.0	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5	26.5
Italy	33.0	33.0	33.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Japan	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0	32.1
Korea	27.5	27.5	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2	24.2
Luxembourg	30.4	29.6	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2	29.2
Mexico	30.0	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0	30.0
Netherlands	31.5	29.6	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0	25.0
New Zealand	33.0	33.0	33.0	30.0	30.0	30.0	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	28.0	28.0	27.0	27.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	27.5	27.5	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5	29.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0	22.0
Slovenia	25.0	25.0	23.0	22.0	21.0	20.0	20.0	20.0	17.0	17.0	17.0
Spain	35.0	35.0	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0	28.0
Sweden	28.0	28.0	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0	22.0
Switzerland	21.3	21.3	21.3	21.2	21.2	21.2	21.2	21.2	21.1	21.1	21.2
Turkey	30.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	30.0	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0	20.0
United States	39.3	39.3	39.3	39.3	39.1	39.2	39.2	39.1	39.1	39.1	39.0
OECD Median	29.0	28.0	27.0	26.8	26.0	25.8	25.5	25.0	25.0	25.0	25.0

Source: OECD Tax Database.

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. There has been a steady, downward trend in statutory corporate tax rates in OECD countries besides the United States. From 2005 to 2015, the median combined statutory corporate income tax rate fell from 30 percent to 25 percent. Moreover, in 2015, the United States currently had the highest combined statutory corporate income tax rate (39.0 percent) among OECD countries, while Ireland had the lowest (12.5 percent).

Adoption of exemption systems

Since 2000, there has been a significant 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 34 countries that make up the OECD, 28 have some form of an exemption system (compared to 13 at the start of 2000).[160]

Intellectual property or "patent box" regimes

Innovation is an important determinant of economic growth, and a number of countries have made it a priority to promote domestic investment in the research and development that generates innovation. Some countries have done so by establishing intellectual property regimes (or "patent boxes"), which offer preferential tax treatment on income attributable to intellectual property ("IP").[161] As discussed further in Part IV.A of this document, the OECD, as part of the OECD/G20 BEPS Project, has developed guidelines that a country may follow in order to ensure that their IP regime is not considered a harmful tax practice. In particular, the IP regime must satisfy a nexus requirement, meaning that there must be a direct nexus between the income receiving tax benefits under an IP regime and the expenditures that give rise to that income.

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

Growth of U.S. MNEs 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.[162] 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

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[160] See PricewaterhouseCoopers, "Evolution of Territorial Tax Systems in the OECD," April 2, 2013.

[161] For a discussion and list of intellectual property regimes, see : Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-51-15), March 16, 2015.

[162] 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).

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 rate of tax (accounting for all features of the tax system such tax incentives and methods of cost recovery) on a marginal investment.[163] 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. As described above in Table 1, this scenario may have grown increasingly likely over the last decade as statutory corporate tax rates in other OECD countries have gradually declined. 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 deduction for income from domestic production activities and accelerated cost recovery methods, that lower the effective marginal tax rate on income earned by foreign (and domestic) businesses.[164]

Ownership of assets

Policymakers may be concerned that the U.S. system of worldwide taxation may put U.S. MNEs at a competitive disadvantage, relative to foreign MNEs, in acquiring U.S. and foreign assets.[165] With respect to U.S. assets, since foreign MNEs 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

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[163] 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.

[164] For estimates of the effective marginal tax rates on capital income broken down by investment type, the legal form of the entity earning the income, and other economic dimensions, see Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 18, 2014.

[165] Tables 3 and 4 of Part III.E provides data on cross-border acquisitions in the OECD.

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.

B. Economic Distortions Arising from Deferral

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

Some U.S. policymakers are 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.

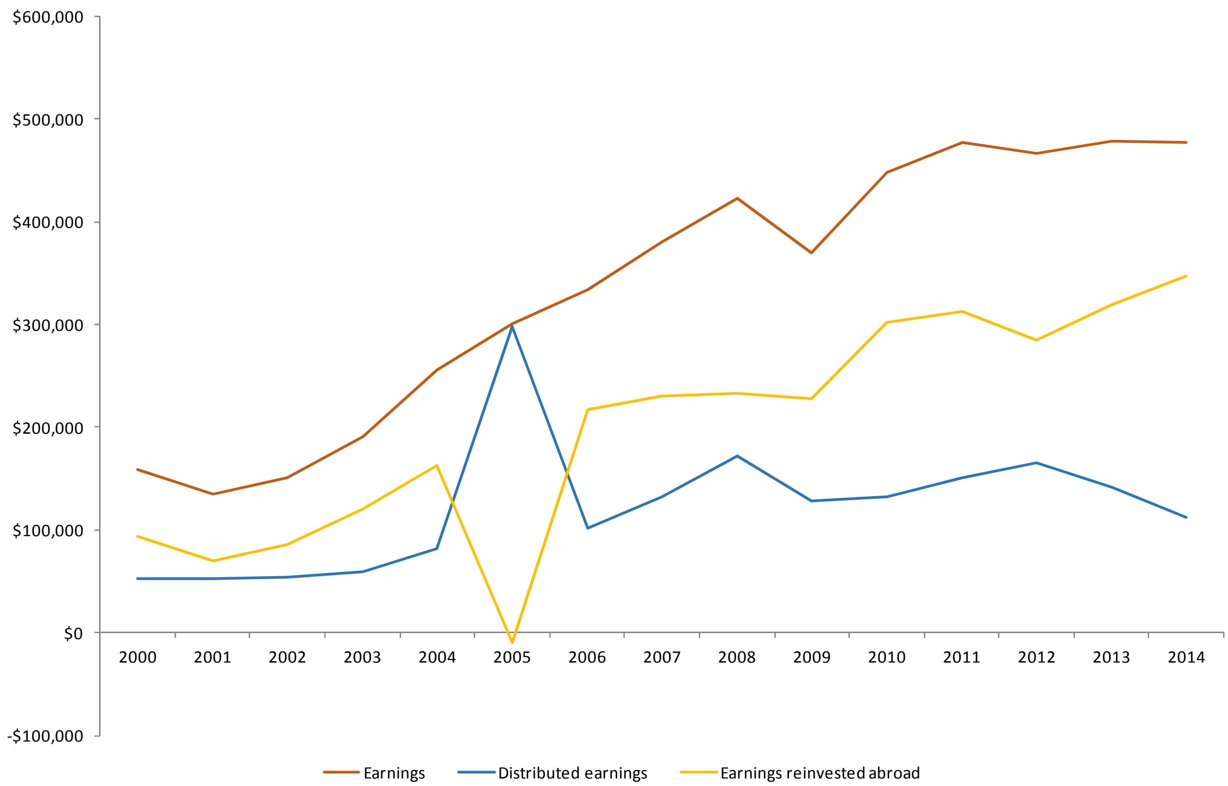
If, instead, the U.S. taxpayer pursues the equivalent investment opportunity in the United States, income from such an investment will not be eligible for deferral. As a result, the taxpayer receives $100 in income today, pays tax of $35, and has only $65 to reinvest. The taxpayer invests that amount 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 are also 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 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 if foreign earnings were exempt from U.S. tax or if those earnings were subject to current U.S. taxation.

Figure 1, below, shows that an increasing amount, and share, of earnings from U.S. direct investment abroad is being reinvested overseas. From 2000 to 2014, earnings from U.S. direct investment abroad grew from $158.2 billion to $476.6 billion, while the amount of those earnings that was reinvested overseas increased from $93.6 billion to $347.6 billion. Therefore, the share of earnings reinvested abroad, as a percentage of earnings from U.S. direct investment abroad, rose from 59.2 percent to 72.9 percent. The amount of earnings that was distributed (*i.e.*, dividends and withdrawals) rose from $52.9 billion in 2003 to $111.8 billion in 2014.[166] 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. 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.

Figure 1.–Earnings from U.S. Direct Investment Abroad: 2000-2014 (nominal dollars, in millions)



Source: Bureau of Economic Analysis, International Transactions Table 4.1 "U.S. International Transactions in Primary Income on Direct Investment." Primary income consists of income from direct investment, portfolio investment, and labor income.

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[166] 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.

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 was no residual U.S. tax liability when earnings are repatriated.[167] Another study reaches a similar conclusion, and estimates the that 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 U.S. tax liability on their foreign earnings—can be significant.[168] Some economists find that the cost of this distortion increases as the accumulated stock of deferred income increases.[169]

3. Distortions in shareholder payouts

Deferral may also contribute to distortions in how U.S. corporations manage shareholder payouts and debt. For example, deferral may provide U.S. corporations with an 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.

[167] 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.

[168] 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.

[169] 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 and Business Operations

Since 1962, the U.S. firms have grown as a result of both growth in the U.S. market and expansion of foreign markets.[170] As they increased their cross-border business transactions, MNEs (both U.S.-based and foreign-based) have been able to determine where and when income will be subject to tax, if any. In recent years, numerous articles and commentary have suggested that the ability to do so reflects either aggressive tax planning or deficiencies in present law, prompting concern that present law may encourage erosion of the U.S. tax base and shifting of income. As U.S. policymakers contemplate reform of the U.S. rules of international taxation, they face a challenge of balancing the calls for reform from a range of U.S. MNEs against concerns that many MNEs have shifted income to low-tax jurisdictions.[171]

MNEs engage in foreign direct investment as they acquire or create assets abroad to manufacture or sell the corporation's goods and services. There are many business reasons that may motivate a U.S. MNE to make outbound foreign direct investments. Building a plant abroad may be the most cost efficient way for a U.S. MNE to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market via direct export from a U.S. location. Foreign direct investment may put the U.S. MNE physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market, which can serve as the basis for improved future marketing of goods and services. A U.S. MNE may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor and less expensive access to raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. Foreign direct investment may provide access to foreign-developed technology.

Tax burden is another factor that may motivate foreign direct investment by U.S. MNEs, in addition to the foregoing nontax business reasons. 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.

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[170] 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 2014. In 1995, three Chinese corporations were included; in 2014, 95 Chinese corporations comprise approximately 20-percent of the list. See, www.fortune.com/global500.

[171] For case studies and analysis of how U.S. MNEs 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.

1. The principal structure and risk limitation

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 structures would typically follow the principal model (described below) and limit contractual risks of certain entities.[172] Using a principal structure, an MNE 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.

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.

In the past, the OECD has recognized the importance of risk-taking and the value that efficient value chain structures contribute to lower the barrier to entry in new markets.[173]

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

[173] OECD (2013), Interconnected Economies: Benefiting from Global Value Chains, OECD Publishing. http://dx.doi.org/10.1787/9789264189560-en, p14.

However, concerns that some allocations of risk may be mere formalities underlie several action items within the ongoing OECD/G20 BEPS Project, which is discussed in Part IV.A of this document. The issues are addressed in both the final report delivered on the digital economy and recommendations on the use of the profit-split method of pricing elements in global value chains.[174] In response to the request for comments from the public to a discussion draft on the latter, commentators have expressed concern that traditional transfer pricing principles are ignored by the OECD recommendations, and if adopted, the OECD proposals would make it difficult for a corporation to know to what extent its structures and risk allocations will be respected.

Surveys of corporate management suggest that there is increasing awareness of the concerns about certain tax practices that may lead to more cautious tax-planning.[175] Greater caution could take the form of avoiding the structure or contractual limitations when possible. On the other hand, adopting certain OECD proposals could also lead to loss of some high-value functions now performed in the United States on a contract basis, such as research and development. If corporate management perceives a possibility that its risk allocations to a principal will not be respected, or that limited contractual risk agreements may be recharacterized or disregarded, it may conclude that tax considerations in favor of moving activities outweigh the nontax reasons for not moving activities. As a result, business operations and the related management and supporting personnel may relocate to the jurisdiction of the foreign principal.[176]

2. 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.[177] 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.[178] One study reports

[174] See OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report,* October 5, 2015, and OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, October 5, 2015.

