INTERNATIONAL TAX POLICY FORUM /
GEORGETOWN UNIVERSITY LAW CENTER

Reform of International Tax: Canada, Japan, United Kingdom, and United States

January 21, 2011

Gewirz Student Center, 12th floor

120 F Street, N.W., Washington, D.C. 20036

International Tax Policy Forum

International Tax Policy Forum and Georgetown University Law Center Conference on:
REFORM OF INTERNATIONAL TAX: CANADA, JAPAN, UNITED KINGDOM, AND UNITED STATES

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   b) B. Mustard, N. Pantaleo, and S. Wilkie, "Why Not Kenora? Reflections on What Canada’s Approach to Taxing Foreign Business Income Is and Could Be," *Report of Proceedings of the Sixty-First Tax Conference, 2009 Conference Report*, Canadian Tax Foundation, (2010) 101
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i) P. Merrill , O. Penn , H-M. Eckstein , D. Grosman, M. van Kessel, "Restructuring Foreign Source Income Taxation: U.S. Territorial Tax Proposals and the International Experience," *Tax Notes*, (May 15, 2006) 220
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International Tax Policy Forum and Georgetown University Law Center Conference on:

REFORM OF INTERNATIONAL TAX: CANADA, JAPAN, UNITED KINGDOM, AND UNITED STATES

with a Keynote Address by **Jason Furman** (Deputy Director, National Economic Council)

Date: Friday, January 21, 2011
Location: Georgetown University Law Center
Gewirz Student Center, 12th floor
120 F Street, NW
Washington, D.C. 20001
Register online at: https://www.law.georgetown.edu/cle/showEventDetail.cfm?ID=252

With the recent adoption of territorial (dividend exemption) tax systems in the UK and Japan, the United States is now the only G-7 country that taxes active business income of foreign subsidiaries under a worldwide tax system. This conference brings together tax authorities and practitioners from Canada, Japan and the UK to discuss why these countries switched from worldwide to territorial tax systems and what the results have been. Issues in the design of a territorial tax system for the United States will be discussed by a panel of tax experts.

8:30 a.m. REGISTRATION

8:55 a.m. WELCOME
William Treanor (Dean, Georgetown University Law Center)
John Samuels (VP and Sr. Counsel—Tax Policy and Planning, GE)

9:00 a.m. INTERNATIONAL TAX RULES IN CANADA, JAPAN, THE U.K., AND THE U.S.: A PRIMER
Moderator: **Charles Gustafson** (Georgetown University Law Center)
Presenter: **Jack Mintz** (University of Calgary)

9:30 a.m. ADOPTION OF DIVIDEND-EXEMPTION SYSTEMS IN CANADA, JAPAN AND THE UK: GOVERNMENT PERSPECTIVES
Moderator: **Will Morris** (GE)
Panel: **Stephen Richardson** (Dept. of Finance, Canada)
Chizuru Suga (Ministry of Economy, Trade and Industry, Japan)
Mike Williams (HM Treasury, U.K.)

10:15 a.m. BREAK

10:30 a.m. ADOPTION OF DIVIDEND-EXEMPTION SYSTEMS IN CANADA, JAPAN AND THE UK: PRACTITIONER PERSPECTIVES
Moderator: **James Hines** (University of Michigan)
Commenters: **Stephen Edge** (Slaughter & May, London)
Nick Pantaleo (PwC, Canada)
Gary Thomas (White & Case, Japan)

11:30 a.m. INTERNATIONALTAX REFORM OPTIONS FOR THE U.S.
Moderator: **Jack Mintz** (University of Calgary)
Panel: **Rosanne Altshuler** (Rutgers)
Michael Graetz (Columbia Law School)
James Hines (University of Michigan
Paul Oosterhuis (Skadden Arps)

12:30 p.m. LUNCHEON

1:00 p.m. KEYNOTE ADRESS
Introduction: **John Samuels** (GE)
Keynote Speaker: **Jason Furman** (Deputy Director, National Economic Council)

