"TERRITORIAL" TAX REFORM: HOMELESS INCOME IS THE ACHILLES HEEL

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The U.S. is stuck in a frustratingly long period of economic stagnation.[1] In this environment, the paramount issue facing Congress and the Obama administration is job creation,[2] and the U.S. tax regime has been blamed for stymieing job creation by creating a competitive disadvantage for US multinational corporations.[3] At the same time, the U.S. fiscal deficit for 2011 is estimated to be $1.3 trillion, and deficits at this extraordinary level are widely believed to be unsustainable and will result in the country's financial ruin if left unaddressed.[4] Several presidential advisory panels have called for the adoption of a territorial tax regime,[5] and on October 26, 2011, Chairman Camp publicly released draft legislation that has set forth a statutory framework for just such a regime along with a technical explanation of the draft legislation.[6] The House Ways and Means

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1. *See* CONGRESSIONAL BUDGET OFFICE, 112TH CONG., THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE IX (Aug. 2011), http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf ("the pace of recovery has been slow, and the economy remains in a severe slump.").

2. *See Jobs & the Economy: Putting American Back to Work,* WHITEHOUSE.GOV, http://www.whitehouse.gov/economy/jobs (last visited Mar. 26, 2012); *see also* Press Release, H. WAYS AND MEANS COMM., *Camp Releases International Tax Reform Discussion Draft* (Oct. 26, 2011), http://waysandmeans.house.gov/News/DocumentSingle.aspx?DocumentID=266168 (claiming that adoption of a territorial tax regime as contemplated in the draft legislation would create 1 million U.S. jobs in the first year alone) (hereafter, "*Camp Releases International Tax Reform Discussion Draft*").

3. *See Camp Releases International Tax Reform Discussion Draft*, *supra* note 2 ("Instead of having laws on the books that encourage hiring U.S. workers, our outdated international tax system encourages employers to keep profits and jobs outside of America. If we are serious about creating a climate for job creation, now is the time to adopt tax policies that empower American companies to become more competitive and make the United States a more attractive place to invest and create the jobs this country needs."); *see also* Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of US Industries,* 63 TAX L. REV. 771, 771 (2010).

4. *See* CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE IX (Aug. 2011), http://www.cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf (providing economic projections and conclusions that the current budget deficits are not sustainable and create a risk of severe economic hardship).

5. *See* NAT'L COMM. ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH, 32-33 (Dec. 2010), http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform; PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, REP. ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION, 89 (Aug. 27, 2010), http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf.

6. H. WAYS AND MEANS COMM., 112TH CONG., 1ST SESS., TAX REFORM ACT OF 2011, TITLE III, §301-14 (Oct. 26, 2011) (hereafter, "**TRA 2011**") (proposed draft); H. WAYS AND MEANS COMM., 112TH CONG., 1ST SESS., TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME, I (Oct. 26, 2011), http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_—_Ways_and_Means_Participation_Exemption_Discussion_Draft.pdf (hereafter, the "**TRA 2011 Technical Explanation**").

Committee announcement that accompanied the release of the draft legislation indicates that the committee released this early draft because it wanted public input from stakeholders on the fundamental changes posited by the draft legislation.[7]

This article responds to this Congressional call for comments, and as such this paper has the sole objective of providing suggestions on how to improve the draft legislation so that it is workable. Thus, this paper does not attempt to address the broader question of whether a territorial tax regime is the optimal tax regime. That discussion is left for another day. Even so, as will be discussed in this paper, the draft legislation raises fundamental questions about the goals of the U.S. Subpart F regime and how the goals of that regime integrate with a territorial tax system. Furthermore, a territorial tax regime raises significant questions about how the United States should protect its territorial tax base from tax base erosion techniques.

However, before critiquing specific aspects of the draft legislation, it is instructive to review the historical responses to tax base erosion because an analysis of those historical responses provides insight into what does not work and what further targeted reforms are necessary. Thus, in **Section I** of this article, the tax base erosion techniques that have plagued the existing U.S. international tax regime are analyzed. Then, in **Section II**, this article explains why the extant U.S. international tax regime has failed to adequately address the tax base erosion techniques set forth in **Section I**. In **Section III,** this article analyzes the draft legislation and assesses how **TRA 2011** would fair under the tax base erosion techniques posited in **Section I** of this article. Most importantly, **Section III** concludes that **TRA 2011** provides the same fundamental tax base erosion opportunities as exist under current law. Consequently, if left uncorrected, the territorial tax regime posited by **TRA 2011** will be subjected to significant tax base erosion. Thus in **Section III**, this paper sets forth targeted solutions to the tax base erosion problems that exist under current law and are repeated in **TRA 2011**. Finally, in **Section IV**, this paper draws tentative conclusions about the way forward.

I. COMPETITIVENESS, NEUTRALITY, AND THE HOMELESS INCOME MISTAKE.

At the outset, it is helpful to recognize that a fundamental design weakness confronts any and all international tax regimes:

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7. *See Camp Releases International Tax Reform Discussion Draft*, *supra* note 2.

whenever effective tax rates in different countries differ among the impacted countries, it is impossible for any country, acting unilaterally, to design an international tax regime that achieves neutrality among all economic participants.[8] Thus, an intractable problem is created by cross-border activities because even the best designed international tax regime creates artificial "winners and losers" and can be attacked for creating "inequities." As a result, it is easy to disparage one's critics in this arena, but if understanding is going to be achieved it is helpful to remember that all international tax regimes must be devised based on second-best principles. Consequently, when we argue about international tax reform, we are arguing about which imperfect system is the most optimal but admittedly still distortive.

If a territorial tax regime were adopted, then parity can be achieved between U.S. multinational corporations ("**US MNCs**") and foreign multinational corporations ("**Foreign MNCs**") but such parity comes at the cost of creating a tax preference for certain overseas profits of US MNCs as compared to the tax treatment afforded to the domestic profits of U.S. corporations that earn all of their income within the United States ("**Domestic Business Entities**").[9] If, instead, a worldwide tax regime were adopted, then parity can be achieved between US MNCs and Domestic Business Entities, but such parity comes at the cost of creating a competitive disadvantage for US MNCs versus Foreign MNCs.[10] These two regimes can be summarized as follows:

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8. STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION SCHEDULED FOR A HEARING BEFORE THE HOUSE COMM. ON WAYS & MEANS 74 (JCX-40-99) (June 28, 1999) [hereinafter DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION].

9. This article will refer to a U.S. Corporation that only earns income within the United States as a "Domestic Business Entities."

10. *See* James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income* 62 TAX. L. REV. 269, 297-98 (2009) (considering a scholarship that argues that over the long-term, providing a tax advantage to Foreign MNCs destroys the U.S. corporate tax base); Mihir A. Desai & James R. Hines, *Evaluating International Tax Reform,* 56 NAT'L TAX J. 487, 499 (2003); Mihir A. Desai, *The Decentering of the Global Firm,* 32 THE WORLD ECONOMY 1271, 1282 (2008) ("In other words, saying an American corporation can't leave for Bermuda is a recipe for a foreign acquirer to buy the American Firm and achieve the same result in other ways."); Daniel N. Shaviro, *The Rising Tax-Electivity of US Corporate Residence,* 64 TAX L. REV. 377, 429-30 (2010) (noting that taxpayers are increasingly able to circumvent the U.S. system of worldwide residence-based corporate taxation by electing foreign corporate residence for U.S. income tax purposes, questions the sustainability of the current system, and concludes that the efficiency case for worldwide residence-based corporate taxation, based on the goal of capital export neutrality, is increasingly discredited); *see* Bret Wells, *What Corporate Inversions Teach Us About International Tax Reform,* 127 TAX NOTES 1345, 1367 (2010) [hereinafter *What Corporate Inversions Teach Us About International Tax Reform*]; Mihir A. Desai &

Territorial Tax Regime

Adantage:	Disadantage:
US MNC and Foreign MNC Neutrality The overseas profits of the US MNCs bear the same tax cost as the overseas profits of Foreign MNC competitors, thus preserving competitiveness of US MNCs vis-à-vis Foreign MNCs.	**Domestic Business Entity Non-Neutrality** If the overseas profits of US MNCs were lower-taxed versus the profits of Domestic Business Entities, a tax advantage would exist for generating overseas profits. This preference arguably places Domestic Business Entities at a competitive disadvantage and may create an incentive to migrate activities overseas.

Worldwide Tax Regime

Adantage:	Disadantage:
Neutrality With Domestic Business Entities If overseas profits of US MNCs are subjected to United States taxation on a current basis, then US MNCs bear the same worldwide tax cost on all of their global income, thus preserving horizontal equity between US MNCs and Domestic Business Entities.	**Non-Neutrality with Foreign MNCs.** If the extra-territorial business profits of US MNCs were subjected to significant additional United States taxation (either on a current or deferred basis), then US MNCs would have a competitive disadvantage versus Foreign MNCs (either on a current or deferred basis).

In **Section II,** this article will explore how the extant U.S. international tax regime has attempted to chart a middle course in an effort to mitigate the full impact of the disadvantages arising from either a worldwide tax regime or a territorial tax regime and why this middle course has proven to be unsatisfying

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Dhammika Dharmapala, *Do Strong Fences Make Strong Neighbors?* 63 NAT'L TAX J. 723, 738-39 (2010); Mihir A. Desai & James R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions,* 55 NAT'L TAX J. 409, 437 (2002).

and widely criticized.[11] However, in order to properly understand the evolution of this "middle course," it is important to understand the "**Homeless Income**" mistake.[12] Homeless Income refers to profits that are removed from the host country where the economic activity occurs and are instead diverted to a low-tax jurisdiction while avoiding taxation in the parent corporation's home country.[13] The income is "homeless" in the sense that it does not have a tax home either in the host country or in the home country of the ultimate parent corporation.[14] Homeless Income can be created through the use of an intermediate foreign subsidiary that is incorporated in a low-tax jurisdiction together with intercompany arrangements that shift profits and profit-making opportunities to the tax haven subsidiary. The planning opportunities that can be used to generate Homeless Income are more fully explained in the following **Illustration #1**.

> **Illustration #1:** In an effort to reduce foreign tax costs of the multinational group and yet defer the incidence of residual U.S. taxation, a US MNC establishes an intermediate foreign holding company ("IFHC") in a low-tax jurisdiction, and the IFHC then engages in the following "base erosion" strategies with affiliates operating in high tax jurisdictions. Examples of such "base erosion" strategies as that term is used in this paper include the following:

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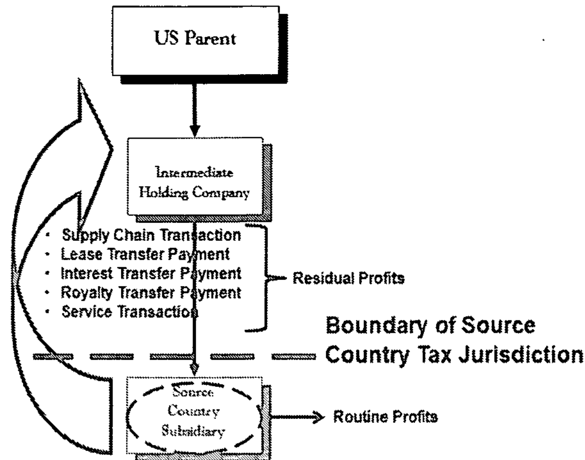
11. *Compare* Clifton J. Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption,* 59 EMORY L.J. 79, 149 (2009), *with* Tax Executive Institute, *Guideposts for Tax Reform,* 37 INS. TAX REV. 1124 (2009) (stating that the Subpart F regime is outmoded and anti-competitive).

12. In other writings, the author and Cym Lowell have argued that base eroding source countries was a purposeful goal that became the foundational premise of the post-World War I international tax policy objective. The Homeless Income mistake was a natural consequence of these early misguided policy goals. *See* Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin,* 65 Tax L. Rev. ___ (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1888397.

13. *Id.* at 7, n.14.

14. *Id.*

Illustration #1: US Multinational Structure



1. The IFHC leases tangible personal property (machinery and equipment) to foreign affiliates located in high tax jurisdictions and charges rent for this equipment **("Lease Stripping Transaction").**
2. The IFHC makes related party loans to fund the working capital and capital investment needs of the various affiliates located in high tax jurisdictions (**"Interest Stripping Transaction"**).
3. The IFHC obtains ownership of intellectual property and licenses the intellectual property to various foreign affiliates located in high tax jurisdictions for their use of the U.S. developed intellectual property (**"Royalty Stripping Transaction"**).
4. The IFHC, through a contract manufacturing arrangement with affiliates, obtains manufactured goods that are resold by the IFHC to other affiliates and thereby earns a significant profit due to its insertion into this intercompany trading pattern (**"Supply Chain Transaction"**).
5. The IFHC charges affiliates for management services, accounting and back-office support,

and risk management services and technical services ("**Service Stripping Transactions**").[15]

Each of the above base erosion techniques allows the IFHC to extract profits from affiliates[16] located in high tax jurisdictions and to earn this income in the low-taxed jurisdiction of the IFHC.[17] With respect to profits derived from transactions with U.S. affiliates (in particular, Supply Chain Transactions and Service Stripping Transactions),[18] such transactions directly reduce the U.S. tax base and can be structured to avoid any immediate United States tax cost until the earnings of the IFHC are repatriated back to the United States. IFHC structures are in vogue today.[19] The popular press has reported that Google[20]

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15. These base erosion techniques have been studied and well documented. *See e.g.*, JOINT COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING (JCX-37-10) (July 20, 2010); *see also* U.S. DEP'T OF THE TREASURY, REP. TO THE CONG. ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (2007).

16. Foreign MNCs can engage in each of the above base erosion strategies subject only to the United States transfer pricing rules of Section 482 except that **Interest Stripping Transactions** must also comply with Section 163(j)'s earning stripping rules, and U.S. withholding tax on outbound payment of interest, rentals, and royalties when not eliminated by treaty.

17. JOINT COMM., *supra* note 15; U.S. DEP'T OF THE TREASURY, *supra* note 15.

18. In the author's experience, U.S. MNCs do not generally use a foreign affiliate to receive rentals, interest, or royalties from the U.S. Parent or other U.S. affiliates. Presumably this is due to the Subpart F rules. *See* §952(a)(1) (Subpart F income includes foreign personal holding company income); §954(c)(1) (foreign personal holding company income includes, among other items, interest, royalties, and rents). *See also* §956 (loans to U.S. affiliates from controlled foreign corporations may give rise to a current inclusion in income), *but see* §954(c)(3) (providing that certain same country dividends, interest, rents, and royalties are not considered foreign personal holding company income); *and see* §952(b) (excluding U.S. source income from Subpart F income only if it is effectively connected income). Although it is true that some Supply Chain Transactions may be subject to immediate taxation under the Subpart F regime, various exceptions often apply. *See* Treas. Reg. §1.954-3(a)(1) through (a)(4). Moreover, U.S. MNCs can engage in Service Stripping Transactions with U.S. or foreign affiliates because managerial services can be charged to the U.S. affiliate without creating a Subpart F inclusion by reason of the related party services income provisions of §954 if those services are performed within the country of the service provider's incorporation. *See* Section 954(e)(1)(B); Treas. Reg. §1.954-4(a)(2). The ineffectiveness of the U.S. Subpart F regime to provide an adequate backstop to tax base erosion will be further explored in detail in **Section II.A** of this paper.

19. *See* Dolan, Jackman, Dabrowski & Tretiak, US Taxation of International Mergers, Acquisitions and Joint Ventures at ¶26.

20. Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG (October 21, 2010), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html; *see also* John Sokatch, *Transfer-Pricing With Software Allows for Effective Circumvention of Subpart F Income: Google's "Sandwich" Costs Taxpayers Millions*, 45 INT'L LAW. 725, 726-27 (2011).

and General Electric[21] have dodged their U.S. tax obligations by the use of IFHC structures located in tax haven subsidiaries, and the Obama Administration has claimed that large US MNCs are shirking their responsibility to pay their fair share of taxes.[22] As the following discussion will indicate, artificial income shifting to tax haven jurisdictions is an issue that has frustrated Congress for at least fifty years and has been the flashpoint for public outrage.[23] Recent empirical evidence suggests that large amounts of income are being earned in tax haven subsidiaries that may

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21. *See e.g.*, David Kocieniewski, *At G.E. on Tax Day, Billions of Reasons to Smile*, N.Y. TIMES, March 25, 2011, at A1.

22. The essence of President Obama's explanation of the current situation was that many American taxpayers are "shirking" their responsibilities, and that the U.S. tax code is "a broken system, written by well-connected lobbyists on behalf of well-heeled interests and individuals."

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

See Obama Unveils Far-Reaching Proposals to Crack Down on Offshore Tax Abuses, BNA Daily Tax Rep., May 5, 2009, at GG-1.

23. *See* Michael C. Durst, *"The Urgency—and Challenges—of International Reform,"* 131 TAX NOTES 1277, 1277-78 (June 20, 2011) frames the case as well as anyone in the following statement:

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

have little or no substance.[24] An international tax regime (whether a territorial tax regime or a worldwide tax regime) that fails to accurately attribute income to the correct taxing jurisdiction and allows significant profits to become Homeless Income is a regime that is subject to ridicule and will be the subject of repeated calls for reform.[25] It is, therefore, instructive to determine why the current international tax regime has failed the Homeless Income test in order to assess whether the proposed territorial tax regime will fare any better and in order to determine where further targeted reform is needed.

However, before analyzing the root causes of the Homeless Income mistake, the author wants to make clear at the outset that he does not want to fan the flames against MNCs and has tried to avoid his own use of inflammatory language. Allegations against MNCs of "shirking," "dodging," and lack of patriotism are at risk of overlooking the long-standing precept that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, cannot be doubted,"[26] a precept that most members of the public presumably apply in arranging their own affairs. Instead of blaming MNCs for engaging in conduct that is encouraged under current law, a more constructive approach is to identify the aspects of current law that reward the creation of Homeless Income so that needed reforms can be targeted to that mistake.[27] Thus, the author's desire is to take a dispassionate look at what creates Homeless Income without clouding the inquiry by examination of motives of MNCs, their good faith, or similar concepts. Under current law, the playing field is decidedly unlevel with respect to similarly situated taxpayers and the U.S.

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24. Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, TAX NOTES, Mar. 28, 2011, at 1580-81, 1584-86; Martin A. Sullivan, *Transfer Pricing Costs U.S. at Least $28 Billion*, TAX NOTES, Mar. 22, 2010, 1439, at 1441; Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized,* (U.S. Treasury Department Office of Tax Analysis Working Paper, Paper No. 103, 2012).

25. *See e.g.*, J. Richard Harvey Jr., *US MNC's Offshore Operations: An Unbiased View*, 134 TAX NOTES 121, 126 (2012).

26. *Gregory v. Helvering*, 293 U.S. 465 (1935); *see also, e.g.*, *Commissioner of Internal Revenue v. Newman,* 159 F.2d 848, 850–51 (2d Cir. 1947) (L. Hand, J., dissenting) ("Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.").

27. *See* Myron S. Scholes et al., Taxes and Business Strategy: A Planning Approach 10-14 (3d ed. 2005) (authors attempt to show the microeconomic effect of tax laws on firm behavior).

tax base is not adequately protected. As will be discussed in this paper, the draft legislation's proposal to continue and enhance the U.S. Subpart F regime causes the playing field to remain unlevel and also fails to appropriately protect the U.S. tax base from tax base erosion. Once one understands why the Subpart F regime has failed as a backstop regime, then policy-makers can apply that learning towards creating a response that can solve the Homeless Income problem.

II. CURRENT U.S. INTERNATIONAL TAX REGIME.

Since the inception of the corporate and individual income taxes, the U.S. has taxed the worldwide income of U.S. corporations[28] and of its citizens.[29] However, as a general rule, prior to 1962,[30] the U.S. has not generally taxed the income of foreign subsidiaries until the earnings and profits are distributed to the U.S. shareholder (called the "deferral privilege"). The historical record is not entirely clear as to why Congress originally chose to allow the income of foreign subsidiaries to escape immediate U.S. taxation and thus allow the U.S. parent to enjoy a deferral privilege with respect to the foreign subsidiary's profits,[31] but Professor Stanley Surrey in 1956 indicated that the deferral privilege afforded to foreign subsidiary income was "kept so far in the background that Congress is hardly aware of its own generosity."[32]

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28. Revenue Act of 1909, §38, 36 Stat. 11, 112 (1909).

29. Revenue Act of 1916, § 1(a), 39 Stat. 756 (1916).

30. In 1937, Congress enacted the foreign personal holding company rules in order to tax the earnings of certain "offshore pocketbooks." *See* Revenue Act of 1937, § 201, 50 Stat. 813, 818 (1937). These rules only applied, however, if the foreign subsidiary was owned directly or indirectly by five or fewer U.S. individuals. *Id.*

31. *See* Jasper L. Cummings, Jr., *Consolidating Foreign Subsidiaries,* 11 FLA. L. REV. 143, 195-96 (2011).

32. Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 COLUM. L. REV. 815, 826 (1956). However, after noting the significant deferral benefit set forth in the main text, Professor Surrey went on to state his belief in the appropriateness of the deferral privilege as follows:

> The result [of the deferral privilege] is a sensible accommodation of our world-wide income rule to the fact that our foreign investments are subject to taxation at the source. If there are appreciable tax advantages to be obtained by insulating foreign profits as earned from the United States tax, the United States tempers its world-wide income rule to permit the taxpayer by foreign subsidiary operation to obtain those advantages. The United States could pierce through the foreign subsidiary and tax its profits to the parent as earned. It chooses instead to recognize the foreign subsidiary and to defer the taxation of those profits until the subsidiary passes them along to the United States parent. At this point they become commingled with other United States income and are subject to the United States tax under the world-wide income rule.

Yet, despite claiming that this deferral privilege had been unseen in past times from a legislative perspective, Professor Surrey argued in his 1956 writings that the deferral privilege created the "foreign subsidiary rule" and posited that this so-called "foreign subsidiary rule" vested the U.S. shareholder in **Illustration #1** with ultimate control over the timing of the U.S. taxation of the foreign subsidiary earnings and as such represents a significant concession to worldwide taxation.[33] Professor Surrey explored the use of tax haven holding company subsidiaries in his 1956 writings and indicated that the use of tax haven subsidiaries were common and allowed the controlling U.S. shareholder to reinvest foreign subsidiary earnings into lower-tier foreign subsidiaries, thus indefinitely extending the financial benefit associated with the deferral privilege.[34] In effect, the U.S. shareholder could gain a permanent tax advantage through the deferral privilege by reason of the foreign subsidiary rule, which in Professor Surrey's opinion had never been explicitly sanctioned by Congress.[35] However, Professor Surrey's writings accepted that the deferral privilege was a

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Id. at 827-28. However, by 1970, Professor Surrey classified the deferral privilege as a "tax expenditure" and advocated generally that such tax expenditures should be eliminated. *See* Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance,* 84 HARV. L. REV. 352, 356 (1970). The Staff of the Joint Committee on Taxation is ambiguous on the point as to what constitutes the general rule for taxing foreign earnings and simply characterizes the deferral privilege as a "tax-induced structural distortion" while the Treasury Department continues to treat the deferral privilege as a tax expenditure. *Compare* STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 41 (2008); and *with* BUDGET OF THE U. S. GOV'T, FISCAL YEAR 2009 ANALYTICAL PERSPECTIVES 288 (2008).

33. *See* Surrey, *Current Issues in the Taxation of Corporate Foreign Investment, supra* note 32, at 827-28. Other writers who have also discussed the tax have subsidiary techniques prior to Professor Surrey's published work. *See e.g.*, William J. Gibbons, *Tax Effects of Basing International Business Abroad,* 69 HARV. L. REV. 1206 (1956) (identifying techniques to divert profits to base companies located in tax havens); Orrie P. Stevens, *A Current Appraisal of Foreign "Base Companies"*, 40 TAXES 117, 117-19 (1962). However, this paper focuses specifically on Professor Surrey's comments on the subject because he held the position of Assistant Secretary of the Treasury for Tax Policy from 1961-1969 and was instrumental in the development of the Subpart F regime.

34. *See* Surrey, *Current Issues in the Taxation of Corporate Foreign Investment, supra* note 32, at 829-30.