[175] See, polling results from surveys conducted by KPMG LLP, as summarized in presentations at the 305h Annual TEI-SJSU High Tech Tax Institute, November 10 & 11, 2014, available at http://www.cob.sjsu.edu/acct&fin/tax-institute/2014_materials/BEPS_11-10-14.pdf, citing Spring 2014 – KPMG LLP, Tax Executives' Views on Tax Transparency and Base Erosion and Profit Shifting Survey, April 2014 and Summer 2014 – CFO Research, Survey of 112 financial executives in Aug.-Sept. 2014, sponsored by KPMG LLP, Copyright © 2014 CFO Publishing LLC.

[176] Alex Parker, Profit Shifting**:** *CFOs for Procter & Gamble, Eli Lilly Say Tax Concerns Crucial to Decision-Making,* DTR, Feb. 12, 2015

[177] 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.

[178] 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.

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.[179]

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,[180] or an exchange made pursuant to a plan of reorganization that is entitled to nonrecognition treatment with respect to any built in gain[181]); 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;[182] and qualified cost-sharing arrangements.

All licenses or sales of intangible property, and provision of a service that uses 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.[183] Such an arrangement allows related parties to share costs and risks of developing intangibles in proportion to their reasonably anticipated benefits. The related parties are not recognized as separate entities for purposes of the Code, nor are they governed by the rules applicable to partnerships between unrelated parties.[184]

Under the terms of a cost-sharing arrangement, a U.S. owner of existing intangible property rights agrees to make the rights available to a foreign affiliate 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.[185] As a result of the arrangement, the foreign affiliate owns some

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

[180] Sec. 351.

[181] Sec. 361.

[182] 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.

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

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

[185] 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

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 foreign affiliate may have been formed specifically for its role in the arrangement, and received the funding necessary to satisfy its financial obligations under the arrangement from the U.S. parent. Such arrangements were widely used throughout the late 1990s and earlier this century to achieve the outbound transfer 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 transferor of intangible property must recognize imputed income 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.[186] The appropriate amounts of those imputed payments are determined using transfer-pricing principles, with the exception of transfers of intangibles specifically exempted by regulation, such as transfers of foreign goodwill or going concern value.[187]

3. Subpart F rules and disregarded entities.

Taxpayers are able 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 controlled foreign corporation ("CFC") rules of subpart F[188] and the passive foreign investment company rules.[189] As the discussion of the lockout effect in Part III.B. 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 achieved by use of the principal structure in conjunction with statutory or regulatory exceptions to avoid current

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.

[186] Sec. 367(d).

[187] Temp. Treas. Reg. sec. 1.367(d)-1T(b).

[188] Secs. 951-964.

[189] Secs. 1291-1298.

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 can be structured to result in royalties and other payments from higher-tax jurisdictions to entities in lower-tax jurisdictions.[190]

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[191] can affect whether income is currently includible under subpart F. In addition to selecting a jurisdiction in which to locate a foreign principal based on a favorable tax rate, the extent to which a company would locate employees and business operations in that country are also considered. 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 have activities in other locations attributed to it by use of a hybrid entity organized immediately below the principal. The hybrid entity's fiscal transparency to the United States results in attribution of its activities and all related profits to the principal. Cross-border payments between disregarded entities may also be disregarded, thus avoiding foreign personal holding company income.[192]

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[190] See discussion below, in Part 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.

[191] 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 to its home jurisdiction but is recognized by the U.S tax authorities.

[192] For examples of the flexibility with which an MNE 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.

D. Locating Deductions in the United States

Introduction

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.[193] Moreover, although later superseded and never effective, the concept of allowing deductions to reduce gross income in the income tax liability computation has its beginnings with the first Civil War Income Tax Act of 1861.[194] Conceptually, deductions are tied to a decrease in the taxpayer's wealth and should be taken into account in determining the income tax base. Generally, ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business are deductible,[195] with exceptions for certain allowances or disallowances provided by the Code.[196]

Deductions related to cross-border activity

Certain features of the U.S. tax system provide incentives for MNEs 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 U.S. has the highest combined statutory corporate income tax rate in the OECD.[197] As such, a tax deduction in the U.S. 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.

U.S.-parented MNEs

In the context of U.S.-parented groups, 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

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

[194] 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).

[195] Sec. 162.

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

[197] Combined statutory corporate income tax rate reflect taxes levied by U.S. State and local jurisdictions.

liability on its taxable foreign-source income in each of two limitation categories.[198] 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.[199]

For example, a U.S. corporation may deduct the interest expense[200] 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. MNE 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. MNE 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 this respect, the current U.S. tax system can be viewed as subsidizing overseas growth and investment by U.S.-parented groups.

Similarly, the Code allows a U.S. taxpayer a deduction or credit for expenditures in relation to research and experimentation activities.[201] A U.S. corporation may undertake research and experimentation activities in the U.S. and claim associated deductions and credits against its U.S gross income. 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 Part III.C.3. Following transfer of the IP, the profits may accumulate in a low tax environment offshore in a manner in which it is shielded from current U.S. taxation. This provides a clear example of the distortions that may be created by the U.S. tax regime, which features a high statutory tax rate coupled with deferral from taxation of certain income earned offshore. While generous with the claiming of deductions and credits, despite a portion being potentially designated as foreign-sourced, the associated income may be deferred from U.S. taxation despite the potential for it to be directly or indirectly derived from U.S. sources. On the other hand, the current treatment of research and experimentation expenses, and the associated income from these activities, encourages the performance of research and experimentation

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[198] 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.

[199] 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.

[200] Sec. 163.

[201] Secs. 41 and 174.

activities in the United States. That is, the current policy may implicitly encourage the practice of shifting income attributable to valuable intangible assets from the United States without adequate compensation in the form of royalties or other payments, which boosts the potential for profitable returns on investment and therefore encourages additional research activities in the United States.

<u>Foreign-parented MNEs</u>

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 amounts such as interest, 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.[202] Taking excessive tax deductions in this manner, when motivated by U.S.-income tax avoidance, is known as "earnings stripping." 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 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. That may be the case if the country of the income recipient provides a low general corporate tax rate or reduced taxes with respect to financing or other arrangements.

The generation of excessive interest deductions arguably is the most available form of earnings stripping.[203] However, as mentioned above in Part III.B.3, 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.[204]

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[202] 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.

[203] 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*.

[204] Tax reform proposals intended to curtail the tax benefits of earnings stripping by foreign-parented U.S. corporations have been proposed in different varieties, largely directed at interest payments. Those proposals generally involved the tightening of the objective criteria in relation to determining whether interest expense is excessive under present law. There have been proposals to: (1) eliminate the debt-to-equity safe harbor ratio of 1.5 to 1; (2) reduce the modified taxable income threshold limit of 50 percent to a lower level; (3) shorten the carryforward period for disqualified interest; and/or (4) eliminate the ability to carryforward of excess limitation. Some proposals have been directed at groups that include expatriated entities, as defined within the bill, and some

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through 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.[205]

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, reinsurance 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 U.S. reflecting the local market distribution activities. Indeed, as opportunities for stripping earnings based on interest payments are exhausted, taxpayers may increasingly find it attractive to strip earnings through other means. 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.

In contrast to arguments regarding the negative impact of earnings stripping on the U.S. tax base, there may be some economic benefit to sanctioning its practice. A Treasury Department report suggests that income shifting may support increased investment in high-tax jurisdictions (such as the United States) by lowering the effective tax rate with respect to such investments.[206] In fact, the question of whether the ability of U.S. businesses to pay interest to related foreign debt-holders should be further abated may be part of a larger policy discussion

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would have applied to all foreign-parented U.S. groups. For example, refer to the President's proposals for fiscal years 2005-2014, which contained variations of proposals to modify application of the limitations under sec. 163(j).

[205] 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).

[206] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,* p. 24. Existing empirical research does not address this question. *Id*. The linkage between foreign investment and labor compensation requires that a number of things be held constant–for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

that balances revenue requirements and other economic objectives. It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. Nevertheless, one way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrow policies such as the facilitation of earnings stripping.

Empirical studies

Although few academic studies have analyzed the effect of tax rates on the location of deductible expenses directly, a number of papers have looked at the relationship between a country's statutory corporate income tax rate and the leverage ratios of companies operating in that country, thereby providing indirect evidence of how an MNE's level of interest expense responds to tax rates. The studies generally find that the tax incentive to use internal debt to finance a foreign subsidiary's operations increases as the tax rate in that foreign country increases, as does the incentive to issue external foreign debt in that country.[207] One paper finds that higher tax rates in a particular country lead to higher leverage ratios for U.S. affiliates operating in that country.[208] Another study, focusing on European MNEs from 1994 through 2003, also finds that MNEs respond to increases in tax rates in a particular country by increasing their leverage in that country, which the authors interpret as evidence of international debt shifting.[209]

The effectiveness of present law in limiting earnings stripping was the subject of a 2007 Treasury Department report, which used 2004 tax return data to compare certain financial characteristics of foreign-controlled domestic corporations with domestic corporations.[210] The report concluded that there was strong evidence that inverted corporations were stripping earnings out of U.S. operations, and, consequently, that section 163(j) of the Code was ineffective at preventing earnings stripping by such corporations, a number of which satisfied the debt-equity safe harbor of section 163(j). The results for other foreign-controlled domestic corporations were not conclusive. The report found that foreign-controlled domestic corporations were generally less profitable (as measured by the ratio of net income to total receipts) than their domestically controlled counterparts, which may suggest that foreign-

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[207] See John Graham, "Do Taxes Affect Corporation Decisions? A Review," in G.M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Co., 2013, pp. 123-210.

[208] See Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *The Journal of Finance*, vol. 59, no. 6, December 2004, pp. 2451-2487.

[209] See Harry Huizinga, Luc Laeven, and Gaeten Nicodeme, "Capital Structure and International Debt Shifting," *Journal of Financial Economics*, vol. 88, no. 1, April 2008, pp. 80-118.

[210] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, 2007.

controlled domestic corporations are reducing their taxable income through earnings stripping.[211] However, the report also found that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestically controlled corporations, which may suggest that foreign-controlled domestic corporations are not incurring excess interest expense in the United States.[212] Overall, the report did not find conclusive evidence that foreign-controlled domestic corporations are engaged in earnings stripping, and could not determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[213]

[211] *Ibid.*, p. 13. These analyses were performed separately for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

[212] *Ibid.*, p. 18.

[213] *Ibid.*, pp. 25-26.

E. Cross-Border Mergers and Acquisitions and Inversions

Cross-border mergers and acquisitions

The preceding four sections of this pamphlet have described policy issues related to the U.S. taxation of cross-border business operations. These four sections identify 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. For instance, the ability of foreign-controlled domestic corporations to engage in earnings stripping under current tax rules may provide them with opportunities to reduce taxes, and increase the after-tax return to investment, that are unavailable to domestic corporations.

Tables 2 and 3, below, provide information on cross-border acquisitions in OECD countries from 2006 to 2015, where a U.S. company was either the target or acquirer of a company based in another OECD country. The data comes from the Zephyr database, which is maintained by the Bureau Van Dijk and includes mergers and acquisitions data for a wide range of companies worldwide. The data reported below only includes transactions in which final acquisition values and ownership stakes are known. As a result, the data is not comprehensive and all figures should be interpreted in light of these sampling restrictions. Assignment of a company to a country is based on the company's country of incorporation rather than country of tax residence, although the two may coincide.