1:30 p.m. ADJOURNMENT

International Tax Policy Forum

Web site: www.itpf.org

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About the International Tax Policy Forum

Founded in 1992, the International Tax Policy Forum is an independent group of approximately 40 major multinational companies with a diverse industry representation. The Forum's mission is to promote research and education on the taxation of cross-border investment. Although the Forum is not a lobbying organization, it has testified before the Congressional tax-writing committees on the effects of various tax proposals on U.S. competitiveness. The ITPF briefs Congressional staff periodically and sponsors annual public conferences on major international tax policy issues. The January 2010 ITPF conference on "Locating the Source of Taxable Income in a Global Economy" was co-sponsored with the American Enterprise Institute.

On the research front, the Forum has commissioned over 20 papers on international tax policy topics such as the effects of the interest allocation rules on the competitiveness of U.S. firms, the compliance costs of taxing foreign source income, and the linkages between foreign direct investment and domestic economic activity (*see* www.ITPF.org).

Members of the Forum meet three times a year in Washington, DC to discuss key international tax policy issues with leading experts in government, academia, and private practice.

PricewaterhouseCoopers LLP serves as staff to the Forum. **John Samuels**, Vice President and Senior Counsel for Tax Policy and Planning with General Electric Company, chairs the Forum. The ITPF's *Board of Academic Advisors* includes ITPF Research Director Prof. **James Hines** (University of Michigan), Prof. **Alan Auerbach** (University of California, Berkeley), Prof. **Mihir Desai** (Harvard), Prof. **Michael Devereux** (Oxford), Prof. **Michael Graetz** (Columbia), and Prof. **Matthew Slaughter** (Dartmouth).

ITPF Mission Statement

The primary purpose of the Forum is to promote research and education on U.S. taxation of income from cross-border investment. To this end, the Forum sponsors research and conferences on international tax issues and meets periodically with academic and government experts. The Forum does not take positions on specific legislative proposals.

Dean William Treanor

Welcome to Georgetown Law. While it's impossible to describe such a diverse community in a single page, I hope this will give you a taste of what the Law Center is all about. When we ask our students what attracts them to the school, the response always includes Georgetown's reputation as an academic leader – and the fact that it's in the heart of Washington, D.C. Intellectually and geographically, Georgetown Law is the place where law and ideas meet.

In addition to teaching, members of the Law Center faculty have served key roles in shaping, enforcing, challenging and defending the law in all its forms. Whether they are arguing before the Supreme Court, testifying before Congress, leading a discussion on national security law or serving their government for a time, our students reap the benefits of their expertise.

Georgetown's top–ranked clinical programs give students hands–on experience in more than a dozen areas of law. Our institutes and centers seek innovative solutions to challenges in areas such as global health, climate change and human rights. More than 90 percent of the cases heard by the Supreme Court are mooted first by the Supreme Court Institute. And in any given year, students hear from a variety of speakers ranging from lawyers and judges to Cabinet officials and members of Congress.

Our reach stretches far beyond national boundaries. Initiatives like our Center for Transnational Legal Studies in London offer unique opportunities for study overseas. Our graduates have developed careers in law firms, governments, NGOs, courts, businesses and universities from Europe to Asia and Washington, D.C. And no matter where they are, Georgetown students and alumni demonstrate a commitment to service born of our Jesuit heritage.

At home, students enjoy our dynamic campus in Washington, D.C., just blocks from the U.S. Capitol and the Supreme Court. In addition to the Edward Bennett Williams Law Library and the John Wolff International and Comparative Law Library, Georgetown Law has its own residence hall, sport and fitness center and child care center – a vibrant and collegial community that is convenient for busy law students.

I invite you to browse our website, join our Facebook, Twitter and YouTube sites – or better yet, visit us on campus. Here, you can talk to our faculty, staff and students. Here, you can see firsthand what Georgetown is all about. We look forward to meeting you.