35. *Id.* at 826-36.

reasonable tax policy objective[36] but cautioned that it should not extend to tax haven arrangements.[37]

A. *Subpart F: Then and Now.*

In 1960, Representative Hale Boggs proposed legislation that would extend the deferral privilege to foreign branches of U.S. corporations in a bill that was entitled the Foreign Investment Incentive Act of 1960.[38] In consideration of that proposed legislation, the House Ways and Means Committee held extensive hearings on international tax reform.[39] The deferral privilege was discussed extensively in these hearings, and the committee received extended testimony from industry participants to the effect that the deferral privilege was essential for US MNC competitiveness, and the committee report endorsed this conclusion by stating that "the postponement of American tax as long as funds are used in foreign operations is necessary to place the U.S. corporation operating abroad on a competitive basis with other corporations (either U.S.- or foreign-owned)."[40] In contradiction to Professor Surrey's assertion in his 1956 writings that the deferral privilege had been "kept so far in the background that Congress is hardly aware of its own generosity," the committee report stated that the deferral privilege represented a purposeful policy goal of the American government

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36. *See* Stanley S. Surrey, *United States Taxation of Foreign Income,* 1 J.L. & ECON. 72, 77-78, 94 (1959) ("[o]n this question, tax history, the fact that the organization of so much of our foreign investment is built on this rule [i.e., the deferral privilege], and the desirable accommodation to international relationships which it produces, all favor continuance of the rule"); Surrey, *Current Issues in the Taxation of Corporate Foreign Investment, supra* note 32, at 827, 829-30.

37. *See* Surrey, *United States Taxation of Foreign Income, supra* note 36, at 94 n.31 ("But this does not mean that every application of the rule is proper. Thus, the recent use of Canadian investment companies, essentially American-managed and American-owned, as a vehicle for the accumulation of profits so that the American shareholders need pay only capital gain taxes raises a very serious problem, since the arrangement by-passes all of our tax provisions designed to present investment income from being turned into capital gain.").

38. HALE BOGGS, FOREIGN INVESTMENT INCENTIVE TAX ACT OF 1960, H.R. REP. NO. 86-1282, at 1 (1960).

39. *See, e.g.,* FOREIGN INVESTMENT INCENTIVE ACT: HEARINGS BEFORE THE COMM. ON WAYS AND MEANS, 86TH CONG. iii–xiii (1959); *The National Foreign Trade Council, Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F,* 39-41, http://www.nftc.org/default/tax/fip/NFTC1a%20Volume1_part1.pdf (last visited April 1, 2012).

40. *See* HALE BOGGS, FOREIGN INVESTMENT INCENTIVE TAX ACT OF 1960, H.R. REP. NO. 86-1282, at 1 (1960).

since at least 1949 and had been the subject of President Eisenhower's 1954 budget message.[41]

According to the committee report, the deferral privilege was a necessary and desirable objective, and as a result, the committee report endorsed the effort by Foreign Investment Incentive Tax Act of 1960 to extend this deferral privilege to the branch income of certain U.S. corporations that were classified as "foreign business corporations" so that branch income would not be taxed less favorably than income earned through foreign subsidiaries.[42] The committee report in 1960 ignored the Homeless Income problem posited in **Illustration #1** and emphasized the need for US MNC competitiveness vis-à-vis Foreign MNCs and minimized concerns that Domestic Business Entities would be disadvantaged vis-à-vis their US MNC competitors due to the proposed expansion of the deferral privilege to cover branch income. The Foreign Investment Incentive Act of 1960 was not enacted, but the result of the committee hearings and the committee report was that the deferral privilege, competitiveness, and neutrality were now front and center in the legislative mind-set.[43]

On April 20, 1961, President Kennedy announced a new major tax reform initiative that included accelerated depreciation rules, an investment tax credit, and the elimination of the deferral privilege with respect to "tax haven" subsidiaries and with respect to income earned in the developed countries of Europe while retaining the deferral privilege with respect to business profits earned in underdeveloped countries.[44] The House Ways and Means Committee again held hearings on international tax reform just one year after it had issued its committee report with respect to the Foreign Incentive

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41. *See* HALE BOGGS, FOREIGN INVESTMENT INCENTIVE TAX ACT OF 1960, H.R. REP. NO. 86-1282, at 2 (1960).

42. HALE BOGGS, FOREIGN INVESTMENT INCENTIVE TAX ACT OF 1960, H.R. REP. NO. 86-1282, at 1-2 (1960). This proposed legislation recognized that a potential tax disadvantage might exist between US MNCs and U.S. domestic corporations, and the legislation proposed to carefully define the branch activities that would be entitled to tax deferral "to be sure that the bill does not provide a tax deferral for American corporations in situations where other U.S. corporations operating in this country are paying tax currently." It is a great irony of history that the provisions of this act were to be codified as Sections 951 through Section 958 where just two years later the controlled foreign corporation rules would instead be placed.

43. *See The National Foreign Trade Council, Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F,* 39,-46 http://www.nftc.org/default/tax/fip/NFTC1a%20Volume1_part1.pdf (last visited April 1, 2012).

44. *See* Special Message to the Congress on Taxation, 1961 PUB. PAPERS 290 (Apr. 20, 1961).

Investment Act of 1960, but the policy recommendations this time were remarkably different and diametrically opposed to the ones endorsed just one year earlier.[45] This time, the Homeless Income mistake was front and center in the policy discussion on the appropriate scope of the U.S. international tax regime.[46]

In the course of extended testimony, Secretary of the Treasury Dillon defended the Kennedy administration's Subpart F proposals as a means to deal with the inappropriate transfer pricing results that arose with tax haven subsidiaries.[47] Secretary Dillon testified that "the reductions in tax that can be achieved through the use of tax haven operations assume that the income attributed to the tax haven companies [sic] are fair and reasonable" and then stated that the problem is that "the incomes are often allocated to tax haven companies which are not economically justified,"[48] thus taking square aim at the income shifting and base erosion opportunities afforded to taxpayers in **Illustration #1.** Similarly, IRS Commissioner Chapman testified that the IRS believed that Section 482 was not effectively protecting the U.S. tax jurisdiction from tax haven subsidiary opportunities,[49] thus arguing that the Homeless

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45. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. (1961), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

46. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. ** (1961), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

47. As a matter of historical irony, it is fascinating to compare Secretary Dillon's testimony in the 1961 hearings to his testimony in the 1959 hearings on the Foreign Incentive Investment Act of 1960. In the earlier 1959 hearings, Mr. Dillon was then Undersecretary of State and in that role he strongly supported the deferral privilege and said it was the most important tax policy measure to promote private enterprise and to combat communism during the Cold War and that he could not understand why the Treasury Department would oppose deferral except for revenue desires. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 78-80 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985). The stark reversal of opinion by Secretary Dillon demonstrates on a micro level the overall stark reversal of direction that the 1961 hearings were creating on a macro level.

48. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 29 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

49. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong., 3549 (1961) (statement of M. Chapman, IRS Commissioner), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co.,

Income mistake made possible in **Illustration #1** required a further legislative response.

In response to detailed questioning by Representative Boggs on why Secretary Dillon now decided to not endorse the extension of deferral as contemplated in the "foreign business corporations" concept set forth in the Foreign Investment Incentive Act of 1960 and instead proposed a curtailment of deferral through the proposed new Subpart F regime, Secretary Dillon pointed at the Homeless Income problem as the reason for his policy reversal, stating that "the tax haven thing became a much bigger problem last year than we were aware of" and also stating that "U.S. tax haven companies increased by a third in one year."[50] Secretary Dillon alleged that the explosive growth of tax haven subsidiaries was "a very recent and growing phenomenon."[51] The Kennedy administration's Subpart F proposal was motivated by a "general objective of getting at this basic tax haven problem and does not hurt or affect the corporation, which is operating in a country with a tax structure similar to ours."[52] In response to Representative Boggs' questions about the competitiveness concerns raised by the Subpart F regime, Secretary Dillon cast the tax haven problem as predominately an American business problem, stating that European companies "have not been quite as rapid as our American businessmen to discover the tax benefits there [in Switzerland]" and that over one-third of controlled foreign corporations that were owned by U.S. corporations were incorporated in Switzerland and were incorporated within the

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Inc., 17th ed. 1985); 107 CONG. REC. 6456, 6458 (1961) (Federal Tax System—Message From the President of the United States).

50. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 305 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985). Again, it is fascinating to read these statements as a possible explanation for reconciling Secretary Dillon's testimony to limit deferral when he had argued for the opposite policy goal of expanding deferral in the hearings with respect to the Foreign Investment Incentive Act of 1960. *See infra* note 47.

51. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 349 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

52. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 343, 345 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

last year.[53] In later testimony, Secretary Dillon indicated that dealing with tax havens was a uniquely American problem because European corporations could not utilize tax haven companies given the "management and control test" used in some countries (such as Germany) and exchange control restrictions that existed in other parts of Europe (such as France).[54] Thus, Secretary Dillon alleged that "American companies make much greater use of these tax haven facilities that are available in Switzerland than do foreign-owned companies, German companies, French companies, and so forth," and so taking away the deferral privilege did not create a competitive issue since European-based multinationals could not avail themselves of the use of Switzerland as could US MNCs.[55] Secretary Dillon understood that an expansive Subpart F regime would create a disadvantage for US MNCs vis-à-vis Foreign MNCs, but Secretary Dillon indicated that it was impossible to achieve equity among all economic participants and that it was more important to preserve neutrality between US MNCs and Domestic Business Entities than between US MNCs and Foreign MNCs.[56] Secretary Dillon stated that if "another fair way or a

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53. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 303 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

54. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 344 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

55. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 349 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

56. In 1961, then Treasury Secretary Dillon stated as follows:

> "There is a problem there, a question of where you are going to have your tax neutrality, whether it is going to be a tax neutrality of the sort you have outlined [i.e., between U.S. MNCs and Foreign MNCs], or neutrality in considering whether an investment should be made in the United States or abroad.
>
> It is impossible to devise a system that will have it both ways and we consider that, due to our balance-of-payments situation, due to the strength of these advanced countries in Europe, that it is more equitable to have neutrality between investment in United States and investment in these areas."

See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means, 87th Cong. 349 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

reasonably simple way" of addressing the tax haven problem could be found, then that "would take care of the bulk of what we are worrying about."[57] The next day, Secretary of Commerce Grudeman reiterated the charge that "the various paper transactions serve as a medium by which large sums [of income] are diverted from the U.S. tax base" and into the hands of tax haven subsidiaries.[58] Furthermore, Secretary of Commerce Grudeman reiterated the belief that ending deferral was not a significant competitive issue because European-based multinationals did not use tax haven subsidiaries to the extent that U.S. multinationals used such vehicles and European-based multinationals were the main competitors to U.S. MNCs.[59] The Joint Committee on Taxation presented a report detailing the base erosion strategies like those set forth in **Illustration #1** that were utilized by "two actual international corporations, which are subsidiaries of large American corporations" that shifted income to tax haven subsidiaries like IFHC in **Illustration #1.**[60] A prominent Chicago attorney touted the benefits of using **Supply Chain Transactions** to route profits into tax haven subsidiary companies, and large US MNCs (such as DuPont) attempted to shift significant profits to tax-haven Swiss companies.[61] Thus, a growing concern was mounting that

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57. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 345 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985). The proposed "**Base Protecting Surtax**" set forth in **Section III.B.1** of this article is "another fair or reasonably simple way" of addressing the Homeless Income problem and as such should be considered acceptable in terms of the policy criteria articulated in the 1962 Hearings since the **Base Protecting Surtax** "takes care of the bulk of what [Secretary Dillon and the Kennedy administration] was worrying about." As more fully explained in **Section III.B.1** of this paper, this alternative approach to the Homeless Income problem is a superior proposal compared to the enhanced Subpart F backstop regime contemplated by **TRA 2011**.

58. *See President's 1961 Tax Recommendations: Hearings Before the H. Comm. on Ways and Means*, 87th Cong. 416 (1961) (statement of Secretary Grudeman), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

59. *See President's 1961 Tax Recommendations: Hearings Before the H. Comm. on Ways and Means*, 87th Cong. 416 (1961) (statement of Secretary Grudeman), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

60. *See* STAFF OF THE JOINT COMMITTEE ON INTERNATIONAL REVENUE TAXATION, TAX EFFECTS OF CONDUCTING FOREIGN BUSINESS THROUGH FOREIGN CORPORATIONS, at 9-18 (JCS-5-61) (1961) (setting forth base erosion opportunities used with two actual U.S. multinational corporations).

61. DuPont attempted to shift approximately half of their profits in 1959 and 1960 to a Swiss tax-haven subsidiary that had little substance based on advice from Russell Baker, a prominent Chicago tax attorney who co-founded a leading global law firm. *See* E.I. Du Pont de Nemours and Co. v. United States, 78-1 U.S.T.C. ¶9374 (Ct. Cl. 1978)

the U.S. transfer pricing rules were not sufficient to prevent inappropriate income-shifting of profits away from the country where the economic activity occurred, and the proposed Subpart F regime was seen as an important "backstop" to prevent these abuses.

Notwithstanding the Kennedy administration's efforts to end the deferral privilege with respect to tax haven subsidiaries and income earned from developed countries in Europe, Secretary Dillon made it clear that the Kennedy administration continued to support the deferral privilege with respect to income earned in lesser-developed countries.[62] The complexity of defining a "developed country" from an "undeveloped country" received considerable discussion in the committee hearings.[63]

Numerous industry groups fiercely opposed the Subpart F regime. For example, Henry J. Heinz II on behalf of the H.J. Heinz Company and a coalition of other US MNCs argued that the deferral privilege with respect to foreign subsidiary earnings in the developed countries in Europe was critical to the continued competitiveness of US MNCs.[64] Now that Professor Surrey was

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(finding as a factual matter the prominent role of Mr. Baker's views on the resulting tax planning efforts of DuPont); *see also* Russell Baker, *Federal Taxation of Income From Foreign Sources,* 8 Tax Exec. 103 (1955) (detailing under then existing law, the opportunities for U.S. tax base erosion strategies like those set forth in Illustration #1). The taxpayer eventually lost the *DuPont* case twenty years later in 1979. *See* E.I. Du Pont de Nemours and Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979). But, in the intervening twenty year period, the government was concerned that the transfer pricing rules may not adequately address cases such as the *DuPont* case, and so Congress enacted the Subpart F regime as a "backstop" regime to counteract this type of tax planning that might not have been adequately addressed under Section 482. Professor Kingson has made the point that Mr. Baker's firm has continued to play a prominent role in significant transfer pricing cases. *See* Charles Kingson, *The Great American Jobs Caper,* 58 Tax L. Rev. 327, 333-334 (2005) (connecting this firm to the transfer pricing cases of *Bausch & Lomb, Inc. v. Comm'r,* 933 F.2d 1084 (2d Cir. 1991); *Dresser Industries v. Comm'r,* 911 F.2d 1128 (5th Cir. 1990); *Eli Lilly v. Comm'r,* 856 F.2d 855 (7th Cir. 1988); *Stokely-Van Camp, Inc. v. United States,* 21 Cl. Ct. 731 (1990)).

62. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means,* 87th Cong. 260 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

63. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means,* 87th Cong. 304-07, 327 (1961) (statement of Hon. C. Douglas Dillon, Secretary of the Treasury), *reprinted in* Reams, U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (Bernard D. Reams, Jr. ed., Volume 17, 1985).

64. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means,* 87th Cong. 3186 (1961) (statement of H. J. Heinz II, Industry Committee of Foreign Investments, Accompanied by Counsel, George Nebolsine, of Coudert Bros., and Albert E. Sawyer, of Albert E. Sawyer Co., Accountants before House Committee on Ways and Means), *reprinted in* BERNARD D. REAMS, JR., U.S. REVENUE

Assistant Secretary of the Treasury, at least one witness attempted to impeach the Kennedy administration's proposed Subpart F reforms by citing Professor Surrey's scholarship where he said that the deferral privilege was a "reasonable accommodation" for the competitiveness concerns of US MNCs operating in developed countries in Europe.[65]

In the end, as a result of the Kennedy administration's forceful testimony regarding the transfer pricing abuses that were available to tax haven subsidiaries (such as the IFHC posited in **Illustration #1**),[66] the House Ways and Means Committee wanted to adopt a Subpart F regime to attack the tax haven subsidiary problem, but at the same time it did not want to repeal the deferral privilege outside of that tax abuse context because doing so would potentially create a competitive disadvantage for US MNCs vis-à-vis Foreign MNC competitors.[67] Consequently, the resulting House bill departed from the Kennedy administration's original proposal in that it did not end deferral for all tax haven subsidiaries.[68] Instead, the House bill viewed the Subpart F regime as an important "backstop" to protect against inappropriate transfer pricing results.[69] Furthermore, the House bill proposed to amend Section 482 to require formulary apportionment as an additional means of dealing with inappropriate diversion of U.S. origin profits into tax haven subsidiaries but refused to repeal the deferral privilege outright.[70] In combination, these proposed legislative changes were believed to address the income shifting opportunities afforded to tax haven subsidiaries as depicted in **Illustration #1** while not disturbing the competitive posture of US MNCs. The House bill, therefore, can be viewed as endorsing the deferral privilege except where there was evidence that the transfer pricing rules were not sufficient to prevent income-shifting to tax haven subsidiaries such as the IFHC in **Illustration #1**.

ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (William S. Hein & Co., Inc., 17th ed. 1985).

65. *See President's 1961 Tax Recommendations: Hearing Before the H. Comm. on Ways and Means*, 87th Cong. 3212 (1961) (statement of George Boyd, Jr., Counsel, American Paper & Pulp Association, quoting Professor Surrey's 1959 article cited *infra* note 36), *reprinted in* Reams, U.S. REVENUE ACTS: 1953-72 LEGISLATIVE HISTORIES, LAWS & CONGRESSIONAL DOCUMENTS (Bernard D. Reams, Jr. ed., Volume 17, 1985). It is important to note that Mr. Boyd failed to indicate that Professor Surrey had questioned whether the deferral privilege should exist for tax haven subsidiaries.

66. *See* H. COMM. ON WAYS AND MEANS, H.R. REP. NO. 1447, at 28 (1962).

67. *See* H. COMM. ON WAYS AND MEANS, H.R. REP. NO. 1447, at 28 (1962).

68. H. COMM. ON WAYS AND MEANS, H.R. REP. NO. 1447, at 57-58 (1962).

69. H.R. REP. NO. 87-1447, at 28 (1962).

70. H.R. REP. NO. 87-1447, at 29.

The Senate bill modified the House bill in several respects, but again the same desire to prevent the inappropriate shifting of income to "tax haven" subsidiaries was the organizing principle that supported the new Subpart F regime.[71] But, the Senate bill deleted the proposed amendment to Section 482.[72] In addition, the final Conference bill reconciled some minor differences between the House and Senate versions and the resulting provisions gave the "controlled foreign corporation" rules that formed the basis of Subpart F.[73]

A steady stream of scholarship has repetitively called for ending the deferral privilege outright.[74] Several legislative

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71. S. REP. NO. 87-1881, at 78-80 (1962).

72. H.R. REP. 87-2508, at 18 (1962). The conference report asserted that the Treasury Department already had regulatory authority under Section 482 to promulgate regulations that would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income. The Service responded to this Congressional call for change to the §482 regulations, which had remained essentially unchanged since 1935, by issuing proposed regulations in 1965, which proposed regulations were withdrawn and reproposed in 1966, and then were issued in final form in 1968. Treas. Reg. §§ 1.482-1(d), 1.482-2, 30 Fed. Reg. 4256 (1965); Prop. Reg. §§ 1.482-1(d), 1.482-2, 31 Fed. Reg. 10,394 (1966); and T.D. 6952, 1968-1 CB 218. The final regulations issued in 1968 reaffirmed the arm's length standard as the principal basis for transfer pricing adjustments, but attempted, for the first time, to establish rules for specific kinds of intercompany transactions applying to Supply Chain Transactions, Lease Transfer Payments, Interest Transfer Payments, Royalty Transfer Payments, and Service Transactions. Treas. Reg. §1.482-1(a)-(b) (1968); Treas. Reg. §1.482-2(a) through (e) (1968). See also T.D. 6952, 1968-1 C.B. 218. In the final regulations, the Treasury Department rejected Congress' invitation to abandon its separate entity approach to transfer pricing; instead, the Treasury Department re-endorsed the separate entity approach and for the first time articulated three transactional methods (the comparable uncontrolled pricing or "CUP," the resale-profit or "RPM," and the cost-plus method) that should be used as the primary methods for determining the arm's length nature of related party transactions. It would not be until 1986 that Congress would return to this question and require a **Two-Sided TP Methodology** by amending Section 482 to require a "commensurate with income test" for intangibles and for Congress to recommend that the Treasury Department provide a study on intercompany transfer pricing regime. *See* STAFF OF JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1016–1017 (1986). The term "**Two-Sided TP Methodology**" refers to a transfer pricing methodology that treats all related parties as "tested parties" and includes such methods as a profit split methodology (either a comparable profit split or a residual profit split methodology). *See* Treas. Reg. §1.482-6. The transformative and revolutionary nature of the explicit adoption of profit split methodologies into the US transfer pricing rubric cannot be overstated. *See* Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Revolution of US International Taxation,"* 15 Virginia Tax Review 89, 135 (1995). An analysis of why the United States for so long endorsed transactional transfer pricing methodologies that tested only "one party" in the MNC context has been exhaustively considered by the author and a co-author in Wells & Lowell, *"Homeless Income: Collection at Source is the Linchpin,"* 65 Tax L. Rev. ___ (forthcoming 2012).

73. For a discussion of the variations in the House and Senate bills and their reconciliation in conference, *see* H.R. REP. 87-2508, at 29-36.

74. *See* Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 31 TAX NOTES INT'L 1177, 1207 (2003); Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Getting Serious*

attempts since 1962 were made to entirely repeal the deferral privilege with respect to foreign subsidiary earnings, but none of these proposals were ever enacted.[75] However, although Congress has never endorsed the repeal of the deferral privilege outright, it has expanded the scope of the Subpart F regime when Congress believed that a stronger "backstop" was needed to prevent inappropriate income-shifting to the IFHC in **Illustration #1** or when some other non-tax policy objective was at stake. For example, in 1975, Congress decided to expand the scope of Subpart F income to include certain shipping income,[76] which is a particular portable type of income.[77] In 1976, Congress expanded the definition of Subpart F income to include income earned from participating in an unsanctioned international boycott[78] in order to promote non-tax foreign policy objectives of the U.S. government. In 1982, Congress expanded the scope of Subpart F income to include "foreign base company oil related income."[79] In 1986, Congress expanded the scope of the types of shipping income subject to Subpart F income and also extended the scope of the foreign personal holding company income regime to include certain income from commodity sales,

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About Curtailing Deferral of US Tax On Foreign Source Income, 52 SMU L. REV. 455, 458 (1999); *see, e.g.*, Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check- the-Box*, 74 TAX NOTES 219, 224 (1997); Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401, 1422 (1996); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (1990); Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 75 (1993); John McDonald, Comment, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 NW. J. INT'L L. & BUS. 248, 281 (1995); Peter Merrill & Carol Dunahoo, *Runaway Plant' Legislation: Rhetoric and Reality*, 72 TAX NOTES 221, 221 (1996); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1061 (1996); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062, 1063 (1988). Lee Sheppard, Last Corporate Taxpayer Out the Door, Please Turn Out the Lights, 82 TAX NOTES 941, 944 (1999). *But see*, James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385, 401-02 (1999).

75. *See* H.R. 62, 93rd Cong. (1973); S. 2592, 92nd Cong. (1971); 120 CONG. REC. 39,527-28 (1974); 121 CONG. REC. 7306, 7491-93 (1975); 122 CONG. REC. 21,285-88 (1976). President Carter announced an intention to end deferral entirely in 1978. *See* Message from the President of the United States, Transmitting Proposals for Tax Reductions and Reform, H. R. DOC. NO. 95-283, at 19 (1978). Candidate John Kerry also supported ending deferral in his election campaign in 2004. *See* Fact Sheet on John Kerry's Plan to Create 10 Million Jobs, U.S. NEWSWIRE, Mar. 26, 2004 (reprinting Kerry's election platform tax plan that seeks to tax immediately all corporate income, whether earned domestically or internationally).