Table 2, below, shows the number of acquisitions that occurred during each year of the sample period. For the sample in 2015, 226 companies from an OECD country (besides the United States) were acquired by U.S. companies, while 196 companies in the United States were acquired by a company based in another OECD country. For the sample from 2006 to 2015, there is no clear trend in the number of acquisitions involving companies based in the United States and another OECD country. However, in seven of the ten years in the sample, there were more acquisitions involving a U.S. acquirer than a U.S. target.

Table 2.−Number of Cross-Border Acquisitions Involving U.S. and Another OECD Country, 2006-2015

Year	U.S. Acquirer	U.S. Target
2006	331	316
2007	307	340
2008	251	285
2009	131	132
2010	226	175
2011	251	231
2012	185	180
2013	204	145
2014	252	239
2015	226	196

Source: Zephyr Database, Bureau Van Dijk, and calculations by the staff of the Joint Committee on Taxation. Database accessed on February 18, 2016.

Table 3, below, shows the value of the acquisitions reported in Table 2. In 2015, the value of acquisitions made by a U.S. company of a company based in another OECD country totaled $85.6 billion (in nominal U.S. dollars). The value of acquisitions of a U.S. company by a company based in another OECD country totaled $302.6 billion (in nominal U.S. dollars). As in Table 2, there is no discernible directional trend in the data in Table 3, but the value of acquisitions involving a U.S. target was higher than the value of acquisitions involving a U.S. acquirer in nine out of the ten years in the sample.

Table 3.−Value of Cross-Border Acquisitions Involving U.S. and Another OECD Country, 2006-2015 (nominal dollars, in billions)

Year	U.S. Acquirer	U.S. Target
2006	$85.4	$119.3
2007	$89.1	$182.1
2008	$54.3	$171.2
2009	$24.4	$80.4
2010	$67.1	$61.1
2011	$109.9	$110.6
2012	$54.9	$64.5
2013	$54.3	$75.3
2014	$97.7	$159.1
2015	$85.6	$302.6

Source: Zephyr Database, Bureau Van Dijk, and calculations by the staff of the Joint Committee on Taxation. Database accessed on February 18, 2016.

Inversions

Commentators have devoted much attention to cross-border acquisitions that have been seen as motivated to varying degrees by tax considerations. When commentators have viewed cross-border acquisitions involving U.S. multinational companies as being largely motivated by tax considerations, they have referred to these acquisitions as inversions. Acquisitions that commentators have deemed inversions generally share two features: (1) the domestic corporation is bigger than its foreign merger partner, but (2) the new parent company of the combined multinational group has its residence for tax purposes in a country other than the United States (sometimes the country of tax residence of the foreign merger partner and sometimes a third country). Many cross-border acquisitions referred to in popular discussions as inversions also have a third feature: the combined multinational group has its corporate headquarters in the United States even though its tax residence is elsewhere.

As described previously, the anti-inversion rules of section 7874 impose sanctions on a domestic corporation that undertakes a cross-border acquisition with certain defined features, including that (1) the new parent company of the combined multinational group is a foreign corporation; (2) after the acquisition, at least 60 percent of the stock of the foreign parent company of the combined multinational group is owned by former shareholders of the domestic corporation by reason of their ownership of the stock of the domestic corporation; and (3) after the acquisition the multinational group that includes the new foreign parent company does not have substantial business activities in the country of organization of the parent company. Some transactions that commentators have referred to as inversions have avoided the sanctions of section 7874. In some cases, owners of the domestic corporation hold less than 60 percent of the stock of the new foreign parent company. In other cases, the multinational group of companies has substantial business activities in the country of organization of the new foreign parent.

This section of the document addresses cross-border acquisitions referred to colloquially as inversions, whether or not the transactions might be subject to section 7874. The section gives an overview of possible tax motivations for inversions and describes policy concerns related to, and possible responses to, inversions.

Tax motivations for inversions

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.[214] The Code imposes potentially greater taxation on both the foreign earnings and the 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, but not when the foreign subsidiary makes a loan to or an equity investment in a foreign affiliate, including a new foreign parent company following a cross-border acquisition.[215] 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 U.S. 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

[214] For contrasting analyses of tax considerations related to recent inversions, compare Edward D. Kleinbard, "'Competitiveness' Has Nothing to Do With It," *Tax Notes*, September 1, 2014, pp. 1055-69, with Kimberly S. Blanchard, letter to the editor, *Tax Notes*, September 15, 2014, p.1335, and William McBride, letter to the editor, *Tax Notes,* September 1, 2014, p. 1086.

[215] Sec. 956. But see Notice 2014-52, 2014 I.R.B. LEXIS 576 (Sept. 22, 2014), described above in footnote 45.

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.

<u>Policy concerns and possible policy responses</u>

There are several policy concerns related to cross-border mergers and 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.

One policy concern is that cross-border acquisitions, specifically inversions, may erode the U.S. tax base. The Congressional Budget Office ("CBO") has forecast that corporate income tax receipts will decline from 1.8 percent of gross domestic product ("GDP") in fiscal years 2017-2020 to 1.6 percent of GDP by fiscal year 2027.[216] CBO attributes at least part of this decline to greater use of tax-minimizing strategies such as undertaking corporate inversions and increasing the use of intercompany loans.[217]

However, 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

[216] Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*, pp. 97-98.

[217] *Ibid.*

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.[218] (For further economic analysis of foreign acquisitions of U.S. companies, see the discussion of Example 1 in Part III.A of this document.) Notwithstanding the uncertain evidence related to the economic effects of 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.[219]

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. However, stricter U.S. tax rules related to inversions may encourage U.S.-headquartered startups to establish, at the outset, foreign tax domiciles, since they may have more limited opportunities to reduce their tax liabilities through a possible inversion.

Imposing stricter rules related to inversions may, however, 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 workers 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 corporate tax revenue on foreign business income under the current structure of the U.S. corporate tax if a primary policy goal is to maximize domestic investment and employment.

If inversions or foreign acquisition of domestic corporations were found to cause a loss of U.S. headquarters jobs or to reduce reliance on U.S. investment, employment, and research activity to support sales, both domestic and foreign, policymakers may want to reduce the tax burden on U.S. MNEs to make inversions less attractive from a tax perspective or to promote U.S. ownership of both U.S. and foreign corporations. However, if the government requires a certain level of revenue to meet spending needs, reducing the tax burden on U.S. MNEs may require collecting more tax revenue from other components of the U.S. tax base, thereby distorting economic activity in the sectors or areas of the economy that support that tax base (e.g., distortions in investment behavior and labor supply decisions). In other words, changes in

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

[219] For example, see John M. Samuels, "John Samuels Addresses Inversions and Tax Reform," *Tax Notes*, Feb. 9, 2015, pp. 815-18.

tax policy meant to prevent the economic losses associated with inversions or foreign acquisitions of domestic corporations may result in economic losses elsewhere in the economy. Therefore, the overall benefit associated with tax changes meant to prevent inversions and promote U.S. ownership of both U.S. and foreign corporations depends at least partly on (1) whatever domestic economic benefit there is when a domestic parented rather than a foreign parented multinational group owns a particular asset, (2) the consequences of other accompanying tax policy changes and the economic distortions they may give rise to, and (3) the economic effects of funding government spending by current taxation (rather than by current borrowing and possible future taxation).

IV. RECENT GLOBAL ACTIVITY RELATED TO THE TAXATION OF CROSS-BORDER INCOME

A. OECD Base Erosion and Profit Shifting Initiative

This section provides an overview of the base erosion and profit shifting initiative that the Organization for Economic Cooperation and Development ("OECD") undertook at the request of the Group of Twenty ("OECD/G20 BEPS Project"). It describes the genesis of the project and includes a brief summary of each of the final reports on the 15 action items issued by the OECD.[220] Additionally, this section describes responses to several of the action items by the United States and the European Union.

1. General Background and Role of OECD in Development of Tax Policy

As part of its work to promote trade and economic growth, the OECD works to develop normative tax principles that resolve conflicting claims of jurisdiction to tax cross-border income. The principles developed by the OECD for relief of double taxation 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"),[221] a precursor of which was first in the early 20th century.[222] 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 members that are parties to such treaties.

The policies reflected in the OECD Model treaty are developed on the basis of information about the tax regimes and business practices of members and nonmembers, including their experience with actual treaties. At present, the OECD work on taxation is conducted under its Centre for Tax Policy and Administration. Working parties for each article in the OECD Model treaty analyze how such articles are working in practice, and develop formal commentary on the articles. The OECD consults with stakeholders in the private sector, through the Business and Industry Advisory Committee, a group that attempts to build industry consensus and ensure that views of business are given appropriate weight in OECD deliberations.

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[220] 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.

[221] 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 1961 by the United States, Canada and 18 European countries, dedicated to global development, and has since expanded to 34 members.

[222] 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).

Coordination of work with Group of Twenty

The OECD and the Group of Twenty ("G20") Ministers of Finance work on a range of issues including agriculture, employment, energy, social policy, taxation, trade and investment. G20 is a forum for international economic cooperation among 19 member countries and the European Union.[223] The G20 has met regularly since 1999 at the finance minister and central bank governor level. In November 2008, the G20 country leaders held the first G20 summit, in Washington, D.C., to address the global financial crisis. The following year, at its London Summit, the leaders declared that "the era of banking secrecy is over."[224] Later that year, the OECD Secretary-General attended the leaders' meeting for the first time. The leaders designated the G20 to be the premier forum for international economic cooperation among the member countries.[225] The leaders of the members meet annually, while finance and banking regulators meet more frequently throughout the year.

With respect to the enhancement of the ability of tax authorities to gain access to information, the OECD and G20 work on information exchange and transparency have been central to development of an international consensus on the need for improved transparency regarding financial accounts. Under the work of the OECD's Harmful Tax Practices Project, which is carried out through the Forum on Harmful Tax Practices ("FHTP"), more than 40 jurisdictions with harmful tax practices were identified. A Global Forum, an organization of both OECD members and nonmembers, was formed to address the issues of bank secrecy and effective exchange of information. In 2009, the OECD published standards under which adherents to the standards would respect requests to exchange information where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of a requesting State and not permit restrictions on exchange due to bank secrecy or domestic tax interest requirements, while respecting both taxpayer rights and strict confidentiality of information exchanged.[226] These standards have been endorsed by the G20 Ministers of Finance. At the urging of the G20, the OECD also reorganized and renamed the forum the Global Forum on Transparency and Exchange of Information (the "Global Forum").[227] As of

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[223] The members of the G20 are Argentina, Australia, Brazil, Canada, China, France, the European Union, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States of America.

[224] London Summit, Leaders Declaration, paragraph 15, April 2, 2009. Available at http://www.oecd.org/g20/meetings/london/G20-Action-Plan-Recovery-Reform.pdf.

[225] Leaders' Statement, The Pittsburgh Summit, September 24-25, 2009, paragraph 19, available at http://www.oecd.org/g20/meetings/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf.

[226] 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%20%282%29.pdf.

[227] OECD, *The Global Forum on Transparency and Exchange of Information for Tax Purposes*, November 2013, available at http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf; St. Petersburg Declaration, paragraph 51, available at https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf.

2015, all of the 40 jurisdictions identified as having harmful tax practices by the FHTP are members of the Global Forum and are committed to the aforesaid transparency standards.