Bill

William Michael Treanor

THE SCHOOL OF PUBLIC POLICY

International Tax Rules in Canada, Japan, the UK and US

January 21, 2011

Jack M. Mintz
Palmer Chair of Public Policy

Principles for taxing foreign source income

- Fairness: Ensuring individuals are taxed on all sources of income
  - Taxation of passive income
- Efficiency:
  - Equal taxation of foreign and domestic activities of foreign corporations.
    - Capital export neutrality
  - International tax competitiveness – home-based multinationals taxed similarly to other foreign corporations operating abroad
    - Capital import neutrality in foreign jurisdiction
    - National ownership neutrality
- Inter-nation fairness: Countries get their fair share of tax base (capital exporting and importing country)

Meaning of Territorality

- Territoriality is an income tax system that exempts foreign-source income earned by residents.
  - Typically applies to corporations, not individuals, partnerships and trusts. Could apply to branches.
  - Even "worldwide" systems have exempt income – deferral systems (retained earnings from active business income earned by multinationals are exempt).
  - Could include exemptions of dividends, capital gains, branch profits, interest, royalties (eg. French and Dutch systems did have exemptions of this type in the past).
- As a term, "territoriality" discussions are centred around a dividend exemption system (with perhaps capital gains and branch profits exemptions).
- Assumption – we are talking about exemptions for distributions and other sources of equity income earned by the parent corporation related to subsidiaries and branches.

Rationale for Exemption Systems

- Presumption that foreign source income is taxed elsewhere (therefore part of "worldwide" system).
  - Even with taxes on repatriated earnings, not much corporate tax revenue has been raised (Grubert and Mutti)
- Dividend tax credit is complex.
- Tax on dividends can be distortionary since subsidiary investment and financing decisions can affect tax on repatriated income in complex ways (Leechor and Mintz).
- Tax on repatriations encourages corporations to leave income in other jurisdictions.
  - Tax on repatriations make it harder for multinationals to shift cash across countries.

Corporate income tax rates

- An important issue is the corporate income tax rate faced by companies. Creates incentives to shift income from high to low tax jurisdictions even in the presence of taxing foreign-source dividends paid to parent.

Country	2011 Corporate Income Tax Rate %
Canada	**28** *(25.6% by 2012)*
Japan	**36**
UK	**27** *(24% by 2014)*
US	**38** (averaged)

Taxation of Foreign Dividends

- Most countries now have an exemption system for foreign dividends or distributions. Profits before their distribution is subject to tax in the source country.
- It is often the case that domestic inter-corporate dividends received from resident corporations are also exempt (subject to certain limitations in some countries).
- Important exception is the United States (and BRIC countries except Russia).

Country	Foreign Dividend or distributions
Canada	Exempt from of foreign affiliates in countries with exchange of information treaties (minimum 10% votes or value)
Japan	95% Exempt (at least 25% ownership)
UK	Exempt (similar to domestic dividends)
US	Taxable

Exemption of other sources of income

- Branch profits and capital gains are taxed at the corporate level under worldwide systems. They could be eligible for the exemption system.
- Practice varies across countries as to whether other sources of equity income are exempt or not.
- Passive income (CFC rules) is taxed in all countries on an accrual basis with a tax credit for foreign tax.

Country	Foreign Capital Gains	Foreign Branch Profits	CFC Regime for Passive Income
Canada	Taxable	Taxable	Yes
Japan	Taxable	Taxable	Yes
UK	Exempt*	Taxable	Yes
US	Taxable	Taxable	Yes

*Trading and holding period requirements.

Some other features

- Most countries continue to tax foreign royalties, fees and interest received from subsidiaries (credit for withholding taxes).
- Restrictions on overhead and interest expense costs vary across countries. Even with an exemption system, some countries do little to restrict interest or overhead cost deductions.