76. *See* Tax Reduction Act of 1975, §602(d).

77. *See* H.R. REP. NO. 94-120, (1975), *available at* 1975-1 C.B. 624, 631.

78. Tax Reform Act of 1976, §1062.

79. Tax Equity and Fiscal Responsibility Act of 1982, §212.

currency transactions, and interest equivalents, and also repealed the exception for banking and insurance income[80] due to a concern that all of these types of income were susceptible to inappropriate diversion to low-tax jurisdictions.[81] Income earned in countries that are designated as enemies of the state was also made subject to Subpart F taxation[82] in order to promote non-tax foreign policy objectives of the U.S. government. The high-water mark for expanding the scope of the Subpart F regime arguably occurred in 1993 with the passage of old Section 956A that ended deferral to the extent that a controlled foreign corporation held "excess passive assets,"[83] but this provision was short-lived and was repealed in its entirety within three years of its original enactment.[84] The Obama administration has offered several proposals to expand the scope of the Subpart F regime, but they

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80. Tax Reform Act of 1986, §1221.

81. H.R. REP. NO. 99-426, at 391-92 (1985) (reporting the legislative history to the Subpart F treatment for the controlled foreign corporation's sale of passive income producing items, commodity transactions, and currency transactions); S. REP. NO. 99-313, at 366-369 (1986).

82. Omnibus Budget Reconciliation Act of 1986, §8041(a), Pub. L.No. 99-509, 100 Stat.1874 (1986).

83. Excess passive assets existed if more than 25% of the controlled foreign corporation's assets were passive assets. *See* I.R.C. § 956A(c) (1993).

84. *See* H.R. REP. NO. 103-111, at 687-99 (1993) (describing the impact of former I.R.C. § 956A). Old § 956A was repealed by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1501(a)(2), 110 Stat. 1755 (1996). The legislative history indicated that Congress repealed old § 956A because Congress believed that the excess passive asset rules of § 956A were too complex and because the regime created an incentive to invest in otherwise unattractive foreign business investments solely to avoid the application of old § 956A. *See* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGIS., 104TH CONG. 188-89 (Comm. Print 1996). In 1997, the inquiry into the passive asset nature of assets held by a controlled foreign corporation was largely eliminated for intermediate holding companies such as the one depicted in **Illustration #1** when Congress chose to eliminate the separate applicability of the passive foreign investment company rules to the extent that US shareholders of a foreign corporation are already subject to the US subpart F regime. For post-1997 tax years, section 1297(d)(1) treats a foreign corporation as not being a passive foreign investment company with respect to any of its shareholders to the extent the shareholder is a U.S. shareholder (as defined in §951(b)) and the foreign corporation is a controlled foreign corporation. See Sec. 1121 of P.L. 105-34, Taxpayer Relief Act of 1997 (August 5, 1997). The elimination of the application of passive foreign investment company rules to US shareholders of controlled foreign corporations was touted as an effort to eliminate complexity. See H.R. Rep. No. 105-148, Sec. 1121 of H.R. 2014, Revenue Reconciliation Act of 1997, 105th Cong. 1st Sess. at 553 (July 24, 1997) (stating that overlap of the controlled foreign corporation rules and the passive foreign investment company rules was "very complex" and that the "additional complexity caused by this overlap is unnecessary"); H.R. Conf. Rep. No. 105-220, H.R. 2014 Taxpayer Relief Act of 1997, 105th Cong. 1st Sess. at 624-627 (July 30, 1997) (stating that final law adopted House version). In 1997, §1296(e) was redesignated as §1297(e) (see Sec. 1122(d)(4) of P.L. 105-34) and was later re-designated in 2007 as current §1297(d) (see Sec. 11(g)(18) of P.L. 110-172).

have not gained legislative traction.[85] Again, when one considers the actual legislative expansions that have occurred with respect to the Subpart F regime, those expansions have occurred when there was also a sufficient consensus in Congress that the U.S. tax system was in need of a "backstop regime" to protect against inappropriate diversion of U.S. profits to tax haven subsidiaries or because larger non-tax foreign policy objectives were at stake.[86] Other policy desires may well have co-existed at the time of these enacted expansions of the Subpart F regime, but the historical record supports the conclusion that only when the Homeless Income mistake set forth in **Illustration #1** was added to the equation did Congress decide to restrict the scope of the deferral privilege.

However, after dutifully acknowledging the above efforts to expand the Subpart F regime to "backstop" the U.S. transfer pricing rules, it is important to recognize that the realization of this legislative goal has been stymied. An analysis of why these policy goals have been stymied provides important insight into the way forward. The inability of the Subpart F regime to effectively address the Homeless Income problem is seen in at least four Subpart F contexts. First, through careful and creative tax planning, US MNCs were able to use contract manufacturing arrangements that allowed a low-tax foreign subsidiary (such as the IFHC in **Illustration #1**) to be inserted into trading patterns while side-stepping the application of the foreign base company sales rules.[87] In Revenue Ruling 75-7,[88] the IRS had ruled that a controlled foreign corporation's use of a contract manufacturer could qualify the controlled foreign corporation for the manufacturing exception of Section 954(d)(1) but the use of that

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85. The Obama Administration's 2011 budget proposed to expand the scope of Subpart F to currently tax "excessive" returns from transfers of intangible property to "low-tax" jurisdictions. *See* STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL, 111TH CONG., 252 (Comm. Print 2010). Treasury officials advise that the excessive return proposal does not conflict with U.S. transfer pricing or treaty obligations, since it is a Subpart F proposal, not a transfer pricing proposal, and provides a "backstop" to the existing transfer pricing rules. *See* David D. Steward, *Excess Returns Proposals Don't Conflict with OECD Guidelines, U.S. Official Says*, Tax Analysts Worldwide Tax Daily, Oct. 27, 2010, available at 2010 WTD 207-1.

86. *See* text accompanying notes 44-85.

87. The results of these efforts are now set forth in Treasury Regulation Section 1.954-3T (2011). A detailed historical discussion of the evolution of the contract manufacturing exception and its affirmative use in taxpayer planning has been well documented elsewhere and is beyond the scope of this article. *See* Kuntz & Peroni, U.S. International Taxation ¶3.05[1] (WG&L 2011); Dolan, Jackman, Tretiak & Dabrowski, U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures at ¶18.06[2][b] (WGL 2011).

88. Rev. Rul. 75-7, 1975-1 C.B. 244.

controlled foreign corporation would also create a manufacturing branch for the other controlled foreign corporation under Section 954(d)(2).[89] Taxpayers relied on the first holding in Revenue Ruling 75-7 to attribute the manufacturing activities of one controlled foreign corporation to another controlled foreign corporation located in a tax haven jurisdiction and then successfully argued against the second holding of Revenue Ruling 75-7 in the courts, thus creating a non-subpart F result for the profits attributed to the tax haven subsidiary.[90] After several taxpayer victories in the courts, the IRS reversed both of the holdings in Revenue Ruling 75-7 in Revenue Ruling 97-48, holding that the use of a contract manufacturer would not give rise to a manufacturing branch and that the resulting income in the hands of the contract manufacturer did not qualify for the manufacturing exception because the manufacturing activities of the other party would not be attributed to the contract manufacturer.[91] However, in the end, the Treasury Department relented and sanctioned the use of contract manufacturing arrangements as a mechanism to allocate manufacturing income to a tax haven subsidiary, such as the IFHC, without creating Subpart F income because, in the Treasury Department's view, contract manufacturing arrangements had become "a common way of manufacturing products" and "was deemed to be important to the continued competitiveness of U.S. businesses operating abroad."[92] The consequence of the creative use of contract manufacturing arrangements has been that profits generated in **Supply Chain Transactions** (including residual profits earned from sales into the U.S. marketplace) can be routed to the IFHC depicted in **Illustration #1** without generating Subpart F income.[93]

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89. I.R.C. § 954(d) (2010).

90. *Ashland Oil Co. v. Comm'r*, 95 T.C. 348, 349-50, 360, 362-63 (1990); *Vetco, Inc. v. Comm'r*, 95 T.C. 579, 590-92 (1990).

91. Rev. Rul. 97-48, 1997-2 C.B. 89.

92. *See* Notice of Proposed Rulemaking, 73 Fed. Reg. 10,716 (Feb. 28, 2008). The proposed regulations were eventually finalized in I.R.C. §1.954-3(a)(4) (2011). *See* T.D. 9438, 2008-16 I.R.B. 801;T.D. 9563, 76 Fed. Reg. 78545 (2011).

93. *See* OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPS: A POLICY STUDY, 65 (2000), *reprinted at* 2001 TNT 1-1 (Jan. 2, 2001). Two representative § 482 cases are instructive. First, in *Bausch & Lomb v. Commissioner,* 92 T.C. 525 (1989), all of the residual profits derived from sales into the US marketplace were kept by an Irish manufacturing affiliate. The subpart F regime was not an effective backstop because all of the Irish subsidiary's profits met the manufacturing exception even though those profits included residual profits above the manufacturing activity and accordingly related to intangibles. The Tax Court found that nonroutine intangibles existed in both the US affiliate and in the Irish affiliate and that these nonroutine intangibles both contributed to the residual profits for

A second favorable development from the perspective of taxpayer planning occurred in 1996 when the Treasury Department changed its regulations to provide that the tax classification of foreign entities was a matter of taxpayer election and that a disregarded entity held by one taxpayer would be considered as a "branch" for U.S. tax purposes.[94] With the flexibility of the check-the-box regulations, taxpayers were able to have the IFHC engage in **Lease Stripping Transactions, Interest Stripping Transactions**, and **Royalty Stripping Transactions** with lower-tier disregarded entities and thus migrate income from high-tax source countries to the low-taxed IFHC without generating Subpart F income since the income from such transactions are "disregarded transactions" for U.S. tax purposes.[95] In an effort to undue this significant income-shifting planning opportunity, the U.S. Treasury Department

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the MNC, and as a result the Tax Court engaged in a residual profit split methodology to attribute profits among the related parties. This was a good decision that was decided using a **Two-Sided TP Methodology** (i.e., a methodology that seeks to test both parties in order to allocate the combined income of the MNC and does not simply test one party under the transfer pricing rules as discussed in the text accompanying note 264 and note 269, infra), but the point to be made here is that the Subpart F regime did not provide an adequate backstop and that the right answer was reached only by reason of §482. Second, in *Compaq Computer v. Commissioner,* 79 T.C.M. 8122 (1999), a Singapore manufacturing affiliate kept all of the residual profits, and the Tax Court sustained that result. In its analysis, the Tax Court utilized a **One-Sided TP Methodology** where only the US affiliate was the tested party, and the Tax Court refused to utilize a **Two-Sided TP Methodology**. However, the point to be made here is that the subpart F regime did not provide an adequate backstop to prevent the residual profits created from activities associated with the US marketplace from escaping US taxation because all of the Singapore subsidiary's profits met the manufacturing exception even though those profits included residual profits above the routine profits attributable to manufacturing activities. Taken together, the above two §482 cases demonstrate that the subpart F backstop regime is ad hoc and does not prevent residual profit migration from activities associated with the US marketplace and that the only safeguard to inappropriate results is through a transfer pricing methodology under §482 since in both cases the profits earned by the foreign affiliate exceeded the routine return from their manufacturing activities and yet the Subpart F regime did not prevent the residual profit migration. Cost sharing agreements provide the possibility for valuable IP to be owned by an offshore subsidiary. *See* Treas. Reg.§1.482-9. The foreign affiliate can then use the IP created under a qualified cost sharing agreement to manufacture products destined for the US marketplace and earn a residual profit in a nonsubpart F manner. So, apart from the obvious discriminatory treatment that subpart F gives some US MNCs, it also is not effective at holistically stopping the creation of Homeless Income by US MNCs that manufacture from offshore affiliates and then import and resell these manufactured goods into the US marketplace. The inability of the Subpart F regime to serve as an effective "backstop" to the US transfer pricing rules provides strong evidence that a new and different policy response to the Homeless Income problem is needed. An alternative and superior policy response to the Homeless Income problem is to adopt a **Base Protecting Surtax**, and this alternative proposal is more fully discussed in **Section III.B.1** of this paper.

94. *See* T.D. 8697, 1996-24 I.R.B. 20; Treas. Reg. § 301.7701-3(b)(2)(C) (2006).

95. Dolan et al., *supra* note 19, at ¶26.01.

belatedly issued Notice 98-11 and therein attempted to expand the reach of the U.S. extraterritorial taxing jurisdiction.[96] Congress in an extraordinary action chided the Treasury Department for overstepping its authority,[97] and just as in the contract manufacturing saga, the Treasury Department again backed down and withdrew Notice 98-11.[98] However, this time the Treasury Department simultaneously issued proposed regulations that would achieve the same results as Notice 98-11, but in order to give Congress and the administration time to sort through the policy implications of the proposed regulations, the Treasury Department set the effective date for any regulatory change to be five years after the date that final regulations were adopted.[99] After more than twelve years since their original publication, the proposed regulations have still not been finalized, and it is unclear whether they ever will be finalized.

A third favorable Subpart F development from the perspective of taxpayer planning occurred in 1997 when Congress enacted Section 954(h) to reinstate the "active financing exception" to the Subpart F regime that had been repealed in 1986.[100] The effect of the "active financing exception" is that a foreign finance subsidiary located in a low-tax

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96. I.R.S. Notice 98-11, 1998-1 C.B. 433; *see also* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.61[4] (7th ed. 2000) (discussing efforts by the Treasury to limit this use of check-the-box elections).

97. DEPT. OF THE TREAS., GEN. EXPLANATIONS OF THE ADMIN.'S REVENUE PROPOSALS 144-46 (1998).

98. I.R.S. Notice 98-35, 1998-2 C.B. 35.

99. *See* T.D. 8767, 1998-16 I.R.B. 4 (1998); Prop. Treas. Reg. 113909-98, 64 Fed. Reg. 37727 (1999). The earliest possible effective date for the provisions of the hybrid branch regulations is five years from the date that such regulations are finalized. *See* Prop. Treas. Reg. § 1.954-9(c), 64 Fed. Reg. 37731. These proposed regulations have not yet been finalized even though these proposed regulations have been outstanding for over a decade. *Id.*

100. Section 954(h) was originally set to expire for tax years beginning before January 1, 1999. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1175(a)(9)(c), 111 Stat. 990, 993 (1997). However, since that time, Section 954(h) has been repeatedly extended as a temporary provision through December 31, 2011. *See* Tax Relief Extension Act of 1999, Pub. L. No. 106-170, §503(a), 113 Stat. 1918, 1921(1999) (extending Section 954(h) for tax years beginning before January 1, 2002); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 614(a)(2), 116 Stat. 21, (2002) (extending Section 954(h) through tax years beginning before January 1, 2007); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, §103(a)(2), 120 Stat. 346, 347 (2006) (extending Section 954(h) through tax years beginning before January 1, 2009); Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, §303(b), 122 Stat. 3765, (2008) (extending Section 954(h) through tax years beginning before January 1, 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §750(a), 124 Stat. 3320, 3320 (2010). Section 954(h) has been designated as an expiring provision that Congress will consider whether to further extend in the upcoming year. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, LIST OF EXPIRING TAX PROVISIONS: 2011-2012, JCX-1-12, 8 (2012).

jurisdiction can engage in lending and leasing activities with unrelated parties, and the financial services income generated in these transactions would not be subject to immediate U.S. taxation under the Subpart F rules. Public interest advocates have argued that the reinstatement of the "active financing exception" of Section 954(h) has allowed companies such as General Electric to shift significant profits to tax haven subsidiaries.[101]

And fourth, in 2004, Congress enacted Section 954(c)(6) to give non-Subpart F treatment to related-party interest, rents, royalties, and dividends paid by one controlled foreign corporation to another controlled foreign corporation.[102] The effect of Section 954(c)(6) is that the IFHC in **Illustration #1,** can engage in **Lease Stripping Transactions, Interest Stripping Transactions,** and **Royalty Stripping Transactions** with other controlled foreign corporations without generating Subpart F income. Thus, through the enactment of Section 954(c)(6), the Subpart F planning opportunities that the check-the-box rules allowed for disregarded entities was expanded to include the same techniques for the IFHC vis-à-vis other controlled foreign corporations.[103]

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101. *Compare* CITIZENS FOR TAX JUSTICE AND THE INSTITUTE ON TAXATION AND ECONOMIC POLICY, CORPORATE TAXPAYERS & CORPORATE TAX DODGERS, 2008-2010, 13 (Nov. 2011):

> It is oxymoronically titled the "active financing exception" (the joke is that financing is generally considered to be a quintessentially *passive* activity). This tax break allows financial companies (GE has a major financial branch) to pay no taxes on foreign (or ostensibly foreign) lending and leasing, apparently while deducting the interest expenses of engaging in such activities from their U.S. taxable income. (This in an exception to the general rule that U.S. corporations can defer their U.S. taxes on offshore profits only if they take the form of *active* income rather than passive income.

with Letter to the Editor by Kenneth Kies, *Kies Critiques CTJ Corporate Tax Report*, 2011 TNT 224-13, Doc 2011-24017 (November 21, 2011) (stating that active financing exception to Subpart F is narrowly tailored and consistent with historic compromise contained in the Subpart F rules).

102. *See* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, §103(b)(1), 120 Stat. 345, 346 (2006) (enacted Section 954(c)(6) and made it applicable for tax years through December 31, 2008). Section 954(c)(6) has been extended to apply for tax years through December 31, 2011. *See* Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, §304, 122 Stat. 3765, (2008) (extended Section 954(c)(6) to tax years beginning before January 1, 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §751(a), 124 Stat. 3321, 3321 (2010) (extended Section 954(c)(6) through tax years beginning before January 1, 2012). Section 954(c)(6) has been designated as an expiring provision that Congress will consider whether to further extend in the upcoming year. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, LIST OF EXPIRING TAX PROVISIONS: 2011-2012 JCX-1-12, 8 (2012).

103. *See* David R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, 115 TAX NOTES 349, 365-66 (Apr. 23, 2007).

Thus, in part through regulatory changes (with the check-the-box rules), in part through creative taxpayer planning (in the contract manufacturing arena), and in part through legislative changes to the Subpart F rules (through the enactment of Section 954(h) and Section 954(c)(6)), significant opportunities exist to locate profits in tax haven subsidiaries without creating a Subpart F income inclusion to the U.S. shareholder. The Subpart F rules were originally designed to represent a "backstop" for inappropriate transfer pricing results,[104] but the Subpart F regime has never been effective in doing so, and the historical record casts considerable doubt as to whether it ever can do so. For a global business, reactive tax planning can be used to create intercompany structures and intercompany arrangements that fall outside of the Subpart F regime's classification effort to distinguish "tainted" forms of income from "active" income. The solution to the Homeless Income problem needs to be one forged on correcting and preventing inappropriate transfer pricing results from the outset, and such an approach is reconsidered in **Section III.B.1.** in the context of base erosion protection mechanisms.

However, although the historical record demonstrates that the Subpart F regime has been ineffective as a "backstop," the historical record has also shown that the claims made by Secretary Dillon that tax haven subsidiaries represented a "uniquely American problem" is now manifestly acknowledged to be untrue. The European Union no longer has significant exchange control laws within its member states and in fact has implemented directives that make base erosion strategies readily available.[105] Furthermore, the European Commission[106] and the Organization for Economic Cooperation and Development ("OECD")[107] have both identified "harmful tax competition" as a significant threat to all developed countries, not just the United

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104. *See* text accompanying notes 44-86.

105. *See* European Commission, Annex: Growth Friendly Tax Policies in Member States and Better Tax Coordination in the EU, 3 (November 23, 2011).

106. *See* European Commission, Annex: Growth Friendly Tax Policies in Member States and Better Tax Coordination in the EU, 10 (November 23, 2011) stating as follows:

> [T]he Commission believes that tax planning at firm level has become increasingly sophisticated in the past 15 years: instead of simply benefitting from preferential tax regimes of one country, some businesses engage in complex tax engineering whereby tax benefits are achieved through the imperfect alignment of tax systems of two or more countries. These developments have triggered a debate about the current and future role of the Code of Conduct Group. . . . In the current difficult times such loopholes, which also undermine the spirit of the Single Market, must be tackled.

107. *See* Org. for Econ. Co-operation and Dev., *Harmful Tax Competition: An Emerging Global Issues*, 13-14, 18, 70 (1998).

States. The National Foreign Trade Counsel in 1999 released a detailed report that exhaustively reviewed the historical development of the Subpart F rules and argued that this regime's unilateral approach to the tax haven subsidiary problem creates an unacceptable competitive disadvantage for US MNCs.[108] Whereas in 1961 Secretary Dillon claimed that US MNCs with business activities in Europe operated "in a country with a tax structure similar to ours," a detailed review of the major U.S. trading partners now shows that none of them have a worldwide tax system like our own.[109]

In the announcement accompanying the release of the draft legislation, Chairman Camp clearly draws the distinction between today and the time that Secretary Dillon was testifying in 1961 as follows: "our international tax rules were written when the United States accounted for 50 percent of the global economy and had no serious competition from others, a far cry from today's fiercely competitive global economy."[110] The announcement then went on to further state the following:

- **America is losing ground:** In 1960, U.S.-headquartered companies comprised 17 of the world's largest 20 companies – that's 85%. By 2010, just six – or a mere 30% – U.S. headquartered companies ranked among the top 20.
- **Our foreign competitors are actively reforming their tax laws:** Other countries are actively reforming their international tax codes – giving employers lower rates and moving towards a territorial tax system. Countries like the United Kingdom, Canada, and Germany, have

108. Nat'l Foreign Trade Council, Inc., *The NFTC Foreign Income Project: International Tax Policy for the 21st Century: Part One: A Reconsideration of Subpart F*, 1999 TNT 58-17, [9], [57], Doc. 1999-11623 (1999); Reuven S. Avi-Yonah, *Competition & Competitiveness: Review of NFTC Subpart F Report,* 83 TAX NOTES 582, 582 (1999); Peter R. Merrill, *A Response to Professor Avi-Yonah on Subpart F*, 83 TAX NOTES 1802, 1802 (1999).

109. *See* STAFF OF THE JOINT COMM. ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME, JCX-33-11, 1, 7-8 (May 20, 2011) (analyzing nine major trading partners of the United States that provide for an exemption system) [hereinafter BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEMS]; *see also* STAFF OF THE JOINT COMM. TAXATION, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME, JCX-42-11, 1, 20, 72-73 (2011) (reviewing policy considerations between a territorial and worldwide tax system).

110. *See Camp Releases International Tax Reform Discussion Draft, supra* note 2, at 7.

> recently lowered their tax rates to spur job creation and economic growth. Yet, America is sitting on the sidelines doing nothing. We cannot sit back and watch our jobs go overseas because our tax code provides such perverse incentives.[111]

Thus, in 1961, Secretary Dillon could credibly state that Foreign MNCs would not gain a significant competitive advantage as a result of the U.S. Subpart F regime because European countries already controlled the tax haven subsidiary problem and utilized a worldwide tax regime that was similar to the United States, but these assertions cannot be made today with the consequence that Foreign MNCs avail themselves of all of the same income-shifting opportunities depicted in **Illustration #1**.[112]

In addition, at the same time as the competitive tensions between US MNCs and Foreign MNCs has intensified, the competitiveness concerns between US MNCs and Domestic Business Entities has subsided. Unlike the situation that existed in 1961, today a majority of the domestic business income that is earned through non-publicly traded entities is earned within "pass-through entity" structures where no corporate-level tax applies.[113] In fact, over the last twenty-five years, an impressive number of C corporations have been electing to change from C corporation status to S corporation status.[114] This trend can be traced back to the adoption of the reforms implemented as part of

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111. *See id.* at 2.