2. The OECD/G20 BEPS Project

As G20 and various policymakers worked toward greater transparency in tax administration, concerns about the operation of and effects of tax on cross-border activities were voiced. These concerns related to the difficulty of taxing corporations engaged in cross-border activities, a perceived increase in base erosion and profit shifting, and a risk that double taxation may arise if governments acted unilaterally to protect their respective corporate tax revenue bases, and resulting uncertainty for taxpayers with cross-border operations. 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.[228]

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*,[229] presenting an overview of data and global business models, and discussing some of the issues related to base erosion and profit shifting. The BEPS Report 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. The principles that may be inconsistently applied or interact in a way that contributes to base erosion or profit shifting included jurisdiction to tax, the arm's-length principle for determining intercompany transfer pricing, characterization of debt and equity, and anti-avoidance rules.

The traditional bases of jurisdiction to tax (residence of the taxpayer or activity or connection within a country) 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)."[230] 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.

[228] 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.

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

[230] *Ibid.*, pp.35-36.

In addition to the potential asymmetries resulting from jurisdictional issues, the BEPS Report cited the incentive to shift functions, assets or risks, in order to achieve a favorable result under the internationally accepted arm's-length principle for establishing a fair transfer price for inter-company transactions. According to the BEPS Report, "One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and *vice versa*. This therefore creates an incentive to shift functions/assets/risks to where their returns are taxed more favorably."[231]

Other areas of potential tax-planning identified in the BEPS Report were the broad variety of rules for distinguishing between debt and equity for tax and other purposes, which can prompt attempts to create hybrid arrangements that result in debt characterization in the payor's jurisdiction and treatment as equity in that of the recipient.[232] Finally, the BEPS Report noted that countries use a variety of anti-avoidance strategies to ensure fairness and effectiveness of their corporate tax system, including statutory general anti-avoidance rules (often referred to as GAARs), judicial doctrines limiting or denying the availability of undue tax benefits, CFC rules, 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 imposing higher withholding taxes, or denying the deductibility of certain payments. The variety and complexity of these rules lead in turn to a variety of strategies are to avoid the application of anti-avoidance rules, including channeling the financing through an 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.[233]

The OECD/G20 BEPS Action Plan ("BEPS Action Plan")[234] was approved by the G20 leaders at the St. Petersburg summit in September 2013.[235] The BEPS Action Plan reiterated the need for new international standards and identified 15 action items ("BEPS Actions"). The BEPS Action Plan set a goal of completion within two years.

3. 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, stating, "To reach a globally fair and modern international tax system, we endorse the package of measures developed under the ambitious G20/OECD Base Erosion and Profit Shifting (BEPS)

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

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

[233] *Ibid.*, p.44.

[234] 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

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

project. Widespread and consistent implementation will be critical in the effectiveness of the project, in particular as regards the exchange of information on cross-border tax rulings. We, therefore, strongly urge the timely implementation of the project and encourage all countries and jurisdictions, including developing ones, to participate."[236] The G20 leaders asked the OECD to develop an inclusive framework by early 2016 to assist the implementation of the recommendations in interested non-G20 countries and jurisdictions, including developing economies. In expressing support for the implementation of the recommendations, the group reaffirmed its commitment to enhancing the transparency of tax administration and exchange of information, including both automatic exchange and exchanges in response to specific requests.

Action 1. Address the tax challenges of the digital economy

The BEPS Final Report on this action is a study[237] by the Task Force on the Digital Economy ("TFDE"), which was established in late 2013 as a subsidiary body of the OECD Committee on Fiscal Affairs. The TFDE includes non-OECD G20 countries as associates on an equal footing with OECD countries. The TFDE was established to develop a report identifying tax issues raised by the digital economy and to provide detailed options to address them. The TFDE considered options to modify the exceptions to permanent establishment status to ensure that the exceptions were only available for activities that are in fact preparatory or auxiliary in nature. This work is reflected in the work on Action 7. It also identified various options that countries may adopt, such as withholding taxes on certain digital transactions, provided that countries respect existing treaty obligations and that they ensure consistency with existing international legal commitments.

Action 2. Neutralise the effects of hybrid mismatch arrangements[238]

The final Action 2 report provides two categories of recommendations: internal law recommendations and an OECD Model treaty recommendation. The report recommends internal law rules to stop taxpayers from achieving favorable tax outcomes through hybrid mismatch arrangements. These internal law recommendations are categorized according to the particular outcome to which they are addressed: deduction / no inclusion ("D/NI") mismatches and double deduction ("DD") mismatches. The final Action 2 report also recommends possible changes to domestic laws that would deny a dividend exemption in respect of payments that are deductible in the country of payor's residence or prevent hybrid transfers that would duplicate credits for source-country withholding tax.

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

[237] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, October 5, 2015, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en

[238] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm

The final Action 2 report also proposes to revise the OECD Model treaty to include a new provision to ensure that an entity that is a hybrid entity under the tax laws of two treaty countries is eligible for treaty benefits in appropriate circumstances but that treaty benefits are not allowed for income that neither treaty country treats as income of one of its residents.

Action 3. Strengthen CFC rules[239]

Controlled foreign company ("CFC") and other anti-deferral rules combat BEPS by currently taxing certain income earned by foreign subsidiaries. Currently the United States and the 29 other countries participating in the BEPS Project have CFC rules, and many others have expressed interest in implementing CFC rules. The BEPS Action Plan called for the development of recommendations regarding the design of CFC rules. The final report sets out recommendations in the form of building blocks. The recommendations are not minimum standards; rather they provide jurisdictions that choose to implement them with rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.

Action 4. Limit base erosion via interest deductions and other financial payments[240]

While a number of countries already have so-called interest stripping or earnings stripping rules, the OECD is encouraging a more consistent approach across jurisdictions. In principle, the approach would associate an interest deduction with the overall external interest expense of the group, and further, to the income producing activities in the jurisdiction. The final report on Action 4 recommends an approach based on a fixed ratio rule, which limits an entity's net deductions for interest (and payments economically equivalent to interest) to a percentage of its earnings before interest, taxes, depreciation and amortization ("EBITDA"), as measured under relevant tax principles. The recommended approach includes a "corridor" of possible ratios of between 10 and 30 percent for adoption by countries. Action 4 also includes factors that countries should take into account in setting their fixed ratio within the corridor.

A worldwide group ratio rule that allows an entity to exceed this limit in certain circumstances may supplement this approach. If a country does not introduce a group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.

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[239] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report-9789264241152-en.htm

[240] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm.

Action 5. Counter harmful tax practices more effectively, taking into account transparency and substance[241]

The final report to Action 5 of the BEPS Project is an outgrowth of work that the OECD has conducted on identifying and countering harmful tax practices as part of the FHTP, with the goal of 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."[242]

In a 1998 report, the OECD established four key factors and eight other factors to be used to determine whether a preferential regime is harmful. The four key factors are: (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. The eight other factors are: (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 ("substantial activity factor").

The final report to Action 5 describes the substantial activity factor that is one of the eight other factors used to determine whether a preferential regime is harmful, with an emphasis on the substantial activity factor's application to regimes that provide a tax preference on income relating to intellectual property ("IP"). In addition, the report includes recommendations for how to improve transparency in the exchange of information on tax rulings that may give rise to BEPS concerns and offers a review of preferential regimes.

Action 6. Prevent treaty abuse

The BEPS Final Report[243] recommends a series of changes to bilateral tax treaties to reflect a consistent policy against treaty shopping, include specific limitation of benefits rules to address the interposition of third county entities in the bilateral framework of treaty partners and to revise the OECD Model to include a general principal purpose test as an adjunct or an alternative to the limitations on benefits provisions. Countries involved have committed to

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[241] 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

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

[243] 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.

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 an LOB and a PPT rule; (ii) the PPT rule alone; or (iii) the LOB rule accompanied by a mechanism to combat any remaining possibilities for conduit financing arrangements.

Action 7. Prevent the artificial avoidance of permanent establishment ("PE") status[244]

The BEPS Final Report recommends several changes to the threshold for determining whether a permanent establishment exists, including specific changes to the text of the OECD Model treaty. The changes are intended to tighten the agency rules by providing that a permanent establishment results if an enterprise has an agent who habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in the name of the enterprise or for the transfer of, or the granting of the right to use, property of the enterprise or for the provision of services by the enterprise. The independent agent rules are narrowed such that a person who acts exclusively or almost exclusively on behalf of one or more closely related enterprises is not considered an independent agent. A new anti-fragmentation rule is added to prevent an enterprise from fragmenting its activities between closely related enterprises. Finally, the activities of the related enterprises will be viewed together in determining whether they are of a preparatory or auxiliary character that warrant an exception to permanent establishment status.

Actions 8-10. Aligning Transfer Pricing Outcomes with Value[245]

The three action items that address transfer pricing standards are the subject of a combined report that explain changes to the OECD Transfer Pricing Guidelines and related changes to the OECD Model Tax Convention. For countries that formally subscribe to the OECD Transfer Pricing Guidelines, the guidance in the report takes the form of an amendment to the Transfer Pricing Guidelines. The report focuses on intangibles, contractual allocation of risk and the appropriate scope for addressing profit allocations, i.e., the extent to which a transaction may be recharacterized and on what basis profits would be reallocated. The report concludes that misallocation of profits generated by intangibles has contributed to base erosion and profit shifting, and proposes changes to the guidelines to clarify that legal ownership alone does not determine the allocation of such profits, and offers guidance on determination of the appropriate return reflecting the value of each related party's contribution to a transaction. The report provides a framework for analyzing contractual allocations of risk under which such allocations are respected only if supported by actual decision-making and exercise of control over the risk.

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[244] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm.

[245] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports,* October 5, 2015, available at http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm.

The underlying question for all actions is whether the actual transaction has commercial rationality, as compared to arrangements between unrelated parties under comparable economic circumstances.

Action 11. Establish methodologies to collect and analyze data on base erosion and profit shifting and the actions to address it[246]

The final report to Action 11 presents empirical data that confirms the existence of base erosion and profit-shifting and points to its increase in scale in recent years. The report proposes six indicators to analyze the existence, scale, and economic impact of base erosion and profit-shifting over time, [247] and identifies the strengths and limitations of each indicator, emphasizing that analysis of base erosion and profit-shifting should not rely on any one indicator. Instead, the indicators should be viewed collectively to determine the scale and scope of base erosion and profit-shifting. The report also includes suggestions on how to evaluate the effectiveness of the various "countermeasures" proposed by the final reports and offers recommendations on collecting and disseminating data to facilitate analysis of base erosion and profit-shifting.

Action 12. Require taxpayers to disclose their aggressive tax planning arrangements

The final report[248] highlights that tax audits are a key source of relevant information but are not the best tool for early detection of aggressive tax planning techniques. The final report calls for developing mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures similar to the reportable transactions rules in effect in the United States under Code.[249]

Action 13. Re-examine transfer pricing documentation

The final report on Action 13 calls for a three-tiered standardized approach to transfer pricing documentation to enhance transparency for tax administration, including a requirement that multinational enterprises provide all relevant governments with needed information on their global allocation of the income, economic activity, and taxes paid among countries according to

[246] OECD, *Measuring and Monitoring BEPS Action 11: 2015 Final Report*, October 5, 2014, available at http://www.oecd.org/tax/measuring-and-monitoring-beps-action-11-2015-final-report-9789264241343-en.htm.

[247] The six factors are (1) the concentration of foreign direct investment ("FDI") relative to gross domestic product ("GDP"); (2) high profit rates of low-taxed affiliates of top global multinational enterprises ("MNEs"); (3) high profit rates of MNE affiliates in lower-tax locations; (4) effective tax rates of large MNE affiliates relative to non-MNE entities with similar characteristics; (5) concentration of royalty receipts relative to research and development spending; and (6) interest expense to income ratios of MNE affiliates in countries with above-average statutory tax rates.