Country	Statutory Restrictions on Interest and Overhead Cost Deductions
Canada	None
Japan	None (95% exemption)
UK	Net expenses restricted to external gross financing of world-wide group subject to gateway test
US	Apportionment between foreign and domestic income. Water-edge interest allocation

Some key issues with dividend exemption systems to think about

- Treatment of foreign capital gains – exemption appropriate to avoid double taxation and eliminate calculation of surplus pots. However, is not consistent with domestic corporate capital gains taxation (one could argue all corporate capital gains should be exempt like inter-corporate dividends).
- Treatment of foreign branches: could argue such income be exempt as in some countries (eg. Germany by treaty). If not, losses could be imported until such time when foreign entity earns profits – turn into a subsidiary without a toll charge (Japan now provides capital gains exemption upon conversion)
- Treatment of overhead and interest costs – should deductions from domestic tax base fund foreign operations – issue of inter-nation fairness but also efficiency.
- Boundary between passive (CFC rules) and exempt income – need to be enforce – raises issue around check-the-box rules in the United States.
- Treatment of tax havens – exemption or taxation?
  - Could be part of CFC rules (passive income test)
  - Taxation of income if foreign tax rate below some threshold low-tax rate. For example, Japan now uses 20% tax rate (recent budget).

Reform of International Tax: Canada, Japan, United Kingdom and United States

Stephen R. Richardson

International Tax Policy Forum
Georgetown University Law Center
21 January 2011

General Perspective

- Canada has a small open economy with a relatively large amount of inbound and outbound international direct investment
- Canada's economy has a large trade component--over 75% of trade occurs with the United States
- Major sectors include natural resources, financial services, and manufacturing
- Canada has a competitive business tax regime:
  - Combined federal/provincial corporate tax rates around 25%
  - Generally no taxes on corporate capital
  - Mostly, no sales tax on business inputs: VAT-like system in most provinces
- Canadian tax policy has generally aimed to provide resident corporations with a competitive regime for outbound investment

Outbound Investment Taxation in Canada: Historical Perspective

- Pre-1972 Tax Reform: simple dividend exemption system
- Dividends received from foreign corporation by resident corporation were exempt from tax where 25% shareholding
- No deductibility of interest on debt used to acquire foreign corporation shares paying exempt dividends
- No taxation of capital gains on shares
- No CFC regime
- Limited bi-lateral tax treaty network

Outbound Investment Taxation in Canada: Current System

- 1972 Tax Reform created a hybrid system using both the exemption method and the tax credit method for dividends received from a foreign corporation by a resident corporation
  - Exemption depends on location of business earnings in a treaty jurisdiction
- Removed the restriction on interest deductibility on debt used to acquire shares paying exempt dividends
- Introduced a CFC regime ("FAPI" rules) for foreign passive income
- Signalled a major initiative to expand Canada's bi-lateral tax treaty network
  - Canada now has tax treaties with approximately 90 other countries
- Over last 30+ years there has been a steady stream of changes to the system, including addition of many complex technical rules

Outbound Investment Taxation in Canada: Recent Policy Developments

- 2007 Budget: Proposed restriction on interest deductibility on debt used to acquire foreign corporation shares paying exempt dividends
- 2007 Budget: Introduced policy to use "exemption" to encourage negotiation of Tax Information Exchange Agreements
- December 2008 Report of the Advisory Panel on Canada's System of International Taxation
  - Canada's system ". . . is a good one that has served Canada well..."
  - Reform not needed, but improvements recommended
- 2009 Budget: Withdrawal of revised restriction on interest deductibility
- 2010 Budget: Withdrawal of Foreign Investment Entity proposals and substantial revision to Non-Resident Trust proposals (from 1999 Budget)

Outbound Investment Taxation in Canada: Policy Issues

- Continued utility of the hybrid system—i.e. tax credit method—in view of large extension of bi-lateral tax treaty network
- Interest deductibility on debt used to acquire shares of foreign corporations paying exempt dividends
- Treatment of capital gains on shares of foreign affiliates disposed of by resident corporation
- Base erosion relating to delineation of foreign business income from foreign passive income, particularly income from financial activities and IP

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Reform of International Tax: Canada, Japan, United Kingdom and United States

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International Tax Policy Forum
Georgetown University Law Centre

January 21, 2011

Advisory Panel on Canada's System of International Taxation

Principles to Guide Canadian International Tax Policy

- Competitive tax system for Canadians investing abroad
- Level playing field for domestic business activity
- Protect Canadian tax base
- Straightforward tax rules
- Open consultation
- Regular benchmarking