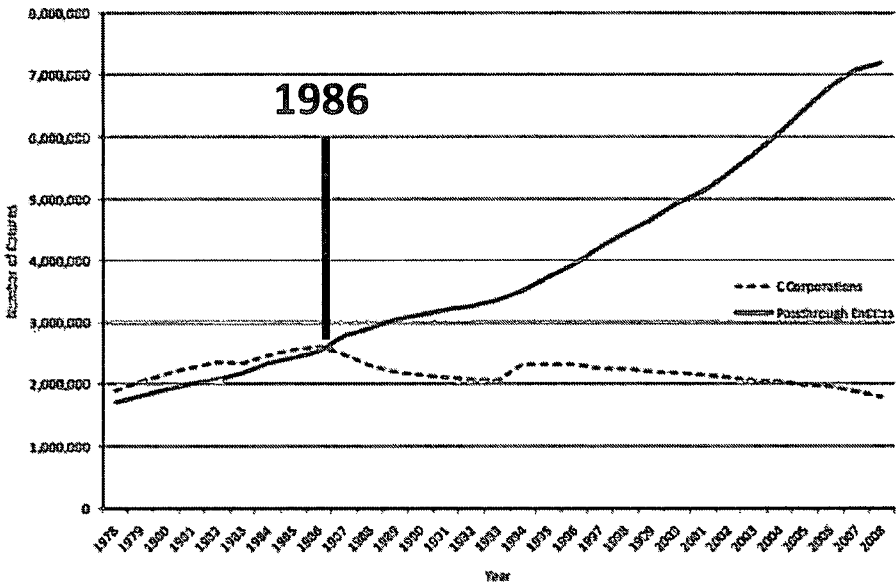
112. For a discussion of the lack of control of the tax haven problem by developed nations generally, *see supra* notes 106-107. The United States is now the last large major industrial country to not have a territorial tax regime. *See* PRICE WATERHOUSE COOPERS, PWC REVIEWS U.K. FINANCE BILL PROVISIONS ON FOREIGN PROFIT REPATRIATION, Tax Doc. 2009-10308, 2009 WTD 87-22 (2009); *see also* Tom Neubig & Barbara M. Angus, *Japan's Move to Territorial Contrasts with U.S. Tax Policy*, 54 TAX NOTES INT'L 252, 252 (2009) (pointing out that the U.S. is becoming increasingly isolated). Others scholars have forcefully made the case that the United States' adherence to a worldwide tax regime, when all of its other major trading partners utilize a territorial tax regime, puts the United States out-of-step with the global economy and creates a significant competitive handicap. *See* Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of US Industries*, 63 Tax L. Rev. 771, 771-72, 787-88, 793 (2010).

113. According to calculations based on IRS Statistics of Income data from 2004 to 2008, individual owners of flow-through businesses earned 54 percent of all business net income. Robert Carroll & Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, 1 (April 2011), http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf.

114. During the 2000-2006 time period, between 78,000 and 97,000 C corporations converted to S corporations per year, representing 23% to 31% of all new corporations. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NON-COMPLIANCE WITH S CORPORATION TAX RULES 45 (2009).

the Tax Reform Act of 1986 ("1986 Act").[115] In testimony before the Joint Select Committee on Deficit Reduction, Thomas Barthold (Joint Committee on Taxation Chief of Staff) provided the following diagram that well summarizes the transformation that has occurred in the tax status of how business is conducted since the 1986 Act:[116]

Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2008



115. Whereas the annual growth in the number of S corporation returns was 9.5% during the 1959-1986 period, the number of S corporations grew by more than 36.5% between 1986 and 1987. George A. Plesko, *The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986*, MASS. INST. OF TECH., 7 http://web.mit.edu/gplesko/www/Plesko%20Sconv.pdf (last visited June 19, 2012). S corporations represented less than 6% of businesses in 1986. *See* JOINT COMM. ON TAXATION, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 6 (Comm. Print 2008). In 2006, S corporations represented 12.6% of all businesses and grew by 35% from 2000 to 2006 to account for nearly 4 million businesses. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NON-COMPLIANCE WITH S CORPORATION TAX RULES 43 (2009).

116. *Testimony of the Staff of the Joint Committee on Taxation Before the Select Committee on Deficit Reduction*, 112th Cong. 10 (2011) (statement of Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation) (line in the above chart that highlights the 1986 date was added by the author).

As indicated in the above chart, since 1986, Domestic Business Entities have been engaged in planning to avoid any corporate-level taxation, and so a territorial tax regime is arguably no longer non-neutral vis-à-vis Domestic Business Entities because the Domestic Business Entities have largely elected flow-through treatment and thus are not subject to U.S. corporate taxation.[117] Consequently, not subjecting foreign earnings of US MNCs to U.S. corporate level taxation is not likely to be a meaningful competitive advantage vis-à-vis domestic-only businesses in today's world because the majority of U.S. domestic-only business activity is already not subject to corporate-level tax either.[118]

The evolution of the Treasury Department and administration's reaction to these calls for a more competitive international tax system over the past decade is quite interesting and instructive. In December 29, 2000, the Clinton administration issued a comprehensive study of Subpart F and the deferral privilege, and the report set forth several possible alternatives for reform but significantly down-played the need for a reversal of existing U.S. policies.[119] The Treasury Department study was issued twenty-five days before the end of the Clinton administration, and the Bush administration announced that they would rethink this study almost immediately upon taking office.[120] In 2005, the President's Advisory Panel and several Congressional studies either advocated or seriously considered the advisability of adopting a territorial tax regime. [121] In 2007, the Treasury Department issued an extensive discussion of international tax reform, and this study focused heavily on the

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117. *See* OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY xi n.14 (2000) (stating that the United States' foreign tax credit reserves "the right to tax their residents to the extent that the source country does not impose tax").

118. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NON-COMPLIANCE WITH S CORPORATION TAX RULES 43 fig.3 (2009) (showing C Corporations' prevalence to be less than Sole Proprietorships, Partnerships, and S Corporations, all of which are treated as pass-through entities).

119. *See generally* OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY, *supra* note 117, vii.

120. Fred Stokeld, *Treasury's Weinberger Preaches Bush Tax Cut; Rangel Not Convinced*, 2001 TAX NOTES 65-5, 65-5 (2000); *see also* Mark A. Weinberg & Charles O. Rossotti, *2001 Priorities For Tax Regulations and Other Administrative Guidance*, 2001 TAX NOTES 82-1 at 10-11 (2001).

121. *See, e.g.*, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 134 (2005); JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 186 (Comm. Print 2005).

need to promote a more competitive international tax regime,[122] thus reversing course from the direction of the earlier Clinton administration's Treasury Department study issued in 2000.[123] In 2010, another Presidential advisory council to President Obama also endorsed a territorial tax regime.[124] Thus, the Treasury Department and the administration have evolved in their thinking and appear to be receptive to fundamentally rethinking the status quo.

B. *Foreign Tax Credit Regime.*

Given the analysis set forth in **Section I.A.** detailing the ineffectiveness of the Subpart F regime as its intended "backstop" to protect against transfer pricing abuses, the question might be asked why taxpayers are so largely dissatisfied with the existing U.S. international tax regime. The source of this taxpayer angst is found in the extant foreign tax credit rules. In this regard, whereas taxpayers have been successful in planning around the Subpart F regime, the ability to rely on the U.S. foreign tax credit rules to avoid international double taxation if and when the foreign subsidiary earnings are repatriated to the U.S. parent corporation has become a mine field such that international double taxation is now the norm, not the exception, for at least two key reasons. First, the significant risk of international double taxation exists because of the narrowing of the eligibility for foreign tax credit relief, and the analysis with respect to this narrowing of the eligibility rules is set forth in **Section II.B.1**. Second, and much more importantly, the foreign tax credit limitation methodology has downgraded to the point that now the amount of foreign tax credits that are actually usable, after the Section 904 calculation is performed, is woefully inadequate to protect against international double taxation, and the analysis with respect to the deficiencies in this Section 904 limitation regime are discussed in **Section II.B.2**. The impact of both these trends has been that U.S. taxpayers must rely on the deferral privilege as the primary means of avoiding international double taxation since repatriation of foreign earnings is likely to bear international double taxation,

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122. *See* OFFICE OF TAX POLICY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY i (2007).

123. *See* OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY, *supra* note 117, at 99 (arguing that an "anti-deferral regime continues to be needed").

124. *See* NAT'L COMM. ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH 28-35 (2010).

and the result of this outcome has been that many US MNCs that would like to redeploy capital back into their U.S. business must continue to hold those funds offshore or else bear double taxation on those earnings.[125] This inability to repatriate funds back to the U.S. parent is discussed at the end of **Section II.B.2** of this paper.

1. Foreign Taxes to Which Foreign Tax Credit Relief is Available.

Initially, the U.S. provided no foreign tax credit relief under the income tax laws of 1909 and 1913,[126] but the income tax rates were admittedly small, so the cost of not providing foreign tax credit relief was not significant. However, with the advent of World War I, tax rates increased sharply in the U.S. and other countries.[127] With increasing tax rates in both foreign countries and the U.S., the cost of international double taxation became a significant cost to U.S. multinationals.[128] As a result, in 1918, Congress adopted a regime that would allow U.S. taxpayers to claim foreign tax credits with respect to foreign income taxes.[129] The objective in providing U.S. taxpayers with foreign tax credit relief was to prevent worldwide double taxation on the same foreign profits.[130] International double taxation would be the result if both the host country and the United States asserted taxing jurisdiction over the same foreign income.

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125. *See* H.R. Rep. No. 108-548, at 146 (2004) ("The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings.").

126. *See generally* Revenue Act of 1909, ch. 6, 36 Stat. 11; Revenue Act of 1913, ch. 16, 38 Stat. 114, at 172.

127. Stanley S. Surrey, *The United States Taxation of Foreign Income*, *supra* note 36, 73 n.3 (1958).

128. *Id.* at 73.

129. Revenue Act of 1918, ch. 18, § 222(a), 42 Stat. 1057. The creation of a broad-based foreign tax credit was principally the invention of Thomas S. Adams, an economic advisor to the Treasury Department at the time. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1038-39 n.71 (1997). "The Netherlands in 1892 adopted a tax credit for traders deriving income from the then Dutch East Indies." *See* SURREY, *Current Issues in the Taxation of Corporate Foreign Investment*, *supra* note 32, at 818 n. 4. "The United Kingdom in 1916 granted a partial tax credit to traders who had paid taxes to other territories of the Empire." *Id.* However, the "United States apparently was the first government to adopt the credit on a world-wide basis and to develop it as a mechanism to meet the problems of double taxation." *Id.*

130. JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 852 (Comm. Print 1986).

It is not clear why Congress chose to limit foreign tax credit relief to situations where the foreign tax is an income tax.[131] A thoughtful scholar has argued that the U.S. should grant a foreign tax credit for all amounts paid to a foreign country,[132] but this has never been the rule. A restriction of foreign tax credit relief to only certain qualifying foreign income taxes has been justified on the grounds that the foreign tax credit should be limited to situations where "the tax is not shifted or passed on by the person paying the tax,"[133] but recent scholarship on tax incidence theory calls into question whether corporate income taxes are also shifted to customers or labor or both.[134] Furthermore, the "United States also relies on income taxes (at all levels of government) for a much greater percentage of its total tax revenues than other developed countries."[135] "In 2006 the United States raised 48.3 percent of its revenue from federal, state, and local income taxes, compared with an average of 35.1 percent in other OECD countries."[136] "In contrast, OECD countries rely more heavily on consumption taxes, including value added taxes ("VATs")."[137] Consumption taxes made up 32 percent of the average OECD countries' revenues in 2006, compared with 16.8 percent in the United States.[138] Thus, by restricting U.S. foreign tax credit eligibility to income taxes, the U.S. system is inherently likely to give rise to international double taxation because foreign taxes that serve as the fiscal equivalent of U.S. income taxes will not be afforded U.S. foreign tax credit relief if such taxes are not income taxes within the meaning of Section 901.

However, even if one focuses on foreign income taxes, which are only a subset of the total foreign taxes paid by US MNCs, the regulatory interpretation of when a foreign tax levy qualifies as

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131. SURREY, *Current Issues in the Taxation of Corporate Foreign Investment, supra* note 32, at 819-822 (making this assertion); *see also* Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* ¶ 16.3.1 at 473-74 (1990).

132. Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes,"* 39 TAX L. REV. 227, 229 (1984).

133. *See* ELISABETH A. OWENS, THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER UNITED STATES INCOME TAX LAW 83 (1961).

134. *See* Karen Moore, *The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal,* 7 AM. J. TAX POL'Y 207, 224 (1988).

135. Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal,* 132 TAX NOTES 1025, 1033 (2011).

136. *Id.*

137. *Id.*

138. *See* Philip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal,* 130 TAX NOTES 1025, 1033 (Feb. 28, 2011).

an "income tax in the U.S. sense" has narrowed considerably over time to create an ever-greater risk of international double taxation. The beginning point for this analysis is the restrictive "separate levy" rule that the Treasury Department adopted in 1983 and the pernicious impact that this interpretive rule has had on the eligibility for foreign tax credit relief.

The "separate levy" rule originated from the Chief Counsel's office as part of its litigating position with respect to dual capacity taxpayers.[139] In this regard, during the 1960s and 1970s, U.S. taxpayers were able to convince various foreign oil-producing governments to forego charging royalties for the development of state-owned mineral interests but to instead charge extra taxes to compensate these governments for their foregone royalty income.[140] Thus, U.S. taxpayers in the natural resources industry attempted to classify what would have been a deductible royalty expense instead as a creditable foreign tax payment. Foreign governments accommodated these U.S. taxpayer requests by adopting special provisions that were incorporated into their general income tax laws in lieu of charging a royalty with the consequence that the amount of U.S. foreign tax credits claimable by U.S. taxpayers was artificially inflated to the detriment of the U.S. fisc.[141] The appropriate U.S. response to these situations would have been to treat the portion of any payment that was made to a foreign government as a non-tax payment to the extent such payment was made in return for a specific economic benefit, and the current "dual capacity taxpayer" regulations explicitly deal with this situation today by bifurcating payments made by "dual capacity" taxpayers into a tax and non-tax component.[142] Thus, with the benefit of

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139. For a thorough explanation of this history, *see* Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 FLA. TAX REV. 83, 126 (1999).

140. *Id.* at 100-01.

141. *Id.* at 101.

142. Treas. Reg. §1.901-2A (1983). Whether a foreign levy is an income tax is determined independently for each separate levy. See Treas. Reg. §1.901-2(a)(1). Where the base of the levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered to impose separate levies for such classes of persons. See Treas. Reg. §1.901-2(d)(1). A foreign levy that is the sum of two or more separately computed amounts, where each such amount is computed by reference to a separate base, is considered, for purposes of §901 and §903, to impose separate levies. Treas. Reg. §1.901-2(d)(1) and (3), *Example (3)*. Special levy rules apply in the case of a dual capacity taxpayer. A "dual capacity taxpayer" is a person who is subject to a levy of a foreign state and who also receives a specific economic benefit from the foreign state. Treas. Reg. §1.901-2(a)(2)(ii)(A). A specific economic benefit is an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country. Treas. Reg.

hindsight, it was not necessary for the Treasury Department to have had any broader response to this phenomenon outside of Treasury Regulation § 1.901-2A.

However, infuriated by the "masquerading royalty" abuse, the Chief Counsel's office launched an all-out assault on these arrangements by arguing for a broad rule that required every separate levy component of a country's general income tax laws to be separately tested in order to determine whether each separate component levy is entitled to U.S. foreign tax credit relief (the so-called "separate levy" rule).[143] The goal of dissecting each separate foreign levy to separately determine whether each individual levy is an income tax "in the U.S. sense" was to ferret out whether a so-called tax payment was in reality a royalty that was "masquerading" as a tax.[144] After endorsing the "separate levy" rule in its litigating position, the IRS then proceeded to revoke fifty years of prior revenue rulings and changed long-standing IRS acquiescences in prior cases to non-acquiesences[145] whenever those prior rulings and decisions were inconsistent with this new "separatee levy" rule.[146] The U.S. Treasury Department then incorporated the "separate levy rule" in Treasury regulations that were finalized in 1983.[147] These actions represented a stark reversal in the IRS's earlier holistic approach to analyzing tax payments made under a generally applicable income tax regime.[148]

The result of the "separate levy" rule is that a broad array of U.S. taxpayers are subject to a significant risk of international double taxation with respect to the general income tax laws of a foreign country even where the U.S. treasury is adequately protected by Treasury Regulation Section 1.901-2A from the "masquerading royalty" problem that was the genesis of the

§1.901-2(a)(2)(ii)(B). In the dual capacity taxpayer situation, Treas. Reg. §1.901-2A, in pertinent part, bifurcates the levy payment into a tax and non-tax component.

143. Coven, *supra* note 139, at 101.

144. *See generally* I.R.S. Gen. Couns. Mem. 36,540 (Jan. 5, 1976); I.R.S. Gen. Couns. Mem. 37,263 (Sept. 21, 1977); I.R.S. Gen. Couns. Mem. 36,552 (Jan. 19, 1976); *see also* Coven, *supra* note 139, at 100-01.

145. *See* Rev. Rul. 84-172, 1984-2 C.B. 315 (declaring each of the following rulings obsolete after adoption of final regulations: Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-63, 1978-1 C.B. 228). *See also* Coven, *supra* note 139, at 101.

146. *See* Coven, *supra* note 139, at 103.

147. *See* Treas. Reg. §1.901-2(e)(4) (as amended in 2008).

148. *Compare* I.R.S. Gen. Couns. Mem. 33,346 (Oct. 6, 1966) *with* I.R.S. Gen. Couns. Mem. 36,540 (Jan. 5, 1976). *See also* Coven, *supra* note 139, at 115-6. For a wonderful synthesis of the analysis with respect to the creditability of foreign taxes, *see* ELISABETH A. OWENS, THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER UNITED STATES INCOME TAX LAW 83-84 (1961).

hyper-technical "separate levy" rule. It is important to recognize that the critical issue for many foreign countries in this decade is not the desire to create "masquerading royalties" but is instead to protect their tax base from inappropriate base erosion that can result from intercompany transactions[149] such as those depicted in **Illustration #1**. In response to the significant tax base erosion opportunities afforded to the multinational corporation in **Illustration #1**, source countries have attempted to defend their income tax base against tax base erosion techniques by the use of alternative tax regimes such as thin capitalization regimes, asset tax regimes, or presumptive tax regimes.[150] Even though these tax base defense mechanisms are designed to supplement the income tax collection efforts of the source country and in fact may be codified as part of their generally applicable income tax laws and apply broadly to all taxpayers as prophylactic anti-abuse rules,[151] the introduction of such tax base protection limitations creates uniquely complex U.S. foreign tax credit issues due to the "separate levy" rule.

For example, if a country were to adopt a separate thin capitalization regime as an alternative minimum tax regime, the "separate levy" rule would require this separate foreign levy to individually have the "predominate character of an income tax in the U.S. sense." Existing Treasury regulations indicate that in order for a foreign levy to qualify as an income tax in the U.S. sense, it must allow for all significant costs and deductions.[152] In the prior temporary regulations, the Treasury Department had provided a comforting example that dealt with thin capitalization regimes that disallowed related party interest expense deductions in order to prevent tax avoidance,[153] but this example was deleted from the final regulations.[154] Further, the final regulations make clear that a foreign tax must either allow a recovery of the significant costs and expenses except in the rare circumstances where it can be shown that the foreign levy would

149. Wells, *supra* note 12.

150. *Id.* at 16, 54.

151. *Id.* at 97-98.

152. *See* Treas. Reg. § 1.901-2(e)(4) (as amended in 2008).

153. Temp. Treas. Reg. §4.901-2(e), Example (24) (1980).

154. In the preamble to the final regulations, the Treasury Department explained this deletion on the grounds that the government wanted to "avoid the possible implication that a tax that disallowed additional deductions [beyond those set forth in the example] would not meet the net income test," but it would have been much preferred if the regulations would have retained this example and given a further clarifying statement about how foreign country base protecting measures would be analyzed under these rules. *See* T.D. 7918, 1983-2 C.B. 113.

reach some net gain in the normal circumstances.[155] Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income if significant expenses are not deductible as long as it is "almost certain" that the foreign levy will reach ***some*** net gain, but the question relates to when is it ***almost certain*** to reach ***some*** net gain.[156] At least now that the United States has followed the lead of other countries and has its own form of a thin capitalization regime in Section 163(j),[157] one would hope that the disallowance of significant related-party interest expense would not disqualify a foreign levy from receiving U.S. foreign tax credit relief under Treasury Regulation § 1.901-2, but existing final regulations are purposely vague on this point.[158]

The availability of U.S. foreign tax credit relief, however, becomes more doubtful if the foreign country relies on an asset tax regime in lieu of disallowing related party expenses via a "thin capitalization" regime. In this regard, many Latin American countries have relied on alternative minimum asset tax regimes to backstop their broad-based general income tax regime.[159] Further, these countries have viewed asset tax regimes as part of their general income tax regimes and as a necessary anti-abuse measure to protect against base erosion from aggressive inbound tax planning.[160] Asset taxes generally range from 0.2% to 2% in the region and indirectly represent a limit on thinly capitalized companies.[161] Some form of asset tax has been enacted in Argentina, Bolivia, Costa Rica, Colombia, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Peru, and Venezuela.[162] Further, in order to identify a taxpayer's net assets, Mexico allowed taxpayers to reduce their net assets by the amount of debt that was payable to other Mexican non-financial institutions but this deduction is not allowed for cross-border related-party debt.[163] Again, Mexico is attempting to

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155. *See* Treas. Reg. §1.901-2(e)(4), (b)(4).

156. Treas. Reg. §1.901-2(b)(4)(i)(B).

157. West, *supra* note 135, at 1044.

158. *See* Treas. Reg §1.901-2.

159. Argentina, 1995 Income and Capital Tax Convention and Final Protocol, Argentina-Denmark, art. 30, Sep. 4, 1997, 96 TNI 234-34, Chile, West, *supra* note 135, at 1033, and Peru have all enacted thin capitalization rules,William J. Gibbons, *Tax Effects of Basing International Business Abroad,* 69 HARV. L. REV. 1206, 1249 (1956). Thus, perhaps the trend to use a limitation on interest expense deductions will be a growing trend in Latin America as well.

160. *See, e.g., for Argentina,* Dictamen D.A.L. 55/99 (25 June 1999).

161. *See* John McLees, *The Business Asset Tax,* 93 TAXES NOTES TODAY 175-24 (September 10, 1993).

162. *See, e.g.,id.*

163. *Id.*

defend its income tax base against base erosion strategies[164] like those depicted in **Illustration #1**.

Prior to the 1983 U.S. Treasury regulations, a business asset tax instituted as an effort to complement a country's collection of its general income taxes would probably have been viewed as a creditable foreign tax under prior authority.[165] In fact, the Argentine government adopted its business asset tax only after it received assurance from the International Monetary Fund ("IMF") that the Argentine asset tax would be creditable in the United States, but the Argentina government was surprised to find out that the IMF's assurances that the Argentine asset tax would be entitled to U.S. foreign tax credit relief was incorrect.[166] With the notable exception of the United States, a survey of existing worldwide tax treaties indicates that a broad international consensus exists that asset tax regimes implemented as part of the overall general income taxes of a foreign country should be eligible for double tax relief under bilateral income tax treaties around the world.[167] However, even

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164. *Id.*

165. *See* Rev. Rul. 67-329, 1967-2 C.B. 257; *see also* Rev. Rul. 73-117, 1973-1 C.B. 344; Rev. Rul. 78-62, 1978-1 C.B. 226.

166. Stephen Hodge, *Argentine Tax On Minimum Presumed Income, U.S. Foreign Tax Credit Out of Sync*, 2001 TAX NOTES TODAY 85-39.