[248] OECD, *Mandatory Disclosure Rules Action 12 - 2015 Final Report*, October 5, 2015, available at http://www.oecd.org/tax/mandatory-disclosure-rules-action-12-2015-final-report-9789264241442-en.htm.

[249] See sections 6111 and 6112 and the regulations thereunder.

a common template.[250] The three recommended documents (master file, local file, and country-by-country report) require taxpayers to articulate consistent transfer pricing positions and 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 are to be implemented for fiscal years beginning on or after January 1, 2016, and apply to multinational enterprises with annual consolidated group revenue equal to or exceeding 750 million euros (or approximately $800 million).

Action 14. Make dispute resolution mechanisms more effective[251]

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.

Action 15. Develop a multilateral instrument

The plan recognizes that there is a need to consider innovative ways to implement the measures resulting from the BEPS Action Plan. The plan requires analysis of the tax and public international law issues related to the development of a multilateral instrument for implementation of measures developed in the course of the OECD work on base erosion and profit shifting. On the basis of the analysis, interested parties will develop a multilateral instrument to provide an innovative approach to international tax matters.

4. Initial Measures Adopting BEPS Standards

U.S. BEPS-related actions

U.S. Treaty Policy

On February 17, 2016, the Secretary published the United States Model Income Tax Convention ("U.S. Model Treaty of 2016").[252] The publication reflects changes to the U.S.

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[250] 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.

[251] 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.

negotiating position on tax treaties that have evolved since the last revision to the U.S. Model Treaty in 2006, including changes to the limitations on benefits (Article 22) similar to provisions included in recently concluded treaties, as well as rules regarding payments to fiscally transparent entities (Article 1, paragraph 8), and mandatory arbitration as part of the mutual agreement procedures (Article 25). These changes are also generally consistent with recommendations throughout the final reports regarding bilateral treaties.

The U.S. Model Treaty of 2016 does not adopt 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.

Country-by-country reporting

In December 2015, the Secretary proposed regulations requiring that the ultimate parent entity of a U.S. multinational enterprise group with revenues above a threshold of $850,000 file a country-by-country report for its global operations. The regulations are intended to implement the country-by-country reporting regime required under the BEPS Final report on Action 13.[253] The earliest taxable periods to which such rules may apply are taxable years beginning on or after the date of publication of final regulations for the entities required to report under such rules. 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. The person required to report is the ultimate parent of a U.S. multinational enterprise group. 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).

Because the regulations are proposed and thus not currently effective, they do not conform to the effective date prescribed in the Action 13 recommendation (taxable years beginning on or after January 1, 2016). As a result, 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. The one year gap in implementation has raised concerns, because the final report also prescribes secondary measures.

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[252] The U.S. Model Treaty of 2016 is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf. It was accompanied by "Preamble to 2016 U.S. Model Income Tax Convention," available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf.

[253] Notice of Proposed Rulemaking, REG-109822-15 (December 23, 2015); FR Doc. 2015-32145; Prop. Reg. sec. 1.6038-4.

Those measures may be used in limited circumstances, to take account of jurisdictions that refuse to comply or do not adopt an acceptable process for implementation. In such cases, filing with a local jurisdiction of a subsidiary could be required. It is not clear whether a one-year gap is within the intended scope of the recommended secondary measures. Neither the preamble to the proposed regulations nor the proposed regulations themselves address whether it is contemplated that such measures apply in the one-year interim with respect to U.S. multinationals that are subject to the United States reporting regime when it is fully implemented.

As a result, it is not clear whether a U.S. corporation may be required to submit its master file and country-by-country reports, as well as local reports, to a jurisdiction that has generally implemented the recommendations and in which it has operations, even if that is a jurisdiction with which the United States does not have a treaty or exchange of information agreement. It is possible that a corporation may avoid that requirement if the corporation is able to file with a jurisdiction that agrees to accept filings from a subsidiary of a U.S. MNE group. Model legislative language included in the final report for Action 13 includes the term "surrogate parent entity," which is defined as a subsidiary appointed by the MNE group to file the country-by-country report in that subsidiary's jurisdiction of tax residence, generally under an agreement between the competent authorities of both jurisdictions.[254] At present, the United States has no agreements in place with any jurisdiction to permit such surrogacy.[255] If such agreements can be reached, they would allow a multinational corporation to ensure that it could submit its documentation to a jurisdiction with which the United States has a tax treaty and which would provide appropriate protection for the materials.

In 2016, Mr. Boustany introduced a bill that would impose several conditions on the manner and timing of the implementation of country-by-country reporting required under the BEPS Final report. The legislation would delay implementation of the proposal for one year and require that the Secretary cease transmittal of such reports to any jurisdiction that is determined to have abused the master file maintenance requirements. Under the bill, such abuse exists if the jurisdiction seeks trade secrets or similar material, consolidated financials that are not required to be filed with the Securities and Exchange Commission, privileged attorney-client communications, or any other information the disclosure of which would violate public policy, or that the Secretary determines would be inappropriate to require for a master file under BEPS.[256]

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[254] See Article 1 "Definitions," paragraph 7, and Article 2 "Filing Obligation," at pages 39-41 of the final report on Action 13.

[255] On February 12, at a panel discussion at the Tax Council Policy Institute's 17th Annual Symposium, February 11, tax administration officials from Canada, the United Kingdom and the United States discussed possible conditions under which a jurisdiction would agree to accept the filings from U.S. multinationals in lieu of the United States. Ryan Finley, "Officials Expect Convergence on CbC Reporting, Differ on EU State Aid," *Tax Notes Today*, February 16, 2016, Doc 2016-3210.

[256] H.R. 4297, introduced December 18, 2015.

Reform proposals

The U.S. Treasury Department, former House Ways and Means committee chairman Dave Camp, former Senate Finance committee chairman Max Baucus, and other members of Congress have made legislative proposals related to the topics addressed by the BEPS project. The Treasury Department's revenue proposals for fiscal years 2015, 2016 and 2017 have included a number of proposals consistent with the recommendations of the various BEPS project actions. These proposals address hybrid arrangements, the digital economy, manufacturing services arrangements, excessive U.S. interest deductions, and corporate inversions.[257] In its fiscal year 2016 budget, the Treasury Department described a more thorough international tax reform that included a minimum tax on foreign income.[258] This more thorough reform was intended, among other things, to address profit shifting.

Members of Congress have introduced comprehensive international tax reform proposals and more targeted legislation. As part of an overall reform of the Internal Revenue Code, former House Ways and Means committee chairman Camp proposed a new international tax system that, among other things, allows a 95-percent exemption for repatriated earnings of foreign subsidiaries of U.S. parent companies; imposes current U.S. taxation of intangible income of CFCs, with a preferential tax rate for intangible income from serving foreign markets; allows a preferential tax rate for foreign intangible income of domestic corporations; and restricts interest deductions of U.S. members of worldwide, U.S.-parented groups.[259] Former Senate Finance committee chairman Baucus released international tax reform staff discussion drafts that, among other things, provide alternative options for imposing current U.S. taxation (including at rates below the general U.S. statutory corporate tax rate) on low-tax foreign income of U.S. companies.[260] More recently, Representatives Charles Boustany and Richard Neal released a discussion draft of a proposal that allows (by means of a 71.4 percent deduction) a 10-percent U.S. tax rate for certain intellectual property income that has a U.S. nexus [261]

[257] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,* March 2014, pp. 58-65. For an analysis of these proposals, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, pp. 25-80. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals,* February 2015, pp. 10-12, 32-38. For an analysis of these proposals, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015, pp. 3, 67-73.

[258] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, pp. 10-23. For an analysis of these proposals, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015, pp. 3-65.

[259] H.R. 1, Tax Reform Act of 2014, 113th Cong., 2nd Sess. (2014).

[260] For the legislative text and explanations of these discussion drafts, see documents available at http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

[261] For a press release and a link to legislative text of the proposal, see http://waysandmeans.house.gov/ryan-welcomes-boustany-neal-innovation-box-discussion-draft/.

European Union BEPS-Response

As part of a broad anti-avoidance proposal, the European Commission recommended a Council Directive on anti-avoidance measures suggested by BEPS, recommended changes to tax treaties consistent with BEPS, revisions to EU law on mutual assistance in tax administration, and a strategy for working with non-EU jurisdictions on BEPS.[262] Accompanying the proposal was a study on aggressive tax planning and its indicators. The proposed Council Directive on anti-avoidance focuses on six areas: the deductibility of interest; an exit or expatriation tax on companies; a switch-over clause that would operate to impose a minimum tax on foreign profits, with a credit given for taxes paid with respect to such profits; a GAAR that would operate Union-wide; strengthened CFC rules that would reattribute mobile passive income to its parent company; and a framework for addressing hybrid mismatches.[263]

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[262] An index of the various components of the anti-avoidance package is available at http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm.

[263] European Commission, "Proposal for Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market," January 28, 2016, COM(2016 26 final; 2016/0011 (CNS). The full text is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1454056979779&uri=COM:2016:26:FIN. 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.

B. State Aid

Introduction

Investigations by European media, non-governmental organizations, as well as the OECD/G20 BEPS Project, alleged that multinational companies with substantial presence in certain European countries were paying little income tax in those countries. In June 2013, the European Commission began investigating the tax ruling practices of European Union Member States to determine whether specific rulings such as advance tax rulings and advance pricing agreements may have been used by Member States to confer competitive advantages on certain taxpayers. Even if the Member State conferring the advantage might conclude that the fiscal benefits to the State outweigh the loss of revenue, the European Commission can declare the advantage in violation of one aspect of European competition law—called State Aid—and require the recovery of the advantage granted to a taxpayer by a Member State. Because the U.S. allows a credit for foreign taxes paid or accrued to a foreign country against U.S. income tax liability that would otherwise be due on the foreign source income of a United States taxpayer, to the extent that State Aid recoveries are eligible for a foreign tax credit, these payments could result in a lower residual tax paid to the U.S. Treasury by U.S. companies. Members of Congress on the House Ways and Means Committee and the Senate Finance Committee,[264] as well as representatives of the Treasury Department, have expressed concern about State Aid investigations, including concerns of possible bias in the selection of U.S. companies as targets of the investigations.

European law on State Aid

The Treaty on the Functioning of the European Union ("TFEU") includes laws to ensure economic markets within the European Union are fair and competitive. One of the laws is the prohibition on State Aid.[265]

The principle rule states:

"…any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."[266]

[264] In a letter to David O'Sullivan, the Ambassador of the European Union to the United States dated December 18, 2015, two Members of Congress, Charles W. Boustany Jr., Chairman of the House Ways and Means Subcommittee on Tax Policy and Richard E. Neal, Ranking Member of the Subcommittee, expressed concern about the State Aid cases. On January 15, 2016, Chairman Orrin Hatch and Ranking Member Ron Wyden of the Senate Finance Committee sent a letter to Treasury Secretary Jacob Lew highlighting their concerns regarding State Aid investigations and the appearance that subsidiaries of U.S.-based multinationals are being targeted. Senators Rob Portman and Charles Schumer, who co-chaired the Senate Finance Committee 2015 international tax working group, co-signed the letter.

[265] Section 2, chapter 1, title VII of the TFEU.

[266] Art. 107(1) TFEU.