Canada
Taxation of Foreign Business Income

Assessment of current system

- "Hybrid" system inconsistent with international norms
- Significant compliance/administrative burden on taxpayers and CRA to track "deferred" income, but for what purpose? Deferred income never taxed!!
- Should exemption system be linked to tax treaties/TIEAs?
- Advisory Panel recommendation:
  - Move to a full exemption system for foreign active business income **including** capital gains/losses on sale of shares of foreign affiliates carrying on such activities

Canada
Taxation of Foreign Passive Income (FAPI)

FAPI regime reflects underlying principle that there is no good reason for Canada's tax system to favour *foreign* over domestic passive income

Future Challenges

- Implications of moving to a full exemption system for foreign active business income – should **all** foreign passive income of all foreign affiliates (not just controlled affiliates) be taxed on an accrual basis?
  - Compliance issues?
- Ensuring base erosion rules do not negatively impede current (global) business practices

Canada
Expense Allocation

No current rules to attribute domestic expenses to foreign exempt or deferred income

In 2007, business community strongly opposed proposed restriction on interest expense incurred with respect to funds borrowed to invest in foreign affiliates

" Canadian businesses need flexibility in raising capital and structuring the financing of their foreign acquisitions and expansions to be competitive with businesses based in other countries. In the Panel's view, this pragmatic concern is of greater weight than the theoretical basis for denying interest deductions on money borrowed to invest in foreign companies or in respect of outbound financings arrangements."

- Advisory Panel on Canada's System of International Taxation, Final Report

Canada
Expense Allocation (cont'd)

End of story in Canada?

- Advisory Panel left door open to restrict deductibility of interest on funds borrowed by *foreign controlled* Canadian companies investing in foreign affiliates in certain circumstances
  - Example of "debt dumping"

Thank you.

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Advisory Panel on
Canada's System of
International Taxation

FINAL REPORT — EXECUTIVE SUMMARY

Enhancing Canada's International Tax Advantage

Advisory Panel on Canada's System of International Taxation

December 2008

Introduction

1 Canada's system of international taxation is important to our country's competitiveness. At the global level, competitiveness is crucial to attracting high-value activities, spurring innovation, and creating skilled jobs. Establishing Canada's competitive advantage is part of the Government of Canada's strategic policy, as set out in *Advantage Canada*,[1] its long-term economic plan. Improving the international tax system will enhance Canada's advantage to the benefit of all Canadians. For this reason, the Minister of Finance established the Advisory Panel on Canada's System of International Taxation in November 2007.

Our mandate

2 The Panel's mandate was to recommend ways to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs, and facilitate administration and enforcement by the Canada Revenue Agency (CRA). The Panel members were drawn from the Canadian business community, professional tax advisory firms, and the tax policy research field. The chair and vice chair of the Panel are Peter C. Godsoe, OC, and Kevin J. Dancey, FCA. Also on the Panel are James Barton Love, QC, Nick Pantaleo, FCA, Finn Poschmann, Guy Saint-Pierre, CC, and Cathy Williams.

Our approach

3 Canada is on its way to achieving the lowest effective tax rate on new business investment in the G7 and is "open to two-way trade, investment and talent,"[2] as encouraged by the Competition Policy Review Panel. With this context in mind, the Panel focused primarily on how Canada's international tax rules affect Canadian businesses investing in foreign markets (the "outbound" tax rules) and how they affect foreign businesses investing in Canada (the "inbound" tax rules).

4 Released in April 2008, the Panel's consultation paper[3] framed the issues and asked questions; numerous submissions were received in response. To obtain a wide range of views, the Panel held meetings across Canada with businesses, industry groups, economists and tax advisors, as well as officials from the Department of Finance and the CRA. The Panel also undertook a research program to supplement its consultations and deliberations.

1 Department of Finance Canada, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Public Works and Government Services Canada, 2006).