167. This is recognized explicitly in many treaties. *See, e.g.*, The Argentine-Canada Tax Treaty, Art. 2(3)(b)(ii) and Art. 23(1)(a), Dec. 30, 1994; The Argentina-Denmark Tax Treaty, Art. 2(3)(b)(ii) and Art. 24(2); The Argentina-Finland Tax Treaty Art. 2(3)(b) and Art. 23(1)(a)(ii); The Argentina-Spain Tax Treaty Art. 2(3)(b) and Art. 23(1); The Argentina-Sweden Tax Treaty Art. 2(3)(a)(ii) and Art. 22(2)(a); Art. 2(3)(b)(ii) and Art. 23(4) of the Argentina-United Kingdom Tax Treaty; Art. 2(3)(b) and Art. 22(1) of the Canada-Mexico Tax Treaty. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Can.-Mex., Apr. 8, 1991, 1883 U.N.T.S. 350; Mexico-Chile Tax Treaty Art. 2(3)(b)(ii) and Art. 23(1)(1). Agreement between the United Mexican States and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital (with protocol), Mex.-Chile, Apr. 17, 1998, 2484 U.N.T.S. 350.; Mexico-Denmark Tax Treaty Art. 2(3)(a)(ii) and Art. 24(2). Convention between the United Mexican States and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Mex-Den., Jun. 11, 1997; The Finland- Mexico Tax Treaty Art. 2(3)(a)(ii) and Art. 22(2)(a). Agreement between the Republic of Finland and the united Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fin.-Mex., Feb. 12, 1997, 2124 U.N.T.S. 295.; The Mexico-France Tax Treaty Art. 2(2)(b)(ii) and Art. 21(1)(a). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Mex.-Fr., Nov. 7, 1991, 1719 U.N.T.S. 330; The Mexico-Germany Tax Treaty Art. 2(3)(a) and Art. 23(2)(b). Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital (with protocol), Mex.-Ger., Feb. 23, 1993, 1764 U.N.T.S. 204.; The Mexico-Italy Tax Treaty Art. 2(3)(a) and Art. 22(2). Convention between the United Mexican States and the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, Mex.-It.; The South Korea-Mexico Tax Treaty Art. 2(3)(a)(ii) and Art. 23(4). Convention for the Avoidance of Double Taxation

though out-of-step with international norms, the U.S. law is clear that an asset tax must be separately tested under the "separate levy" rule on a stand-alone basis[168] and that any foreign levies paid thereunder do not qualify for U.S. foreign tax credit relief due to the fact that an asset tax regime fails to meet the realization, gross receipts, and net income requirements.[169] Given the broad international consensus that foreign tax credit relief should be available for alternative minimum taxes such as asset taxes, the fundamental question is what U.S. tax policy justification exists for diverging from this international consensus and for creating international double taxation with

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and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), S. Kor.-Mex., Oct. 6, 1994, 1873 U.N.T.S. 139; The Netherlands-Mexico Tax Treaty Art. 2(1)(b) and Art. 22(2). Agreement between the Kingdom of the Netherlands and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Neth.-Mex., Sept. 27, 1993, 2217 U.N.T.S. 105; The Mexico-Norway Tax Treaty Art. 2(3)(a)(ii) and Art. 24(8). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Mex.-Nor., Mar. 23, 1995, 1947 U.N.T.S. 166; The Spain-Mexico Tax Treaty Art. 2(3)(b) and Art. 23(1). Convention for the Avoidance of Double Taxation and the Prevention of Fraud and Fiscal Evasion with Respect to Taxes on Income and Capital (with protocol), Spain-Mex., Jul. 24, 1992, 1832 U.N.T.S. 179; The Mexico-Sweden Tax Treaty Art. 2(1)(a)(ii) and Art. 22(3). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (with protocol), Mex.-Swed., Sept. 21, 1992, 1719 U.N.T.S. 407; The Mexico-Venezuela Tax Treaty Art. 2(3) and Art. 22(3). Convention Between the Republic of Venezuela and the United States of Mexico for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mex.-Venez.) (states asset taxes of both countries are considered income taxes); The Venezuela-Czech Republic Tax Treaty Art. 2(3)(b)(ii) and Art. 23(2); Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income Between the Republic of Indonesia and the Republic of Venezuela, Indon.-Venez., art. 2(3)(a) & 23(2), Feb. 27, 1997, 2000 WTD 16-35; Doc. 1999-39606; Convention Between the Kingdom of Norway and the Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Avoidance and Evasion with Respect to Taxes on Income and on Capital, Nor.-Venez., art. 2(3)(a)(ii) & 24(2)(a), Oct. 29, 1997, 98 TNI 23-25; Doc 98-4933; Convention Between the Republic of Venezuela and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Switz.-Venez., art. 2(3)(b)(ii) & 23, Dec. 23, 1997, 2235 U.N.T.S. 39782; Convention Between the Government of the Republic of Venezuela and the Government of the Republic of Trinidad and Tobago for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Avoidance with Respect to Taxes on Income and for the Encouragement of International Trade and Investment (with protocol), Trin. & Tobago-Venez., art. 2(3)(b) & 23(1), July 31, 1996, 2407 U.N.T.S. 43447; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (with exchange of notes), U.K.-Venez., art. 2(1)(b)(ii) & 22(1)(a), Mar. 11, 1996, 1972 U.N.T.S. 33711.

168. *See* Treas. Reg. § 1.901-2(d) (2010).

169. *See* Rev. Rul. 91-45, 1991-2 C.B.336. Admittedly, Rev. Rul. 91-45 would allow § 901 relief to apply if the Mexican asset tax payments were refunded and regular income tax payments were later made, but this requires the foreign country to carefully craft its asset tax laws; other Latin American countries with similar asset taxes have not done so, and it is difficult to articulate why they should.

respect to these local base protection regimes, particularly when the disallowance of U.S. foreign tax credit relief places US MCNs in a prejudicial double tax situation even though there is no "masquerading royalty" problem.

Another tax base protection device that source countries have used for offshore foreign investors has been to implement a concurrently applicable alternative minimum tax regime such as a complementary "simplified income tax regime" or a "presumptive tax regime." Under these alternative minimum tax regimes, a presumptive tax is paid on certain categories of transactions based on turn-over or on gross revenue[170] or on net capital gains. Source countries have found it difficult to collect taxes from offshore investors and with respect to cross-border trade flows, and so in response, several countries have implemented presumptive tax regimes that impose a reduced tax rate on the net capital gain or on the gross turnover of a particular activity as a minimum income tax regime while still retaining their general income tax regimes. Again, these alternative minimum tax regimes deal with the practical difficulty of preserving to the source country a practical means of collecting the expected "right amount" of tax in facts patterns like the one set forth in **Illustration #1** while avoiding intractable cross-border transfer pricing controversies. Early case law and early IRS rulings were supportive of such "backstop" regimes and generally held that the taxes paid under such alternative minimum tax regimes would be entitled to U.S. foreign tax credit relief if they were part of the country's general income tax laws and were designed to "backstop" the effective collection of the general income tax of the country.[171] However, under the "separate levy" rule, current law now requires that these regimes must be separately tested to determine their eligibility for foreign tax credit relief, and the IRS has taken a harsh stance to disallow foreign tax credit relief.[172] Even though

170. Because cross-border transfer pricing compliance is difficult, Brazil has instituted a regime that presumes that all related-party exports have at least a presumptive profit margin and the tax on this presumptive margin is required to be paid. *See* Yoon Chung Kim and Sonia Zapata, Taxation in Latin America: Brazil ¶5.11(e) (IBFD 2001). This regime attempts to deal with the base erosion opportunities created by Supply Chain Transactions depicted in **Illustration #1** through a collection mechanism designed to "backstop" the country's general income tax laws.

171. I.R.S. Gen. Couns. Mem. 800 (1926); *see* Burk Bros. v. Comm'r of I.R.S., 20 B.T.A. 657, 661 (1930).

172. *See* Treas. Reg. §1.901-2(b)(4)(i)(B) (2010); Rev. Rul. 76-215, 1976-1 C.B. 194; I.R.S. Gen. Couns. Mem. 38,087 (September 12, 1979); I.R.S. Gen. Couns. Mem. 36,587 (February 17, 1976); I.R.S. Tech. Adv. Mem. 95-32-003 (May 30, 1995); I.R.S. Tech. Adv. Mem. 97-13-001 (April 26, 1995); I.R.S. Tech. Adv. Mem. 2003-31-001 (April 1, 2003). The case law requires that in order for taxes paid under such complementary tax regimes to

the intent of such "backstop" regimes is to collect the "expected right" amount of income tax in a way that defends against tax base erosions strategies available in **Illustration #1**, the design of the foreign levy is not structured "right" in the U.S. sense, and so these taxes fail to qualify for U.S. foreign tax credit relief because they are not "almost certain to reach net gain."

This state of affairs creates needless complexity and aggravation for foreign governments and pitfalls for US MNCs. The "separate levy" rule was contemplated at a time when foreign tax levies represented "masquerading royalties," but the Treasury Department has dealt with that issue with Treasury Regulation Section 1.901-2A.[173] Now, the "separate levy" rule serves to deny eligibility for U.S. foreign tax credit relief when the foreign levy is intended to represent a true "backstop" to a foreign country's efforts with respect to their general income tax laws. Importing countries have significant pressure to ensure that their tax laws are entitled to U.S. foreign tax credit relief, and this pressure inhibits their ability to implement tax base defense solutions that meet their local needs.[174] But, at the same time, source countries confronted with the base erosion strategies set forth in **Illustration #1** have felt compelled to adopt "backstop" levies that complement their general income tax regimes as a means of ensuring that the base erosion strategies available to inbound investors cannot be used to fully eliminate the multinational's obligations under the country's income tax laws. Surprisingly, however, because these "backstop" regimes are not designed "right" in the U.S. sense, adoption of such anti-abuse regimes creates significant risk with respect to whether the foreign taxes paid under these complementary alternative minimum tax regimes are eligible to receive U.S. foreign tax credit relief. As countries tinker with their general income tax laws to better ensure collectability of the expected "right amount" of tax on related-party cross-border activities, the risk of international double taxation continues to grow as a result of the hyper-technical nature of the "separate levy" rule. Furthermore,

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be eligible for US foreign tax credit relief, such tax regimes must be likely to reach net gain. *See* Bank of America Nat'l Trust & Sav. Ass'n v. United States,.459 F.2d 513 (Ct. Cl. 1972), cert. denied, 409 U.S. 949 (1972); Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982). Simplified tax regimes have represented income taxes in the U.S. sense only when the courts were convinced that deductions were allowed that compensated for the non-deductibility of significant business expenses. *See* Exxon Corp. Comm'r, 113 T.C. 338, 1999 WL 98398 (1999); Texasgulf, Inc. v. Comm'r, 172 F.3d 209 (2d Cir.1999), aff'g 107 T.C. 51 (1996).

173. Treas. Reg. § 1.901-2A (2010).

174. Charles E. McLure, Jr. & George Zodrow, *Creditability Concerns Doom Bolivian Flat Tax*, 12 TAX NOTES INT'L 825, 829 (1996).

in an effort to forestall what is perceived as aggressive tax planning,[175] Congress[176] and the Treasury Department have responded to either disallow or defer foreign tax credit relief.[177] These further efforts to clamp-down on the availability of U.S. foreign tax credit relief for actual foreign tax payments creates additional complexity and an increased risk of international double taxation (i.e., that actual foreign taxes will be paid in a manner that is not entitled to U.S. foreign tax credit relief with the consequence that international double taxation on the same income can occur).

2. Foreign Tax Credit Limitation Calculation.

A more significant source of international double taxation for a broad array of U.S. multinationals involves the calculation methodology required by the foreign tax credit limitation regime.

Under the foreign tax credit limitation rules, foreign income is separately categorized under Section 904 and then expenses are allocated and apportioned between domestic and the various separate limitation categories of foreign income to determine the U.S. taxpayer's net foreign income in each category to which the foreign tax credits relate.[178] Thus, to the extent that U.S. expenses are allocated or apportioned to foreign-source income in the general or passive basket, a taxpayer will lose the ability to utilize the foreign tax credits in those baskets to offset its residual U.S. tax liability on its foreign source income. When the Section 904 limitation regime causes a taxpayer to not be able to use foreign tax credits to offset its U.S. tax on foreign earnings, international double taxation is created.[179]

Between 1918 and 1921, there were no limitations on the use of foreign tax credits.[180] As a result, taxpayers could utilize foreign tax credits to fully reduce their residual U.S. tax liability on both domestic source income and foreign source income.[181] The U.S. Treasury Department has stated that an unlimited right to claim U.S. foreign tax credits is consistent with capital-export neutrality because that approach would support the

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175. *See* Compaq Computer v. Comm'r, 277 F.3d 778 (5th Cir. 2001); *see also* Guardian Indus. Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007).

176. *See* 26 U.S.C. § 901(k) (2010); 26 U.S.C. § 901(l) (2010); 26 U.S.C. § 901(m) (2010).

177. *See* Treas. Reg. §1.901-2T(e)(5)(iv) (as amended in 2008).

178. DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION, *supra* note 8, at II.A.5.c (1999).

179. *See* id.

180. *See id.* at II.A.5.c, IV.B. 2 (1999).

181. *See id.* at II.A.5.b, IV.B. 2 (1999).

allowance of a refund even where foreign tax credits exceed the U.S. tax on foreign income, but the U.S. Treasury Department also has stated that U.S. tax policy has consciously chosen to depart from capital-export neutrality,[182] and significant scholarship has accepted the idea that such a deviation from capital export neutrality is appropriate.[183] Thus, in order to protect the U.S. tax jurisdiction's right to tax U.S. source income, Congress in 1921 limited the use of foreign tax credits such that taxpayers could utilize these credits only to the extent that they possessed a U.S. tax liability on net foreign source income.[184] Congress also clarified the source rules for a variety of types of income and directed the Commissioner of Internal Revenue to develop apportionment rules for products manufactured in one country but sold in another.[185] As has been forcefully articulated elsewhere, the primary policy rationale for the foreign tax credit limitation regime was an effort to promote source-based taxation as the ultimate aim for deciding taxing jurisdiction between countries.[186] Thus, Congress has had a longstanding policy of modifying the U.S. foreign tax credit limitation calculation as a means of protecting against erosion of the U.S. taxing jurisdiction with respect to U.S. domestic source income at the expense of potentially creating international double taxation.[187]

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182. *See id.* at IV.B. 3 (1999).

183. *See, e.g.,* Peroni, Fleming & Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules,* 31 TAX NOTES INT'L 1177, 1179-80, n.10 (September 29, 2003).

184. *See* Revenue Act of 1921, ch. 136, § 222(a)(5), 238(a), 904(a), 42 Stat. 227, 249, 258. Although not further discussed in this article, this limitation regime has taken various forms. In 1932, Congress decreed that taxpayers were required to use the lesser of an overall or per-country limitation. *See* Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 169, 211. In 1954, the overall limitation was repealed and only the per-country limitation regime existed. *See* I.R.C. § 904 (2006). In 1960, taxpayers were given the option to use either a per-country or an overall limitation computation. *See* Act of Sept. 14, 1960, ch. Pub. L. No. 86-780, § 1(a), 74 Stat. 1010. In 1976, the per-country limitation was repealed, and the law had come full circle to the position of 1921. *See* Tax Reform Act of 1976, ch. Pub. L. No. 94-455, § 1031, § 904, 90 Stat. 1610, 1620-24. In 1986, the foreign tax credit basket rules were instituted along with an overall limitation regime to form the basis of current law. *See* Tax Reform Act of 1986, Ch. Pub. L. No. 99-514, § 1201, §904(d), 100 Stat. 2085, 2520-28. The 1986 limitation rules are discussed more fully below.

185. *See* Revenue Act of 1921, ch. 136, § 217, 42 Stat. 227, 243-45; *Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245,* 67th Cong. 66-68 (1921).

186. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Tax Policy,* 46 DUKE L. J. 1021, 1027-28 (1996); Thomas S. Adams, *The Taxation of Business,* 11 NAT'L TAX ASS'N PROC. 185, 186 (1917); Thomas S. Adams, *Fundamental Problems of Federal Income Taxation,* 35 Q. J. ECON. 527, 542 (1921); Thomas S. Adams, *International and Interstate Aspects of Double Taxation,* 22 NAT'L TAX ASS'N PROC. 193, 197 (1929).

187. *See* Michael J. Graetz, *The "Original Intent" of U.S., International Taxation,* 46 DUKE L. J. 1021, 1048-49.

The U.S.' willingness to tinker with the U.S. foreign tax credit limitation calculation as a means of protecting the U.S. taxing jurisdiction on U.S. territorial income was further exemplified in 1976. Prior to 1976, taxpayers that incurred start-up foreign losses in one year and foreign income in a later year were not required to net these upfront foreign losses in an earlier year against their foreign income that arose in later years.[188] And yet, the foreign losses in early years could be claimed as deductions and reduce the U.S. tax liability on U.S. domestic source income.[189] Without recapturing this loss, the allowance of a U.S. foreign tax credit against the future income created the ability to deduct foreign losses against U.S. domestic source income and then never pay U.S. tax on the future income.[190] In 1976, Congress enacted legislation that requires foreign source income to be reclassified as domestic source income (and thus excluded from the calculation to compute the taxpayer's overall foreign tax credit limitation) to the extent that foreign source losses had been deducted against U.S. domestic source income in earlier years.[191] Accordingly, the U.S. made a conscious choice to alter the U.S. foreign tax credit limitation in order to protect its right to tax domestic source income even though doing so repudiates the sanctity of the annual accounting period.[192]

In 1986, Congress expressed a further desire to limit the ability of U.S. taxpayers to use foreign tax credits to offset U.S. residual taxation on foreign income.[193] In this regard, Congress decided to further limit the use of foreign tax credits in order to

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188. *See* DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION, *supra* note 8 (detailing the present system).

189. *Id.*

190. *See id.*

191. I.R.C. § 904(f) (1976). Much later, some measure or reciprocity was introduced by the enactment of § 904(g), P.L. 108-357, § 402(a) (2004), which in some cases resources US source income as foreign source income.

192. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 360 (1931) (articulating the general rule that tax liability is an annual determination). The recapture of overall foreign losses can arguably lead to international double taxation in an economic sense. Suppose that, in year 1, a U.S. corporation has a loss of 100 in country A and income of 100 in the United States. In year 2, the corporation has income of 100 in country B and no other income or loss. Country B and the United States each impose tax at a rate of 35%. On these facts, and ignoring for the sake of simplicity the 50% limitation on recharacterizing income per Section 904(f)(1)(B), the corporation would pay tax of 35 to the United States and tax of 35 to country B for total taxes of 70, even though it had net income of only 100 and the applicable tax rates were each 35%. If the corporation's activities are divided into two groups, one, its activities in the United States, and the other, its combined activities outside the United States, the corporation has income of 100, all within the United States, and is paying U.S. tax of 35, a rational result. This may be cold comfort to the corporation, however.

193. I.R.C. § 904(d) (1986).

prevent cross-crediting of foreign taxes against low-taxed foreign income in a way that inappropriately reduces the U.S. residual taxation of foreign income.[194] Thus, Congress's purpose with respect to the U.S. foreign tax credit regime, as redefined in 1986, is to further deviate from capital-export neutrality to the extent necessary to prevent an inappropriate loss of residual U.S. taxation on low-taxed foreign earnings. Thus, the existence of the U.S. foreign tax credit regime along with the limitation regimes of Section 904(a), Section 904(d), and Section 904(f) can be summarized as follows: the U.S. foreign tax credit regime is intended to prevent worldwide double taxation except to the extent necessary to protect the U.S. taxing jurisdiction on U.S. domestic source income and to the extent necessary to protect against prohibited cross-crediting of taxes against low-taxed passive foreign source income.[195]

Although many (including this author) would argue that the above modifications in the foreign tax credit limitation calculation represent reasonable and appropriate adjustments to protect the U.S. taxing jurisdiction over U.S. domestic source income, the same cannot be said with respect to Section 864(e)'s impact on the Section 904 limitation calculation. Section 864(e) was adopted in 1986 and requires U.S. interest expense to be apportioned between U.S. source income and each foreign tax credit basket using a modified global apportionment basis that serves to over-apportion interest expense to foreign source income.[196] Congress has known that Section 864(e) utilizes a flawed apportionment methodology, that it over-apportions U.S. interest expense, and that it harms U.S. jobs by artificially increasing the after-tax cost of capital for borrowing in the United States.[197] When this ill-conceived provision was enacted

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194. *See id.* Effective for years beginning in 2006, the American Jobs Creation Act reduced the number of foreign tax credit baskets down to two baskets: the "passive basket" and the "general basket". American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

195. I.R.C. § 904(a) and (d) (2010).

196. I.R.C. § 864(e) (2006). The conceptual errors in Section 864(e)'s apportionment methodology and how this regime is flawed is not seriously questioned and is thoroughly explored elsewhere. *See generally* Bret Wells, *Interest Allocation: The Dog Days of Summer,* 53 TAX EXECUTIVE 365 (2001); Bret Wells, *Interest Allocation: A Regime in Desperate Need of Sound Policy,* 53 TAX LAW. 859 (2000).

197. *See* 138 CONG. REC. H3817-03 (daily ed. May 27, 1992) (statement by Rep. Rostenkowski introducing H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act"):

> Madam Speaker, the first part of this legislation corrects several problems in the current tax law that could result in over taxation of income earned by U.S. companies conducting business abroad. The most significant provision in this section of the Bill would correct anomalies in the apportionment of interest

in 1986, it was intended to be a revenue-raising provision that was devoid of any reasoned tax policy justification.[198] Congress has known for decades that this provision creates substantial international double taxation and harms the U.S. economy.[199] In fact, Congress has found that "the United States is the only country that currently imposes harsh and anti-competitive interest expense allocation rules on its businesses and workers."[200] Further, the Joint Committee on Taxation has conceded that the effect of Section 864(e)'s interest expense allocation rules has been to increase the cost for U.S. companies to borrow in the United States, to make it more expensive to invest in the United States, and to subject U.S.-based multinationals to excessive amounts of double taxation.[201] And yet, Section 864(e) continues to survive because fixing it has been considered "too expensive" from a budgetary perspective.[202] From 1986 until 2004, Congress attempted to repeal Section 864(e) multiple times, but each time failed with one exception.[203] As to that one exception, in 1999, Congress actually passed

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> expense of U.S. multinational companies between domestic and foreign source income. This is a critical component in the calculation of the foreign tax credit for a significant number of U.S. multinational corporations. Madam Speaker, several members of the business community have told me that this issue relating to the proper apportionment of interest expense may be the number one tax problem for U.S. multinational corporations attempting to conduct business effectively abroad. The correction of these anomalies and the rationalization of these rules would promote the significant policy objective that U.S.-based multinational corporations should be taxed fairly on income generated from overseas operations, and should not be subject to double taxation on such earnings.

H.R. 5270 was not enacted.

198. *See* Joseph L. Andrus, *Planning Under U.S. Interest Expense Allocation Rules*, 70 TAXES 1008, 1010 (1992) (stating that the current interest allocation rules were not the result of a principled approach to international taxation but rather represented a compromise position that was designed to raise revenue); T. Timothy Tuerff & Keith F. Sellers, *Taking Advantage of Exceptions to Asset-Based Apportionment*, 1 J. INT'L TAX'N 261,262 n.4 (1991); *International Taxes: Treasury Urged to Back Interest Expense Allocation by Earnings and Profits Bases*, DAILY TAX REPORT at G-5 (Oct. 7, 1991).

199. *See* 145 CONG. REC. 105, H6239 (daily ed. July 22, 1999) (statement of Rep. Portman) ("let me mention a couple of other great provisions in the Archer bill, such as reforming unfair tax rules like the interest allocation rules that are driving U.S. companies and jobs out of this country").

200. COMM. ON WAYS AND MEANS, American Jobs Creation Act of 2004, H.R. REP. NO. 108-548 at 183.

201. JOINT COMM. TAXATION, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONG., at 265 (Comm. Print 2005).

202. *Id.*

203. *See, e.g.*, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, H.R. 3838, 99th Cong. (1986); H.R. 3545, 100th Cong., § 10242 (1987); H.R. 3299, 101st Cong., § 6210 (1989); H.R. 5270, 102d Cong., 3817 (1992); H.R. 2488, 106th Cong., § 902 (2000).

legislation[204] that would have amended Section 864(e), but President Clinton, for budgetary reason, vetoed the legislation.[205]

In 2004, the country commenced a new chapter in its grizzly Section 864(e) saga, but this new chapter has had the same practical effect. In this regard, Congress enacted a new Section 864(f) to allow taxpayers to elect a worldwide apportionment of interest expense (and thus escape the methodology set forth in Section 864(e)),[206] but Congress delayed the effective date of Section 864(f) until tax years commencing after December 31, 2008, as a revenue-raising provision.[207] However, before taxpayers could make the elections afforded under section 864(f), Congress further delayed the effective date[208] of Section 864(f) until tax years beginning after December 31, 2010, as a revenue raising proposal.[209] In 2009, Congress again delayed the implementation of Section 864(f) until tax years commencing after December 31, 2017, as another revenue-raising proposal.[210] Moreover, the House version of the healthcare reform bill would have repealed Section 864(f) outright as a revenue-raising proposal,[211] but that proposal was not acted upon. Instead, Congress deferred the effective date a third time for Section 864(f) to tax years beginning after December 31, 2020, as another a revenue raising provision.[212] So although it is now accepted wisdom that current law incorrectly allocates U.S. interest expense and that this mistake creates substantial injustice, Congress has chosen to continue to delay the effective date of Section 864(f) in order to raise revenue for other priorities. The unfortunate norm in today's world is that US MNCs find themselves in an excess foreign tax credit posture and experience

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204. H.R. 2488, 145 CONG. REC. 114, S10286-90 (daily ed. Aug. 5, 1999); H.R. 2488, 145 CONG. REC. 114, H7251-52 (daily ed. Aug. 5, 1999).