State Aid is prohibited if the following conditions are all present:

1. The Member State gives a financial advantage to those who receive it;

2. The advantage is granted from Member State resources;

3. The Member State action affects competition and trade between Member States; and

4. The advantage is selective, favoring "certain undertakings or the production of certain goods."

Although Member States are generally granted autonomy to choose direct taxation systems, a specific regime of direct taxation of businesses must comply with State Aid principles. A Member State advance tax ruling or advance pricing agreement may violate the law against State Aid if the tax burden is lower than would have resulted from the Member State's other tax rules.[267] This might occur from the reduction in the tax base, the special application of an exemption or a credit, or a deferment, cancellation or rescheduling of tax debt.

The prohibition against State Aid applies only if the advantage conferred strengthens the competitiveness of the recipient relative to competitors in European Union trade. The advantage must be specific or selective, so that there is a specific taxpayer or group of taxpayers benefiting from the aid, for example, certain sectors of the economy,[268] multinational companies,[269] and offshore companies.[270]

Selectivity of the advantage is determined by:

1. Determining the Member State's "normal" tax system;

2. Determining that the State Aid grants an advantageous deviation from the normal system in a way that distinguishes between taxpayers in similar factual and legal circumstances in the context of the objectives of the Member State's tax system;[271]

3. Determining whether the advantage being conferred is the outcome of the "nature or general scheme of the tax system," *i.e.*, resulting "directly from the basic or guiding principles of

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[267] Report on Implementation, Brussels, 9 February 2004, C(2004) 434, Box No. 1; Notice on Business Taxation, Official Journal of the European Communities ["OJ"], C 384 of 10 December 1998. In the Notice, the Commission for the first time provided that direct tax provisions, specific tax rulings granted to corporate taxpayers, as well as tax ruling regimes, could be held to violate State Aid principles.

[268] Notice on Business Taxation, OJ, C 384 of 10 December 1998, pp. 3-9, para. 18.

[269] Report on Implementation, Brussels, of 9 February 2004, C(2004) 434, Box No. 5.

[270] ECJ 15 November 2011, joined cases C-106/09 and C-107/09 P, Commission v Gibraltar [2011] ECR 1-0, para 107.

[271] ECJ 8 November 2001, C-143/99.

the tax system in the Member States concerned."[272] In order to be permissible, the rules or practice resulting in the State Aid must have a purpose that is necessary for the functioning and effectiveness of the tax system.[273]

Tax rulings

In June 2013,[274] the European Commission began preliminary review of the tax rulings practice of several Member States, during which it requested copies of advance tax rulings and advance pricing agreements involving companies whose tax planning strategies and use of tax rulings had been the subject of media attention, including Amazon, Apple, and Starbucks. By December 2014, it had broadened its inquiries to all Member States, and requested a list of all tax rulings provided by Member States that were in effect during the 2010-2013 timeframe.[275] The scope of the inquiry undertaken in 2014 may be distinguished from legislative grants of exemptions or benefits by which a Member State provides incentives to locate in its jurisdiction, or favors certain domestic taxpayers or industries, which may also lead to allegations of State Aid. In explaining the meaning of the term "tax ruling," for purposes of this new inquiry, the Commission described the type of confidential ruling that is concluded between tax administrators and taxpayers to provide certainty, saying that a tax ruling refers to "a confirmation or assurance that tax authorities give to tax-payers [sic] on how their tax will be calculated. Tax rulings are typically issued to provide legal certainty for taxpayers, often by confirming the tax treatment of a large or complex commercial transaction. Tax rulings are mostly given in advance of the transaction taking place or a tax return being filed."[276] In the context of cross-border transactions, such rulings include advance pricing agreements.[277]

Since receiving information about specific tax rulings from the Member States, the Commission has opened six cases for formal investigation, listed in the table below. The table identifies the country that issued the ruling, the multinational enterprise identified as the beneficiary of the ruling, the tax jurisdiction of its parent, the formal case number, and, where available, the amount by which the tax burden may have been reduced due to State Aid and the years in which the ruling was in effect.

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272 ECJ 8 November 2001, C-143/99.

273 Notice on Business Taxation, OJ C 384 of 10 December 1998, pp. 3-4, paras. 16, 26.

274 European Commission, "State aid: Commission extends information enquiry on tax rulings practice to all Member States," press release, December 17, 2014.

275 "EU State Aid Law and National Tax Rulings," Directorate-General for Internal Policies, European Parliament, October 2015, IP/A/TAXE/2015-02, p. 12.

276 European Commission, "Fact Sheet Combatting [sic] Corporate Tax Avoidance: Commission Presents Tax Transparency," March 18, 2015, section 2.1.

277 Advance pricing agreements are agreements between a tax administration and a taxpayer about the appropriate pricing methodology to apply establish the transfer price on to intercompany transfers of goods or services. The pricing methodology is chosen based on whether it achieves an arm's length result, as required by section 482 and OECD Transfer Pricing Guidelines. In the United States, such agreements are administered in accordance with regulations under section 482 and pursuant to the procedures in Revenue Procedure 2015-41.

Table 4.−Formal EU Tax Ruling Investigations

Country	Identified Beneficiary	Domicile of MNE's Ultimate Parent	Case Number[1]	Amount (Euros)	Years covered by rulings	Status
Belgium	35 MNEs[2]	Various, mainly EU member states	SA.37667	700 million	2005 to present	EC Decision[3]
Ireland	Apple	United States	SA.38373	not available	1991 to present	pending
Luxembourg	Amazon	United States	SA.38944	not available	2011- 2013	pending
Luxembourg	Fiat Group	Italy	SA.38375	20-30 million	2012 to present	EC Decision[4]
Luxembourg	McDonald's Europe Franchising	United States	SA.38945	not available	2009 to present	pending
Netherlands	Starbucks	United States	SA.38374	20-30 million	2008 to present	EC Decision[5]

[1] The case numbers designate cases formally initiated by the Directorate General-Competition, of the European Commission, and are included in a registry of all State Aid cases, available at http://ec.europa.eu/competition/state_aid/register/. The register includes links to all public documents in the case, and will include a redacted version of the decision when that is available.

[2] The identity of the 35 companies have not been disclosed by the Commission. However, at least one, AB InBev, has confirmed in the press that it was one of the 35 companies. http://www.telegraph.co.uk/finance/newsbysector/industry/12092808/Belgian-sweetheart-tax-deals-are-illegal-says-EU.html.

[3] The European Commission announced, on January 11, 2016, a decision finding existence of impermissible state aid that benefited at least 35 multinational companies, mainly from the EU. Press release available at http://europa.eu/rapid/press-release_IP-16-42_en.htm.

[4] The European Commission announced, on October 27, 2015, decisions finding existence of impermissible state aid in both Fiat Chrysler Automobiles and Starbucks investigations. Each case involve advanced pricing agreements. Both Member States have appealed the findings.

[5] *Ibid.*

Amazon (Luxembourg)

Amazon was one of the companies that was the subject of the requests for information from Luxembourg authorities in 2014. Those requests led the European Commission to conduct a preliminary investigation of a 2003 tax ruling under which Luxembourg tax authorities approved the transfer pricing determined for use of valuable intangibles in Amazon's European operations. The ruling applies to Amazon's subsidiary, Amazon EU Sàrl, based in Luxembourg. Amazon EU Sàrl operates all of Amazon's EU e-commerce retail businesses on all of its EU websites, and earns all the profits associated with selling products through the e-commerce retail businesses to end customers.[278] Under the tax ruling, Amazon EU Sàrl is permitted to deduct a royalties it pays to a related limited liability partnership, also established in Luxembourg, and not subject to corporate tax in Luxembourg because it is fiscally transparent. In October 2014, the Commission opened a formal investigation to determine whether the ruling applied transfer pricing guidelines appropriately, stating, "The amount of this royalty, which lowers the taxable profits of Amazon EU Sàrl each year, might not be in line with market conditions."[279] Among the questions are whether the ruling deviates from arm's length results by not requiring use of a pricing method described in OECD guidelines, and whether the tax base reflected the full value of the functions performed and risks assumed by the Luxembourg corporation for the Amazon group. The investigation is ongoing.

Fiat Finance and Trade (Luxembourg)[280]

In June 2014, the European Commission opened an investigation into an advance pricing agreement between Fiat Finance and Trade ("FFT") and Luxembourg's tax authorities. FFT functions as the financial center for Fiat group companies, entering into transactions with the European companies.

In October 2015, the European Commission's investigation concluded that a tax ruling issued by Luxembourg tax authorities in 2012 to FFT gave it an impermissible selective advantage, which purportedly reduced its tax burden since 2012 by €20 - €30 million.

The European Commission compared FFT's activities to a bank, and claimed the taxable profits of FFT could be determined like a bank, as a calculation of return on capital. The Commission concluded that the ruling reduced the amount of tax FFT owed by reducing the

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[278] http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/writev/716/m03.htm

[279] European Commission, "State aid: Commission investigates transfer pricing arrangements on corporate taxation of Amazon in Luxembourg," press release, October 7, 2014. On the same date, the Commission issued a letter soliciting comments and providing detail about the scope of the inquiry, which was published on February 2, 2015, in the Official Journal. European Commission, "State aid-Luxembourg: Alleged aid to Amazon," OJ 2015/C 044/02, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015XC0206%2802%29&rid=1. .

[280] European Commission, "Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules," press release, October 21, 2015, available at http://europa.eu/rapid/press-release_IP-15-5880_en.htm and reproduced in the Appendix.

capital base upon which taxable income is calculated and by depressing assumed return on that capital relative to market returns.

The European Commission concluded that if the estimates of capital and return on capital of FFT had corresponded to market conditions, the taxable profits declared in Luxembourg would have been 20 times higher.

Starbucks (Netherlands)[281]

In June 2014, the European Commission opened an investigation into Starbucks Manufacturing EMEA BV (Netherlands) ("Starbucks Manufacturing"), which sells and distributes roasted coffee and related products to Starbucks outlets in Europe, the Middle East and Africa.

The Commission's investigation concluded that an advance pricing agreement between Starbucks and the Dutch tax authorities in 2008 gave an impermissible selective advantage to Starbucks Manufacturing, which purportedly reduced Starbucks Manufacturing's tax burden in aggregate by €20 - €30 million for certain years covered by the advance pricing agreement (2008-2015). The Commission rejected the application of the transfer pricing methodology used in the agreement, as not in accord with the arm's length principle. The Commission concluded that the royalties paid to a U.K.-based Starbucks company for coffee-roasting know-how do not reflect market value and caused shifting of its profit to the U.K. In addition, the Commission concluded that the Dutch entity pays a higher than market price for green coffee beans to a Switzerland-based Starbucks company.

Apple (Ireland)

In June 2013, the European Commission requested information from Irish tax authorities regarding rulings issued to several entities affiliated with Apple Corporation. On June 11, 2014, the Commission formally opened its investigation into two rulings issued in 1991 and in 2007, by the Irish tax authorities on the calculation of the taxable profit allocated to Apple Sales International and of Apple Operations Europe.[282] The 1991 ruling specifically approved a cost-sharing agreement (or cost contribution arrangement, in OECD terminology) that remained in effect, with certain revisions under the 2007 ruling, to the present. The Commission noted possible areas in which the rulings departed from the arm's length standard for determining rates of return and profits, as well as the length of time the rulings remained in effect, among other issues. No findings or conclusions have been announced regarding this ongoing investigation.

[281] *Ibid.*

[282] State Aid Ireland, Invitation to submit comments, OJ 2014/C 369/04, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2014.369.01.0022.01.ENG&toc=OJ:C:2014:369:TOC#ntr1-C_2014369EN.01002401-E0001.