2 Competition Policy Review Panel, *Compete to Win* (Ottawa: Public Works and Government Services Canada, June 2008), at p. 13.

3 Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: April 2008).

5 Our views and recommendations have been shaped by the submissions we received, by our deliberations, consultations and research, and by our experiences.

6 The predominant view formed by the Panel is that the Canadian international tax system is a good one that has served Canada well. As such, the Panel's recommendations seek not to reform but rather to improve our existing system.

7 Although the Panel's mandate did not specify that our recommendations should be fiscally neutral, the Panel considered how they could affect Canada's tax revenues. In considering the fiscal impact of our proposals, the Panel recognized the importance of promoting competitiveness and the responsibility of sustaining Canada's tax revenues, especially in light of the current economic climate. We believe the consequences of our recommendations, taken together, should not result in any net fiscal cost to the government.

8 The Panel's goal is to offer pragmatic, balanced and actionable advice to the Minister of Finance toward improving Canada's international tax system for the benefit of our country.[4]

4 The Panel's final report, *Enhancing Canada's International Tax Advantage,* is available at: www.apcsit-gcrcfi.ca

The Current Environment

9 The global landscape is changing quickly. Current events show how swiftly capital markets can change and influence industrial and commercial activity, and how adaptable Canadian companies need to be in response. As a relatively small trading nation, Canada has historically pursued an open economy; its system of international taxation reflects this pursuit.

Cross-border investment and tax policy

10 Cross-border business investment has become central to the world economy. Global two-way trade is important to Canada's prosperity, as it is to that of other countries. New competitors are emerging, notably from developing economies. Some of these new competitors are aggressively seeking capital, while others have substantial amounts of capital to invest. Canadian businesses need to be able to compete with them for investment on both the outbound and inbound fronts.

11 Direct investment by Canadian businesses abroad is associated with efficiency gains and greater productivity. Such benefits may arise from the ability to achieve scale economies and greater specialization, set up global supply chains, and access foreign technologies. Although a common worry among some Canadians is how Canadian direct investment abroad affects Canadian employment, the Panel found no clear evidence that such investment leads to the export of jobs or increases unemployment in a capital-exporting country like Canada.

12 Investment by foreign businesses in Canada adds to the stock of capital invested in Canada, resulting in faster growth, greater employment, higher living standards, and additional tax revenues for governments in Canada.

13 To support Canadian business investment abroad, attract foreign business investment at home, and strengthen our open economy, tax policy must keep pace with global trends. The significance of two-way trade and the need for a complementary system of international taxation are central to the Panel's recommendations.

Principles for Guiding Canada's International Tax Policy

14 The Panel acknowledges that setting international tax policy entails trade-offs and practical constraints. In the Panel's view, Canadian international tax policy makers should be guided by the following principles:

1. Canada's international tax system for Canadian business investment abroad should be competitive when compared with the tax systems of our major trading partners.
2. Canada's international tax system should seek to treat foreign investors in a way that is similar to domestic investors, while ensuring that Canadian-source income is properly measured and taxed.
3. Canada's international tax system should include appropriate safeguards to protect the Canadian tax base.
4. Canada's international tax rules should be straightforward to understand, comply with, administer and enforce, to the benefit of both taxpayers and the CRA.
5. Full consultation should precede any significant change to Canada's international tax system.
6. Canada's international tax system should be benchmarked regularly against the tax systems of our major trading partners.

15 We believe that an international tax system that is consistent with these principles will be competitive, efficient and fair, and deliver predictable and certain results. The system will also be less costly for all businesses to comply with, and easier for the CRA to administer and enforce.

16 The Panel believes that mutual responsibility and cooperation among businesses, tax advisors and government will strengthen our self-assessment system and help to achieve efficiency and simplicity within Canada's system of international taxation. Applying the above principles, in a spirit of cooperation and mutual respect, would offer Canada an opportunity to distinguish itself from other countries and enhance its international tax advantage.

Our Recommendations

17 The Panel has designed an integrated package of specific recommendations for improving Canada's system of international taxation in the following areas: outbound and inbound tax rules, non-resident withholding taxes, and administration, compliance and legislative process.