205. *See After Veto, White House Dismisses GOP Extenders Bill*, 1999 TAX NOTES TODAY 185-1, 185-1 (Sept. 23, 1999).

206. Section 864(f) was added to the code by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 401(c), 118 Stat. 1418 (2004).

207. *Id.*

208. Housing and Economic Recovery Act of 2008, Pub.L. No. 110-289,122 Stat. 2654 (2008).

209. *See e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, 110th Cong., GENERAL EXPLANATION OF LEGISLATION ENACTED IN THE 110TH CONGRESS 257 (Comm. Print 2009) (stating, without explaining, that "Congress believes it appropriate to delay implementation of the worldwide interest allocation rules").

210. Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92,123 Stat. 2984 (2009) (stating, without explaining, that "Congress thought it appropriate to delay implementation of the worldwide interest allocation rules").

211. Affordable Health Care for America Act, H.R. 3962, 111th Cong., § 554 (2009).

212. Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

international double taxation even though the U.S. corporate income tax rate is higher than all other major countries.[213]

Faced with potential international double taxation, US MNCs simply refused to repatriate their foreign earnings.[214] In 2004, Congress believed that the effect of current law was to create a "lock-out effect" that was harmful to the U.S. economy,[215] and so Congress enacted Section 965,[216] which provided for a temporary 85% dividends received deduction for certain cash dividend repatriations.[217] The Obama administration and Congress have been pressured by US MNCs to re-adopt Section 965 again.[218] Thus, Section 965 represents another data point indicating that the current U.S. international

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213. Martin Sullivan, *"Interest Allocation Reform: Time to Talk or Time to Act?"* 19 Tax Notes Int'l 871 (1999).

214. *See* COMM. ON WAYS AND MEANS, American Jobs Creation Act of 2004, H.R. Doc. No. 108-548, at 146 (June 16, 2004). Admittedly, some US MNCs earn low-taxed foreign income in their controlled foreign corporations and refuse to repatriate those low-taxed controlled foreign corporation earnings due to the residual US taxation that would apply upon repatriation. To the extent that the lock-out effect is explained by this alternative fact pattern, the lock-out effect is not entirely attributable to international double taxation but instead is attributable to a desire to continue the deferral privilege. However, to the extent that the foreign tax credit mistakes discussed in II.B. result in a denial of appropriate foreign tax credit relief upon a repatriation of foreign earnings, international double taxation is created to that extent. In the author's experience, the foreign tax credit mistakes set forth in this article contribute to the creation of international double taxation and in turn discourage repatriation of foreign earnings. Thus, even though the lock-out effect is not fully explained by international double taxation, a part of the explanation is attributable to inappropriate international double taxation due to the inaccuracies of the foreign tax credit relief under current law.

215. *See* COMM. ON WAYS AND MEANS, American Jobs Creation Act of 2004, H.R. Doc.. No. 108-548, at 146 (June 16, 2004) ("The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings. The Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad. The Committee emphasizes that this is a temporary economic stimulus measure."). However, for a recent report that finds that Section 965(a) had no meaningful impact on US job creation, *see* CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis* by Jane G. Gravelle and Donald J. Marples (October 27, 2011).

216. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1514, §§ 422, 965 (2004). It appears that the temporary dividends received deduction did not have significant effect on U.S. job creation. *See* Jane G. Gravelle and Donald J. Marples, CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis* 5 (2011).

217. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1514, § 422 (2004).

218. *See e.g., Repatriation Holiday Can't Wait for Tax Reform, Corporate CEOs Say,* 2011 TAX NOTES TODAY 222-31, Doc. 2011-24101 (Nov. 15, 2011) (letter to President Obama was signed by 15 CEOs of the largest U.S. MNCs). For a further discussion of the "lock-out" effect of current law, see STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME, JCX-42-11, 74-75 (2011).

tax regime is seriously broken. Current law has failed the Homeless Income test. But, at the same time, to the extent that Section 965 signals that US MNCs that have paid significant foreign taxes are not able to avoid international double taxation through their reliance on the existing U.S. foreign tax credit rules, Section 965 provides further evidence that the current international tax rules are not working effectively and that fundamental reform is in fact needed.

III. CHAIRMAN CAMP'S PROPOSAL.

On October 26, 2011, Chairman Camp released draft legislation entitled the Tax Reform Act of 2011.[219] In the House Ways and Means Committee announcement that accompanied the proposed legislation, Chairman Camp indicated that this draft legislation ultimately will encompass a broad reform package that would include a reduction in the individual tax rates to 25% offset by individual revenue-raising provisions that would be designed to broaden the individual tax base.[220] On the corporate tax front, **TRA 2011** proposes to reduce the maximum corporate tax rate to 25% offset by corporate base-broadening proposals that are also in the process of being developed by the committee.[221] Finally, the announcement indicates that international tax changes in the context of comprehensive tax reform are intended to be revenue neutral, so international reforms should not fund, and should not be funded by, tax reforms implemented in other areas.[222] In **Section III.A** below, this paper analyzes the general framework of the draft legislation. In **Section III.B**, this paper discusses four key challenges to the efficacy of the territorial tax regime contemplated in the draft legislation. The objective of setting forth the deficiencies and design challenges relating to the draft legislation is done in order to set forth areas where further targeted reform is needed.

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219. *See* Press Release, supra note 2.

220. *See* Press Release, *supra* note 2; *See also* **TRA 2011,** § 101 (2011) (placeholder for revenue-raising reforms to achieve budget neutrality).

221. *See* COMM. ON WAYS AND MEANS, SUMMARY OF WAYS AND MEANS DISCUSSION DRAFT: PARTICIPATION EXEMPTION (TERRITORIAL) SYSTEM 1 (April 20, 2012), http://waysandmeans.house.gov/UploadedFiles/Summary_of_Ways_and_Means_Draft_Option.pdf (last visited Mar. 24, 2012).

222. *Id.*

A. *Overview of Proposed Legislation.*

In the draft legislation, a new Section 245A would provide for a [95%] dividends received deduction ("**DRD**") with respect to the foreign-source portion of dividends received from a controlled foreign corporation by a domestic corporation that is a U.S. shareholder within the meaning of existing Section 951(b).[223] The utilization of a DRD approach to eliminate the risk of international double taxation is likely to be broadly welcomed by both US MNCs that earn low-taxed income in structures such as those set forth in **Illustration #1** as well as with US MNCs that have lost confidence in the efficacy of the U.S. foreign tax credit regime to appropriately mitigate international double taxation for the reasons set forth in **Section II.B** of this paper. The technical explanation indicates that the 5% taxable portion of any foreign source dividend is "intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income."[224] Thus, this aspect of the draft legislation is similar to the French tax regime, which allows a 95% participation exemption and a full deduction for headquarters expenses.[225]

Under new Section 245A(b)(2), the [95%] DRD would also apply to the income of foreign branches of a domestic corporation, which would be treated as controlled foreign corporations.[226] The desire to conform the tax treatment afforded to foreign branches with those of foreign subsidiaries is consistent with the original formulation of the "foreign business corporation" in the Foreign Incentive Investment Act of 1960.[227] The technical explanation confirms the following implications with respect to this conformity: (1) foreign branches would become subject to Subpart F; (2) all rules applicable to intercompany transactions (such as Sections 482 and 367) would apply to transactions between the foreign branch and its domestic corporation; and (3) no credit or deduction generally would be allowed for foreign taxes paid by the foreign branch (other than under Section 960 for a Subpart F

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223. *See also* **TRA 2011,** § 301 (2011).

224. **TRA 2011 Technical Explanation,** *supra* note 6.

225. *See* BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEMS, 22-23 (2011).

226. *See* **TRA 2011,** § 245A(b)(2)(A) (2011) ("(i) such branch shall be treated for purposes of this title as a separate corporation which is a controlled foreign corporation, and (ii) such domestic corporation shall be treated for purposes of this title as a United States shareholder with respect to such controlled foreign corporation.").

227. See H.R. Rep. No. 1282, H.R. 5 Foreign Investment Incentive Act of 1960, 86th Cong. 2d Sess. at -2 (February 19, 1960).

income inclusion with respect to the foreign branch).[228] The technical explanation indicates that the rules and principles applicable to determine whether a foreign corporation is engaged in a U.S. trade or business would apply to determine whether a foreign branch exists.[229] New Section 245A(b)(1) allows a domestic corporation to elect to treat all its 10/50 companies as controlled foreign corporations with the consequence that the domestic corporation would be treated as a U.S. shareholder with respect to each 10/50 company.[230] The election would be made by the domestic corporation and would cover all current and future 10/50 companies of the domestic corporation.[231]

The draft legislation has the [95%] DRD amount in brackets presumably because the exact percentage of the foreign DRD has not been definitively determined.[232] This percentage is different from all other possible DRD rates already existing in Section 243 and Section 245,[233] and so an initial question would be whether Congress should use this opportunity to harmonize the DRD percentages allowed under existing Section 243, Section 245, and new Section 245A. If these percentages were harmonized, then needless planning opportunities premised on accessing the larger DRD rates may be avoided. If Congress chooses to not harmonize the rates, then further clarification is needed in order to determine what planning strategies are consistent with the purpose for the various DRD rates of Section 243, Section 245, and Section 245A.[234] As to how to determine eligibility for new Section 245A, the technical explanation indicates that the rules in existing Section 245 are to be coordinated with the application of new Section 245A.[235] However, further guidance is likely to be needed with respect to the application of new Section 245A, as indicated in the below **Illustration #2A** and **Illustration #2B**.

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228. *See* **TRA 2011 Technical Explanation,** *supra* note 6 at 22.

229. *Id.*

230. *See* **TRA 2011,** § 245A(b)(1)(A) (2011).

231. *See* **TRA 2011 Technical Explanation,** *supra* note 6 at 21.

232. *See* James P. Fuller, *U.S. Tax Review,* 64 TAX NOTES INT'L 741, 745 (2011).

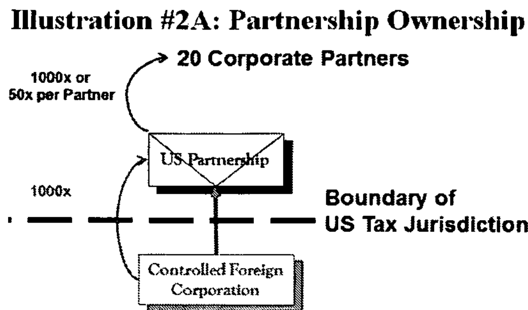
233. *See* I.R.C. §§ 243, 245 (2006) (containing a number of other percentages for dividends received deduction rates, none of which is 95%).

234. In this regard, new Section 245A(c) provides that the foreign-source portion of a dividend qualifying for the [95%] dividends received deduction would be determined based on the ratio of the controlled foreign corporation's undistributed foreign earnings to the controlled foreign corporation's total undistributed earnings, which earnings is defined as the earnings and profits of the foreign corporation computed under Sections 964(a) and Section 986 but including earnings previously included by the U.S. shareholder under Subpart F. *See* United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 245A(c) (2011).

235. *Id.* at 19.

Illustration #2A: A U.S. partnership owns all of the stock of a foreign corporation that has $1,000x of undistributed foreign earnings and profits and no U.S. source earnings and profits. The U.S. partnership is owned equally by 20 U.S. corporations, all of which own 5% of the U.S. partnership. The controlled foreign corporation makes a $1,000x distribution to the U.S. partnership and the U.S. partnership in turn distributes 50x to each partner.

Illustration #2A: Partnership Ownership



In the above ownership structure, it is clear that the foreign corporation in **Illustration #2A** is a controlled foreign corporation because the U.S. partnership is considered a U.S. shareholder for purposes of applying Section 957.[236] However, even though the U.S. partnership is a U.S. shareholder of the foreign corporation, arguably the corporate partners of the U.S. partnership would not be entitled to the [95%] DRD because none of the domestic corporate partners "is a United States shareholder with respect to such controlled foreign corporation" if this test were applied at the partner level and not at the partnership level, but this result may not be entirely clear.[237] If Section 245A were applied in this manner, then the foreign

236. *See* I.R.C. § 957 (2006).

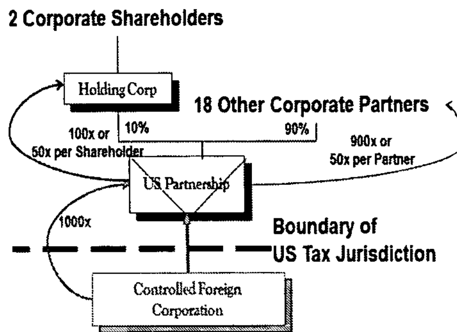
237. *See See* I.R.C. § 702(a)(5); WILLIAM S. MCKEE, WILLIAM F. NELSON, & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS at ¶9.03(4th ed.. 2011) (stating that the dividends received deduction under § 243(a)(1) and (c)(1) is determined at the partner level and not the partnership level but admits that the law is not sparse on this point). The law is clear that eligibility for deemed foreign tax credits under Section 902 is determined at the partner level. *See* I.R.C. § 902(c)(7) and Rev. Rul. 71-141, 1971-1 C.B. 211. But Section 311(a) of **TRA 2011** repeals this analogous line of authority. *See* United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 311(a) (2011). *See also* I.R.S. Priv. Ltr. Rul. 2001-37-038 (June 19, 2001) (the character of foreign sales corporation dividends to corporate partners flows through in determining 100 percent dividends-received deduction under § 245(c)(1)); I.R.S. Nat'l Office Field Serv. Adv. 2000-26-009 (Mar. 23, 2000) (same).

dividend would be taxable to each U.S. domestic corporation at the full corporate tax rate without the benefit of the DRD.

To mitigate the risk that new Section 245A may not apply in the fact pattern set forth in **Illustration #2A**, taxpayers may engage in the planning set forth in **Illustration #2B**, below.

> **Illustration #2B:** The facts are the same as **Illustration #2A** except that two of the U.S. corporate partners decide to form a U.S. domestic corporation to serve as a holding company to own the partnership interest in the U.S. partnership so that 90% of the U.S. partnership is owned by eighteen 5% U.S. corporation partners and 10% of the U.S. partnership interest is owned by one U.S. corporate holding company. The U.S. corporate holding company in turn is owned 50:50 by Corp. A and Corp. B. The controlled foreign corporation makes a $1,000x distribution to the U.S. partnership and the U.S. partnership in turn distributes 50x to each partner.

Illustration #2B: Corporate Holding Corporation



Under the modified facts set forth in **Illustration #2B**, the holding company now would be entitled to the [95%] DRD set forth in new Section 245(c) and in addition any future distribution from the holding company to its shareholders would appear to be entitled to an 80% DRD under Section 243. The ultimate US tax obligation incurred in **Illustration #2A** is significantly different than the US tax obligation in **Illustration #2B**, and the question should be asked whether there is a clear policy rationale for such a distinction in rates due to the insertion of a paper holding company. If there were such a justification,

then it would be helpful for the legislative history to more fully detail the rationale for such a distinction.

The technical explanation states that the Subpart F regime would be retained to ensure that the [95%] DRD applies only to income from the conduct of an active foreign business.[238] The draft legislation modifies the current Subpart F regime as follows: (i) Section 956 would be repealed[239] because, as explained in the technical explanation, all the foreign earnings of a controlled foreign corporation generally would be eligible for the [95%] DRD, and (ii) Sections 959 and 961 would be repealed,[240] which would mean that 5% of any earnings of a controlled foreign corporation that are currently taxed to a U.S. shareholder under Subpart F would again be subject to U.S. tax when actually distributed.[241] Thus, at a maximum corporate tax rate of 25%, a distribution of Subpart F income would be subject to additional U.S. tax of 1.25%.[242]

New Section 245A(e) disallows the foreign tax credit otherwise available under Section 901 for any taxes paid or accrued with respect to any dividend for which the [95%] DRD would be allowed.[243] Additionally, no deduction would be allowed for any taxes that were disallowed as a credit by reason of new Section 245A(e).[244] Section 311 of **TRA 2011** repeals Section 902[245] (which treats a domestic corporation as paying foreign taxes paid by a foreign corporation in which it holds a qualifying interest)[246] and repeals Section 78[247] (which requires a dividend "gross-up" for deemed paid credits under Section 902).[248] The repeal of Section 902 creates a significant potential tax cost to 10/50 companies if the U.S. shareholder does not elect to treat the 10/50 company as a controlled foreign corporation for purposes of the [95%] DRD because dividends from a non-electing 10/50 company would be subject to full U.S. taxation without the [95%] DRD and without deemed paid credits.[249]

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238. *See* **TRA 2011 Technical Explanation,** *supra* note 6 at 18.

239. *See* **TRA 2011,** § 321(a) (2011).

240. *Id.* at §§ 322(a)-(b)

241. *See* **TRA 2011 Technical Explanation,** *supra* note 6 at 30.

242. This double taxation result would be minimized if Congress adopted the **Base Protecting Surtax** set forth in **Section III.B.I** of this paper in lieu of the expansive Subpart F backstop regime contemplated in the draft legislation.

243. *See* **TRA 2011,** §§ 245(e)(1)-(e)(2) (2011).

244. *Id.*

245. *See* **TRA 2011,** § 311(a) (2011).

246. *See* I.R.C. § 902 (2006).

247. *See* **TRA 2011,** *supra* note 6, § 311.

248. *See* I.R.C. § 78 (2006).

249. *See* **TRA 2011 Technical Explanation,** *supra* note 6, at 21.

Notwithstanding the [95%] DRD, a U.S. shareholder of a controlled foreign corporation would continue to be taxed currently on any Subpart F income of the controlled foreign corporation[250] and would continue to be eligible for deemed-paid foreign tax credits under Section 960.[251] However, any foreign earnings previously taxed under Subpart F would be treated as foreign undistributed earnings of the controlled foreign corporation for purposes of determining the foreign source portion of any dividend eligible for the [95%] DRD.[252] The same treatment would apply to any 10/50 company treated as a controlled foreign corporation for this purpose.[253]

B. *Unresolved Issues with Proposed Legislation.*

1. Tax Base Erosion.

As previously mentioned, the draft legislation continues to rely on the Subpart F regime as the principal backstop regime to prevent the erosion of the U.S. tax base and the creation of Homeless Income out of U.S. territorial profits. Unfortunately, as previously discussed above in **Section II.A**, the Subpart F regime has never been an adequate backstop to prevent U.S. tax base erosion, and the historical record casts considerable doubt about whether it could ever serve as an effective "backstop" to the U.S. transfer pricing rules. Nevertheless, despite the historical ineffectiveness of the U.S. Subpart F regime, the draft legislation continues to rely on the existing Subpart F regime as the principal means of protecting the U.S. tax base and then includes three additional alternatives for enhancing the Subpart F regime.

Section 331A of **TRA 2011** proposes to add a new Section 954(a)(4) in order to treat any excess returns of a controlled foreign corporation from "covered intangible" property as Subpart F income if such income is subject to a low foreign effective tax rate.[254] This proposal has been advanced by the Obama Administration as a needed reform for several years.[255] These

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250. *Id.* at 18.

251. *Id.* at 27.

252. **TRA 2011 Technical Explanation**, *supra* note 6, at 19.

253. *Id.* at 20-21.

254. *Id.* at 32.

255. *See* DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS 42-45 (2011); *see also* JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL, JCS-2-10, at 273 (2010). Treasury officials advise that the excessive return proposal does not conflict with U.S. transfer pricing or treaty obligations, since it is

proposals represent more of the same in terms of relying on the Subpart F regime as a "backstop" to inappropriate transfer pricing results, but the historical record augurs against any belief that such reliance will have any effect.

Section 331B of **TRA 2011** creates a new Section 952(a)(3) to treat all "low-taxed cross border foreign income" as a new category of Subpart F income.[256] For this purpose, low-taxed foreign income would include the gross income of a controlled foreign corporation that neither is subject to an effective tax rate greater than 10%, nor is derived in the home country of the controlled foreign corporation.[257] In broad terms, Section 331B represents the original policy recommendation of President Kennedy in his speech on April 20, 1961 and advocated by then Secretary Dillon in the 1961 House hearings.[258] This result creates the greatest competitive problem because it attacks the tax haven problem by implementing rules that only apply to US MNCs and ignores the Foreign MNC use of tax haven subsidiaries. Given the global competitive environment, the likelihood of this regime being adopted is even less likely than in 1961. Even if adopted, US MNCs would be able to side-step new Section 952(a)(3) entirely simply by incorporating the IFHC in **Illustration #1** in a jurisdiction that had a 10% tax rate, and one would expect that several countries would provide for a corporate tax regime that will satisfy this 10% tax rate requirement.

Section 331C of **TRA 2011** treats all of a controlled foreign corporation's foreign intangible income as a new category of

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a Subpart F proposal, not a transfer pricing proposal, and provides a "backstop" to the existing transfer pricing rules. *See* David D. Steward, *Excess Returns Proposals Don't Conflict with OECD Guidelines, U.S. Official Says*, 2010 WORLDWIDE TAX DAILY 207-1 (Oct. 27, 2010).

256. **TRA 2011 Technical Explanation,** *supra* note 6, at 33.

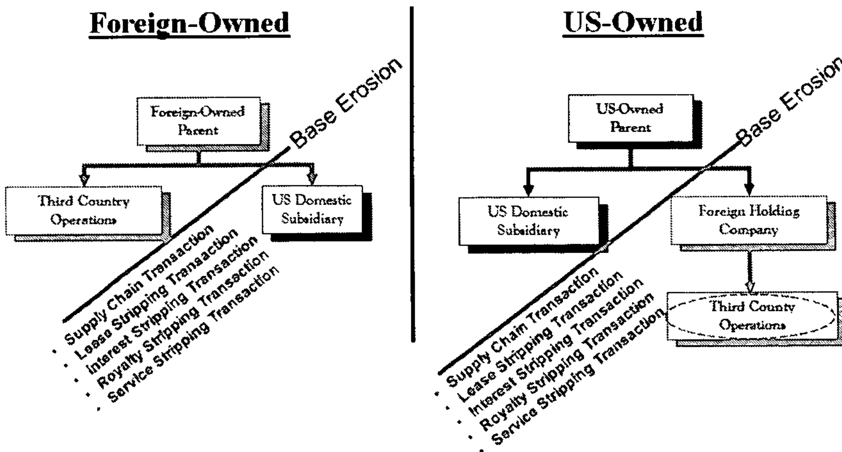
257. *See* **TRA 2011 Technical Explanation,** *supra* note 6, at 33. For this purpose, new Section 331B(b)(2) provides that income would be considered derived by a controlled foreign corporation in its home country only if (1) the income is earned in the conduct of a trade or business of the controlled foreign corporation in such country, (2) the controlled foreign corporation maintains an office or other fixed place of business in such country, **and** (3) the income is derived from the sale of property for use, consumption or disposition in such country or from services that are provided in such country. *Id.* Condition (3) seems to adopt the assumption that tax avoidance is afoot when a US-controlled group consolidates a manufacturing or distribution operation in one foreign country rather than setting up a separate plant or distribution center in each foreign country where sales will be made.

258. *President's 1961 Tax Recommendations: Hearings Before the House Comm. on Ways and Means*, 87th Cong. 1st Sess. 30 (1961) (statement of Secretary Dillon) *reprinted in* 17 INTERNAL REVENUE ACTS OF THE UNITED STATES: REVENUE ACTS OF 1953-1972 WITH LEGISLATIVE HISTORIES, LAWS AND CONGRESSIONAL DOCUMENTS, 30 (Bernard D. Reams ed., 1985).