McDonald's (Luxembourg)

In December 2015, the European Commission opened an investigation into two rulings granted by Luxembourg authorities to McDonald's Europe Franchising, a Luxembourg entity that has two branches, one in Switzerland, the other in the United States. It has paid no corporate tax in Luxembourg since the rulings were granted in 2009. The Luxembourg entity receives royalties from franchisees operating throughout Europe and Russia. The royalties received are paid to the Swiss branch, which then pays then to the U.S. branch of the company. In the first ruling, the royalties were tax-free in Luxembourg on the condition that the company established annually that the profits transferred to the U.S. branch were subject to tax by the United States. The Luxembourg tax authorities learned shortly after the first ruling was issued, that the profits represented by the royalties were not in fact taxed by the United States. A second ruling was reached in which the Luxembourg authorities accepted the position of McDonald's that the royalties from its European franchisees that were ultimately transferred to the U.S. branch were not subject to tax in either Luxembourg or the United States, because while Luxembourg domestic law would find that the U.S. branch was a permanent establishment in the United States, that branch would not constitute a permanent establishment under United States law. The investigation was formally announced in 2015 to determine whether the 2009 rulings derogated from the law in Luxembourg under both its legislation and the tax treaty with the United States.

Belgian Excess Profits[283]

In February 2015, the European Commission opened an investigation on purported selective tax advantages granted by Belgium under its "excess profit" which was claimed to benefit 35 multinationals. The names of the companies impacted have not been released to the public.

The Belgian "excess profit" tax program has been in place since 2005. The program was intended to reduce the corporate tax paid by the impacted companies by discounting "excess profits" that allegedly result from being part of a multinational group.

Under the Belgian tax rulings, the profit of a multinational is compared with the hypothetical average profit of a company not in a multinational group in a comparable situation. The alleged difference in profit is deemed to be "excess profit" by the Belgian tax authorities, and the multinational's tax base was reduced proportionately. This is based on a premise that multinational companies make "excess profit" as a result of being part of a multinational group.

In January 2016, the European Commission found that the program departed from normal practice under Belgian tax law and was illegal under European Union state aid rules. It concluded that the aggregate reduction of the tax burdens of the multinationals receiving the rulings exceeded approximately €700 million, and that the companies who benefitted were predominantly headed by firms in Member States of the European Union.

[283] European Commission, "State aid: Commission concludes Belgian 'Excess Profit' tax scheme illegal; around €700 million to be recovered from 35 multinational companies," press release, January 11, 2016, available at http://europa.eu/rapid/press-release_IP-16-42_en.htm and reproduced in the Appendix.

Recovery of State Aid

If the Commission determines that State Aid had been unlawfully granted, it orders the Member States to seek recovery of the advantage plus interest from the taxpayer that benefitted from the rulings. This takes place under normal Member State procedures.[284]

U.S. implications

When a recovery is ordered, one question is whether the amount paid by the subsidiary of a U.S. company to the relevant European country is creditable in the United States against U.S. tax that would otherwise be due on earnings repatriated from the foreign subsidiary.[285]

Mr. Robert Stack, Deputy Assistant Secretary (International Tax Affairs) of the U.S. Treasury has testified[286] at Congressional hearings on the Administration's concerns regarding State Aid investigations, which can be summarized as follows:

1. The European Commission appears to be targeting U.S. corporations disproportionately.

2. The State Aid investigations potentially undermine, and conflict with, U.S. rights under bilateral tax treaties.

3. The retroactive recovery of taxes in State Aid cases raises questions of fairness, based on the extent to which a taxpayer could anticipate that a ruling would be overturned.

4. The IRS and Treasury have not yet completed their analysis of the foreign tax credit issues raised by State Aid recoveries, because they raise novel issues, but are concerned that recovery payments may give rise to creditable foreign taxes when the U.S. companies actually, or are deemed to, repatriate income under U.S. law, with the result that U.S. taxpayers would be "footing the bill" for the recovery amounts.

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[284] Council Regulation 659/1999 (EC) of 22 March 1999.

[285] In general, the United States allows a credit for foreign taxes paid or accrued to a foreign country against the U.S. taxes that would otherwise be due on the foreign source income of a U.S. taxpayer. In order for a payment to a foreign country to be creditable, it must be a tax and it also must be a payment that is based on net income as defined in the U.S. sense. In order for the payment to be a tax, it must be a compulsory payment that is based upon the foreign country's authority to levy tax and must not be based upon the receipt of a specific economic benefit. Treas. Reg. section 1.901-2(a). Generally, foreign taxes may be taken as a credit in the year in which the taxes are accrued. However, when taxes that are ultimately paid differ from the amount accrued, or if the taxes are not paid within two years of the end of year to which the taxes relate, special adjustments to the income tax pools may be required under the proposed regulations. Secs. 905(a) and (c). T.D.9362.

[286] See, for example, Testimony of Robert Stack, Deputy Assistant Treasury Secretary (International Tax Affairs), Senate Finance Committee (December 1, 2015), available at http://www.finance.senate.gov/imo/media/doc/01dec2015Stack.pdf.

APPENDIX

On the following pages are two press releases from the European Commission:

1. October 27, 2015, announcing its adverse findings in two State Aid cases involving Luxembourg (Fiat) and Netherlands (Starbucks).

2. January 11, 2016, announcing its adverse findings in the State Aid case regarding Belgium and its excess profits tax ruling practice.

European Commission - Press release

Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules

Brussels, 21 October 2015

The European Commission has decided that Luxembourg and the Netherlands have granted selective tax advantages to Fiat Finance and Trade and Starbucks, respectively. These are illegal under EU state aid rules.

Commissioner Margrethe Vestager, in charge of competition policy, stated: *"Tax rulings that artificially reduce a company's tax burden are not in line with EU state aid rules. They are illegal. I hope that, with today's decisions, this message will be heard by Member State governments and companies alike. All companies, big or small, multinational or not, should pay their fair share of tax."*

Following in-depth investigations, which were launched in June 2014, the Commission has concluded that Luxembourg has granted selective tax advantages to Fiat's financing company and the Netherlands to Starbucks' coffee roasting company. In each case, a tax ruling issued by the respective national tax authority artificially lowered the tax paid by the company.

Tax rulings as such are perfectly legal. They are comfort letters issued by tax authorities to give a company clarity on how its corporate tax will be calculated or on the use of special tax provisions. However, the two tax rulings under investigation endorsed **artificial and complex methods** to establish taxable profits for the companies. They do not reflect **economic reality**. This is done, in particular, by setting prices for goods and services sold between companies of the Fiat and Starbucks groups (so-called "transfer prices") that do not correspond to market conditions. As a result, most of the profits of Starbucks' coffee roasting company are shifted abroad, where they are also not taxed, and Fiat's financing company only paid taxes on underestimated profits.

This is illegal under EU state aid rules: Tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification and which unduly shift profits to reduce the taxes paid by the company. It would give that company an unfair competitive advantage over other companies (typically SMEs) that are taxed on their actual profits because they pay market prices for the goods and services they use.

Therefore, the Commission has ordered Luxembourg and the Netherlands to recover the unpaid tax from Fiat and Starbucks, respectively, in order to remove the unfair competitive advantage they have enjoyed and to restore equal treatment with other companies in similar situations. The amounts to recover are €20 - €30 million for each company. It also means that the companies can no longer continue to benefit from the advantageous tax treatment granted by these tax rulings.

Furthermore, the Commission continues to pursue its inquiry into tax rulings practices in all EU Member States. It cannot prejudge the opening of additional formal investigations into tax rulings if it has indications that EU state aid rules are not being complied with. Its existing formal investigations into tax rulings in Belgium, Ireland and Luxembourg are ongoing. Each of the cases is assessed on its merits and today's decisions do not prejudge the outcome of the Commission's ongoing probes.

Fiat

Fiat Finance and Trade, based in Luxembourg, provides financial services, such as intra-group loans, to other Fiat group car companies. It engages in many different transactions with Fiat group companies in Europe.

The Commission's investigation showed that a tax ruling issued by the Luxembourg authorities in 2012 gave a selective advantage to Fiat Finance and Trade, which has unduly reduced its tax burden since 2012 by €20 - €30 million.

Given that Fiat Finance and Trade's activities are comparable to those of a bank, the taxable profits for Fiat Finance and Trade can be determined in a similar way as for a bank, as a calculation of return on capital deployed by the company for its financing activities. However, the tax ruling endorses an artificial and extremely complex methodology that is not appropriate for the calculation of taxable profits reflecting market conditions. In particular, it artificially lowers taxes paid by Fiat Finance and Trade in two ways:

- Due to a number of **economically unjustifiable assumptions and down-ward adjustments**, the capital base approximated by the tax ruling is much lower thanthe company's actual capital.
- The estimated **remuneration** applied to this already much lower capital for tax purposes is also much lower compared to market rates.

As a result, Fiat Finance and Trade has only paid taxes on a small portion of its actual accounting capital at a very low remuneration. As a matter of principle, if the taxable profits are calculated based on capital, the level of capitalisation in the company has to be adequate compared to financial industry standards. Additionally, the remuneration applied has to correspond to market conditions. The Commission's assessment showed that in the case of Fiat Finance and Trade, if the estimations of capital and remuneration applied had corresponded to market conditions, the taxable profits declared in Luxembourg would have been 20 times higher.

Starbucks

Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing"), based in the Netherlands, is the only coffee roasting company in the Starbucks group in Europe. It sells and distributes roasted coffee and coffee-related products (e.g. cups, packaged food, pastries) to Starbucks outlets in Europe, the Middle East and Africa.

The Commission's investigation showed that a tax ruling issued by the Dutch authorities in 2008 gave a selective advantage to Starbucks Manufacturing, which has unduly reduced Starbucks Manufacturing's tax burden since 2008 by €20 - €30 million. In particular, the ruling artificially lowered taxes paid by Starbucks Manufacturing in two ways:

- Starbucks Manufacturing pays a very substantial **royalty** to Alki (a UK-based company in the Starbucks group) for coffee-roasting know-how.
- It also pays an **inflated price** for green coffee beans to Switzerland-based Starbucks Coffee Trading SARL.

The Commission's investigation established that the royalty paid by Starbucks Manufacturing to Alki cannot be justified as it does not adequately reflect market value. In fact, only Starbucks Manufacturing is required to pay for using this know-how – no other Starbucks group company nor independent roasters to which roasting is outsourced are required to pay a royalty for using the same know-how in essentially the same situation. In the case of Starbucks Manufacturing, however, the existence and level of the royalty means that a large part of its taxable profits are unduly shifted to Alki, which is neither liable to pay corporate tax in the UK, nor in the Netherlands.

Furthermore, the investigation revealed that Starbucks Manufacturing's tax base is also unduly reduced by the highly inflated price it pays for green coffee beans to a Swiss company, Starbucks Coffee Trading SARL. In fact, the margin on the beans has more than tripled since 2011. Due to this high key cost factor in coffee roasting, Starbucks Manufacturing's coffee roasting activities alone would not actually generate sufficient profits to pay the royalty for coffee-roasting know-how to Alki. The royalty therefore mainly shifts to Alki profits generated from sales of other products sold to the Starbucks outlets, such as tea, pastries and cups, which represent most of the turnover of Starbucks Manufacturing.

Recovery

As a matter of principle, EU state aid rules require that incompatible state aid is recovered in order to reduce the distortion of competition created by the aid. In its two decisions the Commission has set out the methodology to calculate the value of the undue competitive advantage enjoyed by Fiat and Starbucks, i.e. the difference between what the company paid and what it would have paid without the tax ruling. This amount is €20 - €30 million for each of Fiat and Starbucks but the precise amounts of tax to be recovered must now be determined by the Luxembourg and Dutch tax authorities on the basis of the methodology established in the Commission decisions.