18 Two key directives emerge from applying the Panel's principles:

- The federal government should maintain the existing system for the taxation of foreign-source income of Canadian companies and extend the existing exemption system to all active business income earned outside of Canada by foreign affiliates.
- The federal government should maintain the existing system for the taxation of inbound investment and adopt targeted measures to ensure that Canadian-source income is properly measured and taxed.

19 These principles and the recommendations in our final report are pragmatic ones, reflecting the Panel's belief that Canada's current international tax system is a good one that requires only some improvements.

List of Recommendations

The Panel's recommendations to the Minister of Finance are listed below. Recommendation numbers correspond to the chapters in which they are discussed in the Panel's final report *Enhancing Canada's International Tax Advantage*.

Taxation of outbound direct investment

Recommendation 4.1: Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.

Recommendation 4.2: Pursue tax information exchange agreements (TIEA) on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA is not obtained.

Recommendation 4.3: Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets.

Recommendation 4.4: Review the "foreign affiliate" definition, taking into account the Panel's other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments.

Recommendation 4.5: In light of the Panel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.

Recommendation 4.6: Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses.

Recommendation 4.7: Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 of the Income Tax Act should be repealed.

Taxation of inbound direct investment

Recommendation 5.1: Retain the current thin capitalization system, and reduce the maximum debt-to-equity ratio under the current thin capitalization rules from 2:1 to 1.5:1.

Recommendation 5.2: Extend the scope of the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations.

Recommendation 5.3: Curtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected.

Non-resident withholding taxes

Recommendation 6.1: Consider further reducing withholding taxes bilaterally in future tax treaties and protocols to the extent permitted by the government's fiscal framework and its agenda regarding additional corporate tax rate reductions.

Administration, compliance and legislative process

Recommendation 7.1: Take immediate action to enhance the dialogue among taxpayers, tax advisors and the Canada Revenue Agency to promote the mutual responsibility and cooperation required to uphold Canada's self-assessment system.

Recommendation 7.2: Take steps to improve administration of the transfer pricing rules in resolving disputes, centralizing knowledge for better consistency, and resolving technical issues.

Recommendation 7.3: Eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.

Recommendation 7.4: Eliminate withholding tax requirements related to the disposition of taxable Canadian property where the non-resident certifies that the gain is exempt from Canadian tax because of a tax treaty.

Recommendation 7.5: Exclude the sale of all publicly traded Canadian securities from notification and withholding requirements under section 116 of the Income Tax Act.

Recommendation 7.6: Develop a comprehensive, long-term plan to optimize tax information collection, and set up the information management systems needed to efficiently process and analyze this information.

Reform of international tax: Canada, Japan, United Kingdom, and United States

Mike Williams

Director Business and Indirect Tax,

HM Treasury

International Tax Policy Forum

Georgetown University Law Center

21 January 2011

Some important differences from the US

- UK economy is more open, with >50% foreign ownership of quoted companies by 2005
- UK growth of UK groups with big UK market share constrained by anti-trust concerns
- UK had (and has) no
  - Significant restriction of interest relief
  - Constructive dividend rules
  - Check the box
- UK bound by the EU fundamental freedoms

Need clarity round purpose of exemption of foreign profits

- Two possibilities
  - Just an efficient (or different) way of relieving foreign taxation?
  - A decision that foreign profits shouldn't in general be taxed, so long as no domestic base erosion?
- Former possibility implies a continued need to tax low or zero-taxed foreign profits, latter doesn't (absent abuse)
- UK has opted for the latter possibility

UK international tax reform

- Exemption of companies' foreign dividends from 2009
- Tax rate cut from 28% to 24% over 4 years from 2011 to 2014
- Foreign branch exemption to be introduced in 2011
- CFC rules to be reformed in 2011, 2012
  - Sole aim will be to prevent UK base erosion
  - "Foreign to foreign" transactions no longer to be targeted
- Patent box (10% tax rate) from 2013