Subpart F income, foreign base company intangible income, but would allow this category of Subpart F income to be taxed at a concessionary [15] percent tax rate.[259] This proposal creates a form of "Patent Box" regime that is similar to regimes utilized in several European countries that also have territorial tax regimes.[260] This proposal attacks **Royalty Stripping Transactions**, but importantly it leaves intact all of the other base erosion planning techniques. These foreign patent box regimes have created significant complexity and have not appeared to have any effect on the tax haven problem and again attack the Homeless Income problem solely as a US MNC problem and ignores the role of Foreign MNCs.

None of the above approaches represent a comprehensive approach to base erosion strategies that can create Homeless Income for either a Foreign MNC or a US MNC. If one were to view the defense of the U.S. territorial tax base in a comprehensive manner, then one may view the issues as depicted in the below **Illustration #3.**

Illustration #3: MNC Comparison



As indicated in the above **Illustration #3**, the issues that must be addressed include tax planning and base erosion opportunities afforded by the five enumerated base erosion strategies set forth above and as described in **Illustration #1.**

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259. *See* **TRA 2011 Technical Explanation,** *supra* note 6, at 34.

260. *See* BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEMS, 11 (stating general patent box type regime); *Id.* at 34 (discussing the Dutch patent box regime); *Id.* at 38 (discussing Spain's patent box regime); *Id.* at 45-46 (discussing the U.K.'s patent box regime).

Base erosion opportunities are available to both US MNCs and to Foreign MNCs. A Subpart F-type base protection regime that is designed to apply to only a subset of the global MNC community (namely US MNCs) and includes only a subset of the total related-party base erosion strategies available to US MNCs (namely, **Interest Stripping Transactions, Lease Stripping Transactions**, and **Royalty Stripping Transactions**) is unlikely to be successful. In addition, to the extent that an enhanced Subpart F-type regime were implemented as part of **TRA 2011**, then it would create a further competitive disadvantage for US MNCs versus Foreign MNCs, and this would promote the potential for US MNCs being acquired as a means of eliminating this disadvantage.[261]

Instead of continuing to rely on the Subpart F regime as a backstop, this paper proposes that Congress should repeal the Subpart F regime (except for the foreign personal holding company rules of Section 954(c) and the foreign insurance income rules of Section 953)[262] and should instead address tax base erosion and the Homeless Income problem by correcting the transfer pricing mistake before it is created, and this can be done if the United States were to impose a gross "**Base Protecting Surtax**" on any base erosion payment made by the U.S. payer to a foreign affiliate.[263] The proposed replacement regime that would be substituted for the expanded Subpart F regime set forth in **TRA 2011** would have the following elements:

1. U.S. taxpayers would be required to prepare their transfer pricing documentation along with their transfer pricing methods using a One-Sided TP Methodology.264 This

261. *See generally What Corporate Inversions Teach Us About International Tax Reform, supra* note 10, at 1345; (describing how U.S. multinational corporations are at a disadvantage when it comes to tax policy compared to foreign based multinational corporations).

262. The foreign personal holding company rules of Section 954(c) and the provisions under Section 953 regarding foreign insurance income may be justified on grounds independent of base erosion concerns, and so these aspects of the Subpart F rules may be needed in any event.

263. This proposal was first proposed in Wells, *supra* note 12. The proposal set forth herein borrows from that earlier recommendation.

264. **One-Sided TP Methodologies** refer to the traditional transactional tests of comparable uncontrolled price, resale price, cost plus, and comparable profits methods. These methods are "one-sided" in the sense that they apply the arm's length standard by making one party the "tested party" that is entitled to only a "routine profit." Under the Treasury regulations, there is no strict hierarchy of methods. Instead, the Treasury Regulations prescribe a more flexible "best method" approach. The best method is the method that provides the most reliable measure of an arm's length result. Treas. Reg. § 1.482-1(c)(1). In applying the "best method" rule, the parties should use the information

approach would ensure that the U.S. taxpayer reports at least a routine profit margin on the business activities performed in the United States.

2. Congress should enact legislation that subjects a related party U.S. payer[265] to a **Base Protecting Surtax** when the U.S. payer makes a base erosion payment to a related foreign entity.[266] The purpose of the **Base Protecting Surtax** is to collect a tax upfront for the expected U.S. tax that should be due with respect to the residual profits that are represented by the base erosion payment.[267] For purpose of establishing the amount of the **Base Protecting Surtax**, the U.S. government should establish the surtax at the high end of the range (say, a 10% surcharge). Thus, under this proposal, the determination of the amount of residual profits, non-routine intangibles, and the associated profit split would not be deferred to taxpayers to report. Instead, an upfront surcharge will be collected assuming that significant residual profits above the routine

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that is considered the most reliable. Treas. Reg. § 1.482-1(c)(2). The impact of testing only one party and not both parties is that the untested party is entitled to all residual profits by default. The historical development of these transactional transfer pricing methods is more fully set forth in Wells, *supra* note 12.

265. For this purpose a U.S. payer is either (i) a U.S. affiliate of the foreign recipient entity or, potentially, (ii) an unrelated U.S. entity that regularly makes base erosion payments to a foreign entity.

266. A foreign entity would be any entity or group of entities that do not pay U.S. tax on a net income basis.

267. The Ad Hoc Group of Experts studied the appropriate gross-versus-net relationship for a roughly similar purpose with respect to the effort to determine an appropriate withholding tax rate for interest, rents and royalties. Further, the commentary to the UN Model Treaty indicates that the OECD believed that ten percent was considered "a reasonable maximum" for interest, but broad agreement was not able to be reached within the member nations. See United Nations Model Double Taxation Convention Between Developed and Developing Countries, Articles 11(2) and 12(2), ST/ESA/102 (1980). As a result, the rates for royalties, rents, and interest were left unspecified in the UN Model Treaty with the percentage to be established through bilateral negotiations. See United Nations Model Double Taxation Convention Between Developed and Developing Countries, Articles 11(2) and 12(2), ST/ESA/102 (1980). However, the Ad Hoc Group of Experts did provide guidance on how member nations should determine the appropriate gross withholding rate. See Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries at 70-72 and 77-79, ST/ESA/94 (1979).

profits of an enterprise exist and are being migrated away via base erosion payments, so the proposed **Base Protecting Surtax** collects an upfront estimate of this amount. The U.S. payer would include the **Base Protecting Surtax** in its own tax payments and annual tax returns. If the **Base Protecting Surtax** were not paid, the U.S. payer-obligor would lose the right to a U.S. deduction (including no cost of goods deduction) for the cross-border payment made to the foreign entity.

3. If the U.S. payer believes that the amount of the **Base Protecting Surtax** (say, 10% of the gross amount of any base erosion payment) is in excess of the amount needed to protect the U.S. tax base in light of the overall business, functions, and risks performed in the United States, the U.S. payer could request a determination from the IRS that a lower surtax is required through a "**Base Clearance Certificate**" process.[268] However, the burden is on the U.S. payer to demonstrate that the **Base Protecting Surtax** is in an amount that exceeds the normal U.S. tax rate on the payer's share of the residual profits of the MNC. The purpose of the **Base Clearance Certificate** process is to assure that income earned by the U.S. payer, and its resultant domestic tax liability, represents an appropriate application of U.S. transfer pricing principles, but again the U.S. taxpayer must provide evidence based on the combined

268. Such a clearance process could be along the lines of the current Service Advance Pricing Agreement Program. See Rev. Proc. 2006-9, 2006-2 I.R.B. 278. In the event that such a policy were to be implemented, it would be necessary for the Service to expand the APA Program in a manner to facilitate efficient resolution of the influx of requests that could be anticipated. The IRS could also be given authority to provisionally reduce the upfront **Base Protecting Surtax** to a lower upfront amount for particular taxpayers if its application would be excessive in a specific case by allowing the IRS to provide an interim **Base Clearance Certificate** on the condition that the inbound company provide its foreign books and records and participate in a review process that utilizes an appropriate **Two-Sided TP Methodology** that considers the overall combined profits of the MNC after the year-end.

> income of the overall profits of the MNC and allow the IRS the right to confirm that the portion of the MNC's residual profits that are attributable to the U.S. affiliate is in fact less than the surtax's collected amount. Thus, a **Two-Sided TP Methodology**[269] will be used to determine whether the pre-set **Base Protecting Surtax** is excessive based on all of the appropriate facts and circumstances.[270] Importantly, **One-Sided TP Methodologies** would not be a sufficient basis for reducing the amount of the **Base Protecting Surtax** because those methodologies fail to consider the residual profits of the combined global company.

In the event that the U.S. payer were a participant in an APA, CAP, or other advance resolution program that included transfer pricing, it should be able to handle the **Base Clearance Certificate** process efficiently, though the nature of the IRS process would need to be administratively evolved. If the U.S. payer were not part of such a program, then the appropriately determined administrative process would need to be commenced. In this process, the IRS would request all pertinent financial information, presumably including combined income and functional information, as a result of which it would ascertain the residual profit. The process would then be similar to a bilateral transfer pricing or competent authority matter. A functional analysis would be undertaken to determine the arm's length sharing of the combined income, including the residual profits. Again, whereas current law contains a bias against source country taxation of residual profits, the **Base Protecting**

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269. **Two-Sided TP Methodologies** refer to profit split or residual profit split methodologies. These methods are "two-sided" in the sense that both affiliates are considered "tested parties" under these transfer pricing methodologies for purposes of determining how to allocate the combined income of the MNC whereas the traditional transactional transfer pricing methods represent **One-Sided TP Methodologies** in that the transaction transfer pricing methods use only one affiliate as the "tested party."

270. Professor Reuven Avi-Yonah proposed implementing a withholding tax on all deductible payments of U.S. payers, including payments to treaty or OECD countries, which would be refundable when the recipient showed that tax has been reported in the country of residence. *See* Reuven S. Avi-Yonah, "A Coordinated Withholding Tax on Deductible Payments," 2008 TNT 107-35, Doc. 2008-11497 (June 2, 2008). The **Base Protecting Surtax** is not a withholding tax on a foreign person, but the same need for efficient tax collection exists with respect to potential U.S. tax base erosion and Homeless Income. This point has been applied in some source countries. *See, e.g.*, *"Qatar: Companies Required To Withhold on Payments to Firms Not Located in Countries,"* Daily Tax Rep. at I-2, June 14, 2011.

Surtax represents a bias in favor of applying source country taxation over residual profits.

The success of global advance pricing agreement programs—which began with Japan in 1986,[271] the US in 1991,[272] and then spread around the world with OECD Guideline focus[273]—indicates that such a **Base Clearance Certificate** system could be made operational, though it would require a significant expansion of the extant programs. The **Base Protecting Surtax** proposed in this paper is illustrated in the following example:

> **ILLUSTRATION #4.** U.S. Parent has a wholly owned subsidiary (Intermediate Foreign Holding Company, or "IFHC"). Affiliates of the IFHC, through contract manufacturing arrangements with the IFHC, manufacture products on behalf of the IFHC. The IFHC sells the manufactured goods to U.S. Parent for an aggregate purchase price of $1,000 for distribution in the U.S. market. Significant marketing and other intangibles related to the manufactured goods exist due to U.S. R&D efforts with respect to these goods. U.S. Parent earns a profit of $10 from its distribution activities. For U.S. transfer pricing documentation purposes, U.S. Parent applies a **One-Sided TP Methodology** and determines that a profit of $10 is within the arm's length range for a distributor if U.S. Parent had no nonroutine intangibles. The IFHC realizes a $210 profit of which $30 represents a routine manufacturing profit margin and $180 represents residual profits of the US MNC group.
>
> Under the **Base Protecting Surtax** proposal set forth in this paper, an additional surtax of $100x (U.S. Parent's purchase price of $1,000 x 10% surtax) would be owed by the U.S. Parent. Thus, the total tax liability of the U.S. Parent is initially determined to be as follows:

271. See *OECD Transfer Pricing* ¶ 14.31[3].
272. See *US International Transfer Pricing* Chapter 12.
273. See *OECD Transfer Pricing* Chapter 11.

Regular tax: $3.50 ($10X profit x .35)
Surtax: $100.00 ($ 1,000 purchases x .10)[274]
Total US Tax $103.50

Let's assume that a functional analysis indicates that $100 of the $180 of US MNCs residual profits is determined to be allocable to the U.S. Parent's marketing and R&D activities conducted within the United States.[275] In this event, the regular income tax liability of the U.S. Parent in **Illustration #4** would be $ 3.50 (routine distribution profit of $10 x 35% tax rate) plus $35 (i.e., U.S. Parent's share of residual profits of $100 x 35% tax rate) for a total of $38.50. Once the **Base Clearance Certificate** process were completed, the U.S. Parent would file an amended return seeking a refund of the excessive surtax initially reported ($100 - $35 = $65 refund).[276]

The purpose of the **Base Protecting Surtax** is to ensure upfront collection of the estimated tax on residual profits of the multinational enterprise that should be allocated to the United States but that are not so allocated because taxpayers are often permitted to file their tax returns using One-Sided TP Methodologies that fail to consider the existence and sharing of non-routine residual profits. When assessing the appropriate amount of U.S. tax that should apply on residual profits, the United States should give a priority to either a formulary apportionment or a profit-split methodology to ensure that the United States is able to tax its fair share of the residual profits of the combined global income. Furthermore, in applying these transfer pricing methodologies, a functional analysis should be performed to determine which country is entitled to tax the residual income, and until proven otherwise the United States should start with the premise that the residual profits should be taxed in the United States since the base erosion payments are being paid from United States.[277] A **Base Protecting Surtax**

274. The rate of the surtax would need to be determined by comprehensive economic modeling. The overall intention for the surtax is that it would provide an approximation of the overall rate of taxation for the broadest base of MNCs.

275. This determination could be made on the basis of **Two-Sided TP Methodologies** such as a profit split, residual profit split, or formulary apportionment methodology applied in a manner consistent with § 482.

276. The IRS could also be given authority to reduce the **Base Protecting Surtax** to a lower amount if its application would be particularly excessive by providing a **Base Clearance Certificate** on the condition that the inbound company provide its foreign books and records and participate in a review process.

277. In this functional analysis, the IRS should view allocation of profits to tax havens or other jurisdictions with suspicion unless those allocations are supported by true economic substance.

changes the basic presumption that has allowed zero-taxed Homeless Income to be created. This proposal prevents Homeless Income from arising because it collects an upfront surtax on the gross amount of all base erosion payments. If the foreign affiliate of a foreign-owned multinational does not wish to disclose its offshore books and records, then at least a 10% gross surtax is collected and retained. But, for many inbound multinationals, this proposal would create an incentive to be transparent and to work with the IRS to determine the correct amount of tax that is due on the U.S. share of residual net profits arising from U.S. inbound activities. Because current law allows base erosion payments to become Homeless Income with no upfront collection mechanism, the IRS is left in the unenviable position of trying to defend the U.S. tax base against a zero-sharing of the MNCs residual profits through costly and expensive audits where the IRS may have difficulty obtaining foreign books and records. An upfront surtax changes the incentives.

The proposed **Base Protecting Surtax** is a surtax on the payer and is not a withholding tax on the payee. The **Base Protecting Surtax** seeks to collect the tax that is due on the payer's share (not the payee's share) of the residual profits that are earned by the MNC from the U.S. The surtax changes two presumptions by assuming (i) that base erosion payments represent a transfer of residual profits to the offshore recipient and (ii) that the onshore payer should have shared in those residual profits. Section 6662 and the **One-Sided TP Methods** do a fine job of assuring that routine profits are reported by the onshore subsidiary. Although these transfer pricing penalty and documentation rules have been effective at motivating taxpayers to pay U.S. tax on routine profits, these provisions have not been successful at causing self-reporting of U.S. tax on residual profits. The **Base Protecting Surtax** assumes there is a residual profit that exists for the payer that is being base eroded away by the related-party base erosion payments set forth in **Illustration #1** and **Illustration #3** because this is the historical lesson that is learned from the discussion set forth in **Section II.A** of this article. If the MNC discloses its overall books and proves that in fact there is a lesser amount of residual profits to be shared with the onshore payer, then a refund could be paid. Because the proposed **Base Protecting Surtax** relies on a profit split which is one of the accepted transfer pricing methods, because the surtax is refundable if shown to be inconsistent with the arm's length result, and because the

technical taxpayer is the onshore payer and not the offshore recipient, the proposal is consistent with existing treaties.[278]

Since the **Base Protecting Surtax** proposal would be the primary means of protecting the U.S. tax base from tax base erosion, the Subpart F rules (except for Section 954(c) and Section 953)[279] should no longer be needed, and their elimination would reduce a tax handicap borne by US MNCs versus their foreign-owned MNC competitors while meeting the original policy challenge that led to the enactment of the Subpart F regime in the first place.[280] As outlined in **Section II.A** above, the Subpart F rules evolved over a multi-decade time period as a means to protect the tax base from the conversion of U.S. origin profits into Homeless Income, [281] but the basic tools to create Homeless Income were left in place. A commentator could fairly ask "why are you so confident that the adoption of the proposed **Base Protecting Surtax** displaces the need for an expansive Subpart F regime?" The answer is that the upfront surtax is the backstop regime, and it is sufficient because tax is collected upfront on the estimate residual profit that is being transferred via the base erosion payment and the upfront surtax is not refunded unless a **Two-Sided TP Methodology**[282] where both parties are treated as "tested parties" is utilized. By collecting the expected right amount of tax on the residual profits upfront

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

279. *See* note 262, *infra*.

280. As mentioned in note 57, *infra*, Secretary Dillon had said that if another fair or reasonable way of addressing the Homeless Income problem could be found, then that would "take care of the bulk of what [Secretary Dillon and the Kennedy administration] was worrying about." *See* Statement of Secretary Dillon in the Hearings on the President's 1961 Tax Recommendations before the House Ways and Means Committee, 87th Cong., 1st Sess. at 345 (Volume 1) (May 4, 1961), *reprinted at* Reams, U.S. Revenue Acts: 1953-72 Legislative Histories, Laws & Congressional Documents (Volume 17) (1985). The proposed "**Base Protecting Surtax**" is "another fair or reasonable way of addressing the Homeless Income problem and as such should be considered acceptable in terms of the policy criteria articulated in the 1962 Hearings since the **Base Protecting Surtax** "takes care of the bulk of what [Secretary Dillon and the Kennedy administration] was worrying about."

281. *See* Durst, "The Two Worlds of Transfer Pricing Policymaking," 2011 TNT 16-23 (suggesting that backstop provisions of the Subpart F regime are the critical elements of combating U.S. tax base erosion).

282. *See* note 269 for a further explanation of **Two-Sided TP Methodologies** and their superiority over **One-Sided TP Methodologies** for explaining the residual profits of a global MNC. An analysis for why the United States had historically endorsed transactional transfer pricing methodologies that tested only "one party" in the MNC context has been exhaustively considered by the author in Wells, *supra* note 12.

and by requiring a **Two-Sided TP Methodology** to determine the correct attribution of the profits based on a functional analysis of the true origins of the profits with all parties treated as "tested parties," the Homeless Income mistake is quashed before it arises and is handled as a transfer pricing matter where profits can only be attributed to a party that is tested using a functional analysis. With this proposal, the Homeless Income problem is met head-on via an effort to collect the tax on residual profits at the instance that a base erosion payment is being made whereas the existing Subpart F regime does not address the Homeless Income problem at its root cause and attempts to use ad hoc and pre-set classification regimes that police base erosion after-the-fact. The historical experience since the enactment of the Subpart F regime provides strong evidence that Homeless Income will not be thwarted by an ad hoc Subpart F classification paradigm that is applicable to only US MNCs. The solution to the Homeless Income problem is found only by targeting reform at the transfer pricing methodology mistakes that allow Homeless Income to be created. Unless appropriate transfer pricing collection and compliance procedures are put into place to forestall the migration of residual profits via base erosion payments as depicted in **Illustration #1**, the Homeless Income problem will persist.

2. Indirect Expenses.

Even if Congress comprehensively addresses the Homeless Income problem by implementing the **Base Protecting Surtax** set forth in the above **Section III.B.1**, the draft legislation of **TRA 2011** contains an additional policy problem that must be addressed with respect to indirect expenses. In this regard, it is clear to this author that once **TRA 2011** is enacted that US MNCs will attempt to maximize foreign source income eligible for the DRD provided by new Section 245A and will attempt to shift indirect expenses to their U.S. affiliates in order to reduce the U.S. tax on U.S. territorial income.[283] If foreign-situs income is entitled to a [95%] DRD while foreign-situs indirect expenses are fully deductible, a negative tax rate can be created. New Section 904(b)(3) opens the door to this type of planning because it provides that only directly allocable deductions would be disallowed as a deduction while indirect expenses such as stewardship, general and administrative, and interest expense

283. *See* JOINT COMM. ON TAXATION, JCX-42-11, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME, 94 (Comm. Print 2011) (discussing potential to create a negative tax rate).

are explicitly listed as the types of expenses that are not to be disallowed (i.e., not to be apportioned to foreign source income of the U.S. shareholder) if those costs are deductible under Section 162 by the U.S. corporation on the grounds that services performed by the U.S. corporation were for its own benefit (supervisory or stewardship activities) and any benefits received by the offshore subsidiary were secondary in nature or remote and incidental. [284]

Section 332 of **TRA 2011** contains a limited restriction on indirect expenses that are in the nature of interest expense.[285] In this regard, a new Section 163(n) would be added to deny a deduction for interest expense of a U.S. shareholder that is a member of a worldwide affiliated group that includes at least one controlled foreign corporation. The provision is intended to address "base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense."[286] Under the statutory test, excessive interest expense would exist if the U.S. taxpayer fails: (1) a relative leverage test (which compares the leverage of the domestic group members to the comparable leverage of the group), and (2) a percentage of adjusted tax income test.[287] If

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284. *See* Section 312 of **TRA of 2011**; **TRA 2011 Technical Explanation,** *supra* note 6, at 27-28. For a review of the principles for determining whether an expenditures is a shareholder expenditure that primarily benefits the U.S. shareholder or is instead primarily benefits the foreign subsidiary, *see* e.g. Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964), *acq. in part* 1965-2 C.B. 4; *Young & Rubicam, Inc. v. United States,* 410 F.2d 1233 (Ct. Cl. 1969); Treas. Reg. §1.482-9(l)(3)(ii) through (v); *see also* Treas. Reg. §1.861-8(e)(4) (stewardship). For a ruling that demonstrates the application of these principles to general and administrative costs incurred by a foreign subsidiary and the extent to which those costs might be recharged to the U.S. parent when they are incurred to allow the U.S. parent to comply with U.S. securities laws, *see e.g.,* P.L.R. 8806002 (Sept. 24, 1987) (foreign subsidiary costs are entitled to be recharged if (i) duplicative review or performance of activities already undertaken by the subsidiary; (ii) periodic visitations and general review of the subsidiary's performance; (iii) meeting reporting or other legal requirements of the parent-shareholder that the subsidiary would not incur but for being part of the parent's affiliated group; and (iv) financing or refinancing the parent's ownership participation in the subsidiary. Given the substantial corporate governance costs that are now required to comply with the public filings with the U.S. Securities and Exchange Commission and also to comply with the Sarbanes-Oxley Act of 2002 that are not required for the day-to-day operations or local compliance in the local country, one would expect that significant foreign general and administrative costs are incurred primarily for the benefit of U.S. laws compliance efforts. This assertion is further set forth in the discussion to Case One, Case Two, and Case three in the text.

285. *See* **TRA 2011 Technical Explanation,** *supra* note 6, at 35-36.