New investigative tools

In the two investigations the Commission has for the first time used information request tools under a Council decision by Member States of July 2013 (Regulation 734/2013). Using these powers the Commission can, if the information provided by the Member State subject to the state aid investigation is not sufficient, ask that any other Member State as well as companies (including the company benefitting from the aid measure or its competitors) provide directly to the Commission all market information necessary to enable it to complete its state aid assessment. These new tools form part of the State Aid Modernisation initiative launched by the Commission in 2012 to allow it to concentrate its enforcement efforts on aid that is most liable to distort competition.

Further background

Since June 2013, the Commission has been investigating the tax ruling practices of Member States. It extended this information inquiry to all Member States in December 2014. The Commission also has three ongoing in-depth investigations where it raised concerns that tax rulings may give rise to state aid issues, concerning Apple in Ireland, Amazon in Luxembourg, and a Belgian tax scheme.

The fight against tax evasion and tax fraud is one of the top priorities of this Commission. In June 2015, the Commission unveiled a series of initiatives to tackle tax avoidance, secure sustainable tax revenues and strengthen the Single Market for businesses. The proposed measures, part of the Commission's s Action Plan for fair and effective taxation, aim to significantly improve the corporate tax environment in the EU, making it fairer, more efficient and more growth-friendly. Key actions included a framework to ensure effective taxation where profits are generated and a strategy to re-launch the Common Consolidated Corporate Tax Base (CCCTB) for which a fresh proposal is expected in the course of 2016. The Tax Transparency Package presented by the Commission in March also had its first success in October 2015 when Member States reached a political agreement on an automatic exchange of information on tax rulings following only seven months of negotiations. This legislation will contribute to bringing about a much greater degree of transparency and will act as a deterrent from using tax rulings as an instrument for tax abuse - good news for businesses and for consumers who will continue to benefit from this very useful tax practice but under very strict scrutiny in order to ensure a framework for fair tax competition.

The non-confidential version of the decisions will be made available under the case numbers SA.38375 (Fiat) and SA.38374 (Starbucks) in the State aid register on the DG Competition website once any confidentiality issues have been resolved. The State Aid Weekly e-News lists new publications of State aid decisions on the internet and in the EU Official Journal.

IP/15/5880

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Photos & Videos

- Fiat graph
- Starbucks graph

European Commission - Press release

State aid: Commission concludes Belgian "Excess Profit" tax scheme illegal; around €700 million to be recovered from 35 multinational companies

Brussels, 11 January 2016

The European Commission has concluded that selective tax advantages granted by Belgium under its "excess profit" tax scheme are illegal under EU state aid rules. The scheme has benefitted at least 35 multinationals mainly from the EU, who must now return unpaid taxes to Belgium.

The Belgian "excess profit" tax scheme, applicable since 2005, allowed certain multinational group companies to pay substantially less tax in Belgium on the basis of tax rulings. The scheme reduced the corporate tax base of the companies by between 50% and 90% to discount for so-called "excess profits" that allegedly result from being part of a multinational group. The Commission's in-depth investigation opened in February 2015 showed that the scheme derogated from normal practice under Belgian company tax rules and the so-called "arm's length principle". This is illegal under EU state aid rules.

Commissioner Margrethe Vestager, in charge of competition policy, stated: "*Belgium has given a select number of multinationals substantial tax advantages that break EU state aid rules. It distorts competition on the merits by putting smaller competitors who are not multinational on an unequal footing.*

There are many legal ways for EU countries to subsidise investment and many good reasons to invest in the EU. However, if a country gives certain multinationals illegal tax benefits that allow them to avoid paying taxes on the majority of their actual profits, it seriously harms fair competition in the EU, ultimately at the expense of EU citizens."

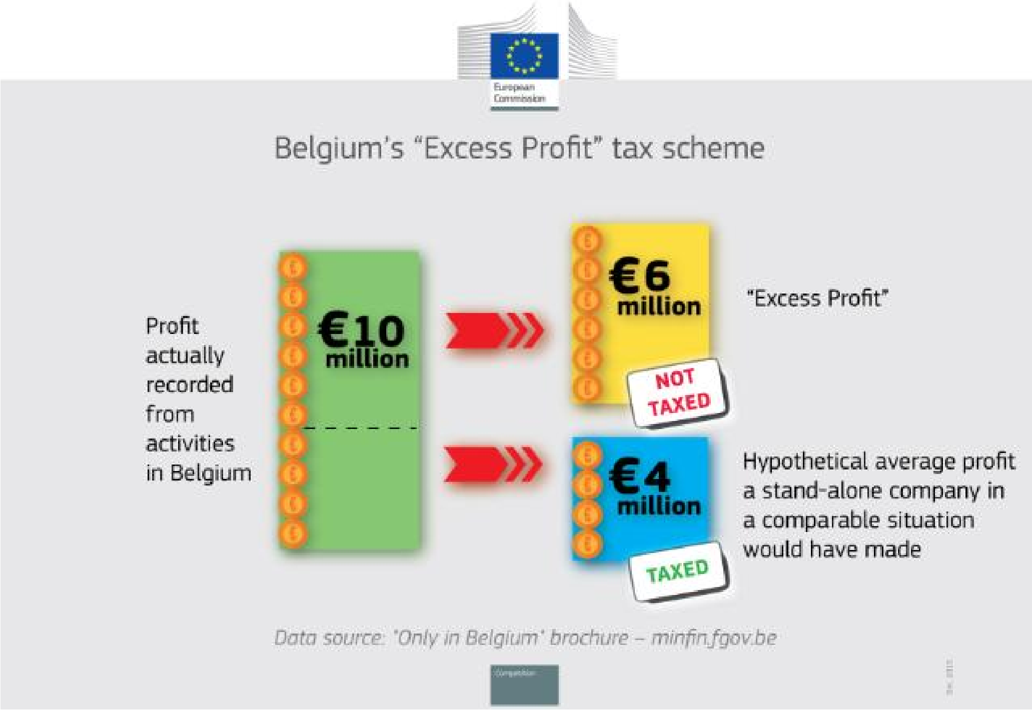
The "excess profit" tax scheme was marketed by the tax authority under the logo "Only in Belgium". It only benefitted certain multinational groups who were granted a tax ruling on the basis of the scheme, whilst stand-alone companies (i.e. companies that are not part of groups) only active in Belgium could not claim similar benefits. The scheme represents a very serious distortion of competition within the EU's Single Market affecting a wide variety of economic sectors.

The multinational companies benefitting from the scheme are mainly European companies, who also avoided the majority of the taxes under the scheme. The Commission estimates the total amount to be recovered from the companies to be around €700 million.

The Excess Profit scheme

Belgian company tax rules require companies to be taxed on the basis of profit actually recorded from activities in Belgium. However, the 2005 "excess profit" scheme, based on Article 185§2, b) of the 'Code des Impôts sur les Revenus/Wetboek Inkomstenbelastingen', allowed multinational companies to reduce their tax base for alleged "excess profit" on the basis of a binding tax ruling. These were typically valid for four years and could be renewed.

Under such tax rulings, the actual recorded profit of a multinational is compared with the hypothetical average profit a stand-alone company in a comparable situation would have made. The alleged difference in profit is deemed to be "excess profit" by the Belgian tax authorities, and the multinational's tax base is reduced proportionately. This is based on a premise that multinational companies make "excess profit" as a result of being part of a multinational group, e.g. due to synergies, economies of scale, reputation, client and supplier networks, access to new markets. In practice, the actual recorded profit of companies concerned was usually reduced by more than 50% and in some cases up to 90%.



The Commission's in-depth investigation showed that by discounting "excess profit" from a company's actual tax base, the scheme derogated both from:

- **normal practice under Belgian company tax rules**. It gives multinationals who were able to obtain such a tax ruling a preferential, selective subsidy compared with other companies. More specifically, at least 35 companies were given an unfair competitive tax advantage over, for example, any of their stand-alone competitors liable to pay taxes on their actual profits recorded in Belgium under the normal Belgian company tax rules; and
- the **"arm's length principle**" under EU state aid rules. Even assuming a multinational generates such "excess profits", under the arm's length principle they would be shared between group companies in a way that reflects economic reality, and then taxed where they arise. However, under the Belgian "excess profit" scheme such profits are simply discounted unilaterally from the tax base of a single group company.

The scheme's selective tax advantages could also not be justified by the argument raised by Belgium that the reductions are necessary to prevent double taxation. In fact, the adjustments were made by Belgium unilaterally, i.e. they did not correspond to a claim from another country to tax the same profits. The scheme does not require companies to demonstrate any evidence or even risk of double taxation. In reality, it resulted in double non-taxation.

The scheme therefore gives companies a preferential tax treatment that is illegal under EU state aid rules (Article 107 of the Treaty on the Functioning of the EU).

Recovery

Since the Commission opened its investigation in February 2015 Belgium has put the "excess profit" scheme on hold and has not granted any new tax rulings under the scheme. However, companies that had already received tax rulings under the scheme since it was first applied in 2005 have continued to benefit from it.

The Commission decision requires Belgium to stop applying the "excess profit" scheme also in the future. Moreover, in order to remove the unfair advantage the beneficiaries of the scheme have enjoyed and to restore fair competition, Belgium now has to recover the full unpaid tax from the at least 35 multinational companies that have benefitted from the illegal scheme. Which companies have in fact benefitted from the illegal tax scheme and the precise amounts of tax to be recovered from each company must now be determined by the Belgian tax authorities. The Commission estimates that it amounts to around €700 million in total.

Background

Since June 2013, the Commission has been investigating the tax ruling practices of Member States. It extended this information inquiry to all Member States in December 2014. In October 2015, the Commission has decided that Luxembourg and the Netherlands have granted selective tax advantages to Fiat and Starbucks, respectively. The Commission also has three ongoing in-depth investigations into concerns that tax rulings may give rise to state aid issues, concerning Apple in Ireland, Amazon in

Luxembourg and McDonald's in Luxembourg.

The fight against tax evasion and tax fraud is one of the top priorities of this Commission. The Tax Transparency Package presented by the Commission in March last year had its first success in October 2015 when Member States reached a political agreement on automatic exchange of information on tax rulings following only seven months of negotiations. This legislation will contribute to bringing about a much greater degree of transparency and will act as a deterrent from using tax rulings as an instrument for tax abuse - good news for businesses and for consumers who will continue to benefit from this very useful tax practice but under very strict scrutiny in order to ensure a framework for fair tax competition.

In June 2015, the Commission also unveiled a series of initiatives to tackle tax avoidance, secure sustainable tax revenues and strengthen the Single Market for businesses. The proposed measures, part of the Commission'- s Action Plan for fair and effective taxation, aim to significantly improve the corporate tax environment in the EU, making it fairer, more efficient and more growth-friendly. Key actions included a framework to ensure effective taxation where profits are generated and a strategy to re-launch the Common Consolidated Corporate Tax Base (CCCTB) for which a fresh proposal is expected in the course of 2016.

The Commission now plans to launch a further package of initiatives to combat corporate tax avoidance within the EU and throughout the world. The proposals will rest on the simple principle that all companies, big and small, must pay tax where they make their profits. The package will be presented on 27 January and will also set out a coordinated EU-wide approach for implementing good tax governance standards internationally.

The non-confidential version of the decisions will be made available under the case number SA.37667 in the State aid register on the DG Competition website once any confidentiality issues have been resolved. The State Aid Weekly e-News lists new publications of State aid decisions on the internet and in the EU Official Journal.

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