286. *Id.*

287. *Id.*

both tests are failed, the interest expense deduction is reduced by the lesser of the two amounts determined under the tests.[288]

The addition of new Section 163(n) represents a needed and appropriate safeguard to protect the U.S. tax base against efforts to park excessive debt in U.S. affiliates. However, the law would be improved if Section 163(n) would provide that the U.S. taxpayer could not argue that its debt-to-equity ratio were more favorable than the debt-to-equity ratio set forth in its publicly-filed financial statements. If taxpayers were required to accept book-tax conformity for purposes of this debt-equity calculation, then planning strategies that would seek to alter this ratio may be minimized. Furthermore, the debt-to-equity ratio set forth in new Section 163(n) would be greatly simplified if new Section 163(n) used a fixed debt-to-equity ratio as does Section 163(j). Moreover, even more broadly, new Section 163(n) and Section 163(j) should be conformed since the earnings stripping impact of **Interest Stripping Transactions** is conceptually the same whether the multinational engaging in an **Interest Stripping Transaction** is a US MNC or a Foreign MNC.

However, the above rules only deal with interest expense and do not address foreign-situs indirect expenses generally.[289] To address the concern that taxpayers will plan to shift significant foreign-situs indirect expenses to U.S. affiliates, new Section 904(b)(3) should be changed as follows:

ALTERNATIVE NEW SECTION 904(b)(3): DEDUCTIONS ALLOCABLE TO FOREIGN SOURCE INCOME ~~ONLY IF DIRECTLY ALLOCABLE~~.—For purposes of subsection (a), the taxpayer's taxable income from sources without the United States shall be determined by allocating deductions to such income ~~only~~ if such deductions are directly allocable to such income or if such deductions are indirect expenses that are not effectively connected to a US trade or business of the recipient payee.

Under current law, it is possible for a foreign payee to treat a payment from a U.S. payer as foreign source income while the

288. *Id.* Section 163(j)(2)(B)(i)(II) already limits deductions for certain interest that exceeds a specified amount of adjusted taxable income. However, existing Section 163(j) applies only to certain interest that is paid to or guaranteed by a related person. *See* Section 163(j)(3) (definition of disqualified interest). Proposed Section 163(n) contains no similar limitation.

289. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, *Present Law and Issues in U.S. Taxation of Cross-Border Income*, 60-61 (JCX-42-11) (September 6, 2011) (recognizing both incentive and opportunity for base erosion outside of **Interest Stripping Transactions** exists but then after recognizing this fact the report does not strongly endorse the need for comprehensive base erosion protection).

U.S. payer is able to claim a U.S. tax deduction for such foreign-situs indirect expenses.[290] Congress should take this opportunity to conform the deductibility for foreign-situs indirect expenses for the U.S. payer with the sourcing rules that apply to the foreign payee recipient so that a U.S. tax deduction is not allowed to the U.S. payer if the recipient of the foreign-situs indirect expense payment is outside the U.S. territorial tax system. If the above changes were not made, then multinationals could effectively create a negative tax rate by getting a full deduction for the foreign-situs indirect expenses while the foreign income would be entitled to a [95%] DRD. Some have argued that indirect expenses should be allowed for competitiveness reasons, but the scholarship seems to focus on indirect expenses that are paid to recipients that are themselves part of the U.S. tax base.[291] This paper assumes that Congress would agree to the symmetry of providing a U.S. tax deduction for indirect expenses when the service provider is subject to U.S. net basis taxation. In that context, there has not been a net reduction in the overall U.S. territorial taxing jurisdiction. However, it is a different matter to allow a deduction for foreign-situs indirect expenses that serve to reduce the U.S. territorial tax base when the foreign-situs indirect expense does not directly contribute to the creation of U.S. territorial profits and where the recipient of such payments are not subject to net basis taxation in the United Status. The **TRA Technical Explanation** offers no stated reason for eliminating the allocation and apportionment requirement of Treasury Regulation Section 1.861-8 for general and administrative expenses,[292] but the concern may be that disallowance of a deduction for indirect expenses may negatively impact U.S. jobs. However, foreign-situs indirect expenses that do not directly contribute to the creation of U.S. origin profits represent a significant concession for the U.S. territorial tax

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290. *Compare* § 862(a)(3) (applies rules for sourcing of income from services) *with* Treas. Reg. §1.861-8 (sets forth rules for allocating and apportioning expenses).

291. *See* James R. Hines Jr., *Foreign Income and Domestic Deductions,*61 NAT'L TAX J. 461, 461-75 (3d ed. 2008); *see also* Johannes Becker &Clemens Fuest, *Foreign Income and Domestic Deductions: A Comment,* 63 NAT'L TAX J. 269, 269-77 (2d ed. 2010) (challenging, and further defending, Hines's view); *see also*James R. Hines, *Reply to Becker and Fuest,* 63 NAT'L TAX J. 278, 278-80 (2d ed. 2010); *see also*Harry Grubert, *Comment on Desai and Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Tax Setting,"* 58 NAT'L TAX J. 263, 263-74 (2d ed. 2005) (providing an earlier exchange on the expensing issue); *see also* Mihir A. Desai &James R. Hines, Jr., *Reply to Grubert,* 58 NAT'L TAX J. 275, 275-78 (2d ed. 2005); *see also* Mihir A. Desai &James R. Hines, Jr., Old Rules and New Realities: Corporate Tax Policy in a Global Tax Setting,__NAT'L TAX J. 937, (2005) (prompting the underlying exchange on the expensing issue).

292. *See* **TRA 2011 Technical Explanation,** *supra* note 6, at 27-28.

system, and as a result it should only be afforded full deductibility if the recipient is also subject to U.S. taxation on a net basis (i.e., the recipient is someone that holds a "U.S. job").

The above recommendations are illustrated through three hypothetical cases as follows.

> **CASE ONE:** A US MNC conducts an extensive external audit of its foreign subsidiaries to comply with the Sarbanes-Oxley Act of 2002 and to comply with SEC reporting requirements. The audit is part of U.S. laws compliance. The cost of the audit, including foreign office costs, are charged to the U.S. parent.

In the fact pattern posited in **CASE ONE**, all costs would represent shareholder costs of the U.S. parent, and therefore are fully deductible by the U.S. parent without any apportionment per Section 904(b)(3).[293] The effect of this result is that the U.S. taxpayer would reduce the U.S. territorial tax base, while the recipient would earn foreign source income that is not subject to U.S. net basis taxation. Under the Alternative Section 904(b)(3) provision set forth in this paper, only the external audit costs that are paid to U.S. payees who report such payment as U.S. taxable income are allowable as a deduction for the U.S. payer in **CASE ONE**. Thus, under the Alternative new Section 904(b)(3), the indirect expenses that are paid to foreign service providers would be non-deductible unless the income is effectively connected with the conduct of a U.S. trade or business of the payee. To allow a deduction for payments to a foreign payee in the fact pattern posited in **Case One**, as new Section 904(b)(3) of

293. *See* Treas. Reg. § 1.482-9(l)(3)(iv) (providing a shareholder activity is not considered to provide a benefit to a foreign subsidiary if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both); Treas. Reg. § 1.482-9(l)(5) Example 9 (indicating that internal audit costs are entirely deductible by U.S. parent). Under existing law, these costs would be required to be apportioned between foreign source income and U.S. source income. *See* 26 C.F.R. § 1.861-8(b)(3) & (c)(3). If these were instead viewed as stewardship expenses, then the allocation regime would be as set forth in Treas. Reg. §1.861-8(e)(4)(ii). For a ruling that demonstrates the application of these principles to general and administrative costs incurred by a foreign subsidiary and the extent to which those costs might be recharged to the US parent when they are incurred to allow the US parent to comply with US securities laws, *see e.g.*, P.L.R. 8806002 (Sept. 24, 1987) (foreign subsidiary costs are entitled to be recharged if (i) duplicative review or performance of activities already undertaken by the subsidiary; (ii) periodic visitations and general review of the subsidiary's performance; (iii) meeting reporting or other legal requirements of the parent-shareholder that the subsidiary would not incur but for being part of the parent's affiliated group; and (iv) financing or refinancing the parent's ownership participation in the subsidiary.

TRA 2011 so allows, would result in a negative income tax rate for the US MNC since these cost did not directly contribute to the creation of U.S. territorial profits. It would also create a net decrease in the overall U.S. tax base since the income recipient is not subject to U.S. taxation while the U.S. payer would be entitled to claim a full reduction in its U.S. territorial taxable income.

A variation of the above example is set forth in the following **CASE TWO:**

> **CASE TWO:** A U.S. multinational group incurs substantial software and implementation costs in order to implement a consolidation software (Hyperion or some other competitor product) that allows information from the local accounting systems to be uploaded into a worldwide accounting package so that the data can be analyzed and used for U.S. financial reporting purposes. The foreign subsidiaries document that their in-house accounting departments spend X amount of time per day on the information reporting required by the U.S. parent entity to comply with SEC reporting requirements. The foreign subsidiary recharges these foreign employee costs and licensing cost for foreign-situs users on a cost basis to the U.S. parent.

In the fact pattern posited in **CASE TWO**, all costs would represent supportive and/or stewardship costs of the U.S. parent under Treasury Regulation Section 1.861-8, and existing Section 482 regulations arguably allow these costs to be recharged on a cost basis. As a result, under existing law, all of these intercompany charges arguably represent an indirect expense that arguably is fully deductible by the U.S. parent without any apportionment per new Section 904(b)(3).[294] Under the Alternative new Section 904(b)(3) provision, the consolidation software costs related to foreign user licenses and the internal employee costs incurred by the foreign offices associated with uploading foreign subsidiary data into the consolidation software are indirect expenses that are not effectively connected with the conduct of a U.S. trade or business, and therefore, are non-deductible to the U.S. parent. To allow a deduction for payments to a foreign payee in the fact pattern posited in **Case Two**, as new Section 904(b)(3) so allows, would result in a negative

294. *Id.*

income tax rate for the US MNC since these cost did not directly contribute to the creation of U.S. territorial profits. It would also create a net decrease in the overall U.S. tax base since the income recipient is not subject to U.S. taxation while the U.S. payer would be entitled to claim a full reduction in its U.S. territorial taxable income.

A final variation on the above theme is set forth in the below **CASE THREE** as follows:

> **CASE THREE:** A foreign subsidiary of a U.S. multinational incurs substantial investigative costs, and process re-design costs in order to comply with the Foreign Corrupt Practices Act, and more broadly with the Sarbanes-Oxley Act of 2002. These additional supervisory and oversight costs are in excess of and are duplicative of what is required to conduct the day-to-day operations of the foreign subsidiary.

Under existing law, these duplicative costs provide only an indirect benefit to the foreign subsidiary and thus arguably are shareholder costs of the U.S. parent, and existing Section 482 regulations arguably allow these costs to be recharged on a cost basis.[295] As such, the costs represent an indirect expense that would be deductible in full under new Section 904(b)(3) of **TRA 2011**.[296] To allow a deduction in this instance would create a negative income tax rate to the U.S. taxpayer since the deduction to the U.S. parent would reduce its U.S. taxable income, and the income recipient is not subject to U.S. taxation upon receipt of the income. However, under the Alternative new Section 904(b)(3) provision, the costs of the added duplicative supervisory costs that are incurred in foreign subsidiaries in order to comply with the FCPA and the Sarbanes-Oxley Act of 2002 are indirect expenses that are not effectively connected with the conduct of a U.S. trade or business of the payee since these costs are borne by foreign situs employees and foreign situs businesses, and therefore are non-deductible to the U.S. parent under the Alternative new Section 904(b)(3). To allow a deduction for payments to a foreign payee in the fact pattern posited in **Case Three**, as new Section 904(b)(3) of **TRA 2011** so allows, would result in a negative income tax rate for the U.S. MNC since these cose did not directly contribute to the creation of U.S. territorial profits. It would also create a net decrease in the overall U.S. tax

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295. *Id.*

296. **TRA 2011**, *supra* note 6.

base since the income recipient is not subject to U.S. taxation while the U.S. payer would be entitled to claim a full reduction in its U.S. territorial taxable income.

The above three cases present a common theme: the foreign-situs indirect expenses incurred by the U.S. affiliate payer created a negative tax rate for the U.S. affiliate payer and on an overall basis represented a net reduction of the U.S. territorial tax base since the foreign payee is not subject to U.S. tax on receipt of the income. The [95%] amount is bracketed in the draft legislation of **TRA 2011**,[297] presumably because the exact amount of the DRD has not been definitively resolved. If the existing mismatches in the sourcing rules for payees and the deductibility criteria for payers are not conformed, then one would expect significant tax planning and significant intercompany recharges will occur. Congress may be surprised by the amount of in-country foreign subsidiary compliance costs that are incurred solely because of the need for the foreign subsidiary to comply with U.S. laws. Under current law, due to the inadequacy of the foreign tax credit relief available under Section 904's calculation methodology, many U.S. multinationals may be motivated to have these foreign-situs, in-country administrative costs borne by each particular foreign affiliate and avoid recharging those costs to the U.S. parent company.[298] However, **TRA 2011** changes the incentives in that these costs would appear to be fully deductible if recharged to the U.S. parent as long as they primarily relate to U.S. laws compliance and are duplicative in nature and not required to conduct the day-to-day operations of the foreign subsidiary. Congress should be concerned about the allowance of a tax deduction for foreign-situs indirect expenses that benefit the overall organization because allowing a full deduction for such expenses when the foreign affiliate's income is eligible for a [95%] DRD opens the

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297. *Id.*

298. However, under certain circumstances the U.S. multinational may be required under Section 482 to make a payment to the foreign affiliate for incurring these costs. *See* Treas. Reg. § 1.482-9(l)(5), Example 11. For a ruling that demonstrates the application of these principles to general and administrative costs incurred by a foreign subsidiary and the extent to which those costs might be recharged to the U.S. parent when they are incurred to allow the U.S. parent to comply with U.S. securities laws, *see e.g.*, P.L.R. 8806002 (Sept. 24, 1987) (foreign subsidiary costs are entitled to be recharged if (i) duplicative review or performance of activities already undertaken by the subsidiary; (ii) periodic visitations and general review of the subsidiary's performance; (iii) meeting reporting or other legal requirements of the parent-shareholder that the subsidiary would not incur but for being part of the parent's affiliated group; and (iv) financing or refinancing the parent's ownership participation in the subsidiary.

door to a significant tax planning opportunity for erosion of the U.S. territorial tax base.

3. Capital Gains Preference.

Section 302 of **TRA 2011** adds a new Section 1247.[299] New Section 1247(a) exempts from gross income [95%] of any gain recognized from the sale or exchange by a U.S. shareholder of stock in qualified foreign corporation, but only if the U.S. shareholder has held such stock for at least one year.[300] Any losses realized from such a sale or exchange would be disallowed.[301]

New Section 1247 is likely to become a rich source of creative dispositional tax planning strategies given that a disposition of a foreign holding company that can be classified as a "qualified foreign corporation" provides the seller of such an entity with significant tax savings without the need to rely on the existing corporate reorganization provisions of existing Section 368. Furthermore, because most foreign countries do not tax the nonresident shareholder on its gain from disposition of stock, the gain would be entirely "homeless" and taxed in no jurisdiction if the home country of the selling shareholder does not tax this gain. Thus, new Section 1247 achieves more than avoiding international double taxation: it allows international double "no taxation" and thus would be a source of Homeless Income. The U.S. tax laws have struggled with "mixing bowl" structures,[302] Midco structures,[303] and have looked at "anti-stuffing" rules[304] to combat aggressive dispositional planning in other contexts, and one would expect that these devices will resurface in the new Section 1247 context as tax planners attempt to repackage

299. **TRA 2011**, *supra* note 6.

300. *Id.*

301. New Section 1247(b) defines a qualified foreign corporation as a controlled foreign corporation (including a foreign branch or 10/50 company treated as a controlled foreign corporation for purposes of the [95%] DRD) provided that at least 70% of the controlled foreign corporation's assets are active assets. *See* I.R.C. § 1247(b) (2011). An active asset for this purpose is any asset that does not produce foreign personal holding company income as defined under Section 954(c). *See* I.R.C. § 954(c) (2011). New Section 1247(c) provides that current Section 1248 would not apply to the extent the [95%] exemption applies to a sale or exchange of controlled foreign corporation stock. *See* I.R.C. § 1247(c) (2011).

302. *See* I.R.C. §§ 704(c)(1)(B), 737 (2004) (attempting to prevent partnerships from being used as a "mixing bowl" to sell unwanted assets through a partnership structure).

303. For an example of using an intermediary tax-preferenced "Midco" in an analogous context, *see* Notice 2004-20, 2004-1 C.B. 608.

304. For an example of an anti-stuffing rule needed to prevent inappropriate usage of tax attributes in a disposition transaction, *see* I.R.C. §§ 336(d)(2), 382(l)(1) (2006); Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B)(1); Treas. Reg. § 1.367(e)-2(b)(1)(ii)(C).

unwanted businesses into a "qualified foreign corporation" wrapper.

To avoid this complexity, an improved rule would be for the United States to exclude [95%] of the shareholder gain to the extent of any unrepatriated foreign earnings and profits of the foreign subsidiary and any gain in excess of such unrepatriated foreign earnings and profits would be subject to normal capital gains rates. Such a regime on its surface appears more complicated than the proposed new Section 1247, but the simplicity of proposed new Section 1247 is likely to disappear over time as anti-abuse rules will be needed to prevent aggressive new Section 1247 disposition planning. Accordingly, the far simpler and more equitable regime would be to adopt a regime along the lines outlined above that is largely patterned after existing Section 1248.

4. Transition Issues.

Section 303 of **TRA 2011** would enact a new Section 965. Under new Section 965(a), the accumulated deferred foreign earnings of controlled foreign corporations (including 10/50 companies treated as controlled foreign corporations) would be treated as a new category of Subpart F income. New Section 965(b) would allow an 85% deduction with respect to this category of Subpart F income so that the effective tax rate on this particular Subpart F inclusion would be 5.25%.[305] New Section 965(e) would allow the U.S. shareholder to claim U.S. foreign tax credits only with respect to the 15% portion that is taxable as a Subpart F income inclusion and provides that the Section 78 "gross-up" would apply only with respect to the taxes that are allowable with respect to this 15% taxable portion.[306]

New Section 965(f) permits the U.S. shareholder to elect to pay any U.S. tax on its Subpart F income inclusion arising by

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305. For this purpose, a controlled foreign corporation's accumulated deferred foreign earnings would mean the controlled foreign corporation's undistributed earnings, excluding Subpart F income under Section 951, previously taxed income excludable from gross income under Section 959, and income effectively connected to a U.S. trade or business determined as of the close of the relevant tax year. Undistributed earnings would mean the earnings and profits of the controlled foreign corporation computed under Sections 964(a) and 986.

306. The above provision has been posited by thoughtful scholars, and new Section 965 represents an endorsement of the approach advocated in these earlier writings. *See e.g.*, Daniel N. Shaviro, *The David R. Tillinghast Lecture The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 417-28 (2010) (stating this transition approach with a higher tax rate on the accumulated deferred foreign earnings).

reason of new Section 965(a) in equal annual installments over two to eight years, with interest.[307]

The accumulated deferred foreign earnings subject to U.S. tax under this transition rule also would be subject to U.S. tax a second time when distributed, but then generally would be eligible for the [95%] dividends received deduction resulting in additional U.S. tax of 1.25%. However, in the case of a 10/50 company that is not treated as a controlled foreign corporation, a subsequent distribution of its accumulated deferred foreign earnings would be subject to full U.S. tax (i.e., the [95%] dividends received deduction would not be available for such distribution).[308] A modification that mitigates this result but is not overly complicated would be to allow a 100% dividends received deduction for any remittance of amounts that had been taxed under Section 965(a) and that are then distributed to the U.S. shareholder within the period that the taxpayer elects to make its installment payments under new Section 965(f). Other than the above minor comment, the transition rule seems to be a thoughtful means of transitioning from the existing law to the proposed territorial regime.

IV. CONCLUSION.

As documented in this paper, the debate over international tax reform, neutrality, competitiveness, and Homeless Income has continued for more than fifty years. With that said, it is important to recognize that the release of the draft legislation of **TRA 2011** by the House Ways and Means Committee has for the first time introduced actual statutory language for implementing a territorial tax regime, and so, if for no other reason, **TRA 2011** has represented an important milestone because it provides interested parties with an opportunity to consider how a territorial tax regime might coordinate with existing rules. Congress and the committee staff are to be commended for this important advancement in this ongoing tax policy discussion.

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307. Under new Section 965(e)(3), the unpaid balance would become immediately due at the time of one of the following events: (1) a failure to make a timely payment; (2) liquidation or sale of substantially all of the U.S. shareholder's assets; (3) the U.S. shareholder ceases its business; or (4) another similar circumstance arises.

308. This double tax result may be a mistake. See Fuller, US Tax Review, 64 Tax Notes Int'l 741, 746 (December 5, 2011). One thing that can be said for this result is that it is administratively simple as there is no tracking of PTI accounts. However, this double tax result would be substantially eliminated if Congress would adopt the **Base Protecting Surtax** proposal set forth in this paper and would repeal the subpart F regime except for the foreign personal holding company rules of §954(c).

However, the draft legislation continues and expands the existing Subpart F regime as the primary means of protecting the U.S. territorial tax base from inappropriate tax base erosion strategies. In this regard, **TRA 2011** seeks to trod the same ground as existing law in that it accepts the notion that the Subpart F regime present Congress' answer to the Homeless Income problem. Yet, even though the Subpart F regime has attempted to represent a "backstop" to protect against inappropriate transfer pricing results, the reality is that the Subpart F regime has never been an effective "backstop" for the U.S. transfer pricing rules. Notwithstanding repeated efforts to reform the Subpart F regime, the Homeless Income problem has not been thwarted. In addition, as U.S. MNCs face greater global competition from Foreign MNCs, the reliance on a "backstop" regime that only applies to one set of global competitors (namely U.S. MNCs) and does not apply to all multinationals makes it apparent that the U.S. tax base will not be protected through this regime. Instead of reliance on a Subpart F regime to police against inappropriate transfer pricing results, Congress should direct their reform efforts towards preventing the transfer pricing compliance and reporting mistakes that are made possible by base erosion payments. To achieve that targeted reform goal, Congress should adopt a **Base Protecting Surtax** as a collection and enforcement mechanism to comprehensively protect the U.S. tax base from all base erosion payments whether made by U.S. MNCs or Foreign MNCs. Congress then should require taxpayers and the IRS to engage in a **Two-Sided TP Methodology** so that residual profits are allocated to a particular party only after the functions of all related parties are analyzed as "tested parties." By employing **Two-Sided TP Methodologies** where all parties are tested parties, Homeless Income will not migrate into the hands of an untested affiliate, such as the IFHC affiliate in **Illustration #1**, because under a **Two-Sided TP Methodology** only those residual profits that can be explained by a factually intensive functional analysis will be allocated under Section 482 to the IFHC. Because history teaches us that residual profits are likely to become Homeless Income under the self-reporting paradigm of current law, a further targeted reform (i.e., a **Base Protecting Surtax** and the mandatory confirming use of a **Two-Sided TP Methodology**) is needed to ensure that appropriate upfront collection and enforcement mechanisms are in place to motivate compliance and transparency with respect to residual profit allocation.

In addition, **TRA 2011** should conform the source rules and the deductibility of foreign-situs indirect expenses so that a

deduction is allowed only with respect to foreign-situs indirect expenses when such payments represent income that is effectively-connected to the conduct of a U.S. trade or business of the recipient payee. With respect to the sale of stock in a controlled foreign corporation, Congress should provide the [95%] DRD only to the extent of the unrepatriated foreign earnings and profits of the controlled foreign corporation. Finally, the draft legislation provides a workable transition rule.

As the United States grapples with its tax policy goals, it must balance the concerns of neutrality, competitiveness, and Homeless Income. The draft legislation of **TRA 2011** provides an international tax regime that arguably achieves a reasonably neutral and more competitive tax system, but in its current form it fails the Homeless Income test just as current law fails the Homeless Income test. History indicates that the United States will continue to be plagued by the Homeless Income problem until Congress comprehensively deals with the transfer pricing compliance and enforcement mistakes that allow Homeless Income to persist. To pass the Homeless Income test, Congress must ensure that **TRA 2011** cannot be manipulated by either U.S. MNCs or Foreign MNCs. If Congress does not modify **TRA 2011** along the lines advocated in this paper, then **TRA 2011** will be destined to suffer the same repeated calls for reform that have plagued the current U.S. international tax regime. Thus, whether in the context of the enacting **TRA 2011** or simply as a targeted reform of current law, in any case it is now time for Congress to comprehensively solve the Homeless Income problem.