Reform of CFC rules

- Interim reform 2011, more fundamental in 2012
- Main focus of fundamental reform on (a) money/finance and (b) IP
- On money/finance
  - to protect base you need interest restriction or CFC rules
  - UK sticking with CFC rules
- On IP, main concern is with lowly taxed superprofits with strong connection to UK

DRAFT SME: 22/04/2010

CORPORATE FINANCE
UK CFC REGIME INCHES TOWARDS SAFETY

Stephen Edge
Slaughter and May

As in Iceland, tectonic plates have been shifting (or showing signs of shifting) recently on both sides of the Atlantic in the critical area of taxation of offshore passive income belonging to UK or US multinational groups.

At a time when governments are short of money, legislators are bound to be casting jealous glances at pools of lowly taxed offshore income.

CFC rules around the world are thus under considerable focus at present.

In the US, those in favour of the Obama healthcare reforms are said to have seen the offshore passive income of US multinational groups as a quick fix to get more money out of the US tax base. For years, the US had had a regime which has encouraged its multinational champions by allowing them to defer US taxation on foreign income by reinvesting overseas and being able to recycle profits between overseas operations at no US tax cost.

With the benefit of a quite considerable nudge from the ECJ (in the Cadbury/Vodafone cases*), the UK seems at last to be pulling back from a similar desire to increase UK tax yield by an easy win offshore (as evidenced in a 2007 Consultative Document which contained tough proposals that many saw as an invitation to leave the UK) to a more business friendly regime. Another Consultative Document released in January of this year contained proposals designed to balance the competing objectives of a competitive regime for our multinationals and discouragement of “artificial diversions of profits” from the UK.

The encouraging signs in the new Consultative Document are that an income based regime has been abandoned in favour of retaining an entity based approach to avoid unnecessary complexity and compliance burdens, there will likely be a number of exemptions operating by reference to objective tests which are likely to be wider than the existing exemptions and may recognise that ‘intra-group’ transactions are not all bad, the motive test will be redesigned to move away from the default assumption that an activity being carried on overseas when it could theoretically have been carried on in the UK is being carried on overseas for tax avoidance reasons and there will be special rules for certain types of business, such as finance companies, and assets such as intellectual property.

There is still, however, a lot of work to be done on the detail – which must now follow the current election.

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* *The litigation was begun by Cadbury which argued successfully before the ECJ that rules which discriminated between making an investment in a subsidiary in the UK (when the income of the subsidiary would never be attributed to the parent) and making an investment in a subsidiary elsewhere in Europe (when CFC rules could impute income to the parent) was contrary to the fundamental freedoms within the EU presenting restrictions on the unrestricted movement of capital. The ECJ qualified this, however, by saying that the freedoms must be exercised properly so that there must be a genuine economic activity being carried on rather than simply “an artificial or fictitious” establishment. In other European litigation, the ECJ has said that choosing another jurisdiction in Europe to establish your business simply because its tax rules are more benign is not a problem so pursuing a tax mitigation strategy is, in itself, OK. Precisely what then is meant by “genuine economic activity” or “artificial or fictitious” has not been resolved in the Cadbury litigation that has now concluded. Vodafone were originally successful in getting the UK courts to strike out all the UK CFC rules as being non-compliant with the EU treaty but that decision was reversed so we are now waiting for legislative or other clarification as to how the UK CFC rules are to be made compliant with the Cadbury judgment.*

One difficult question yet to be addressed is, following Cadbury and Vodafone, how much substance does an EU-based CFC need to fall outside the rules. Achieving taxpayer certainty and avoiding further litigation must be a key objective here.

The jury is thus still out on whether or not the CFC modernisation project will reach a successful conclusion but UK advisers have to be optimistic if the UK is to retain its competitive edge in hosting multinationals - and also if debilitating ongoing EU litigation in this area is to be avoided.

At present, however, the uncertainty over exactly how the regime will finally fall in place is undoubtedly affecting the confidence of UK groups to plan things going forward – much less to make transforming acquisitions.

The UK government has been fortunate that the cross-border M&A markets have been fairly quiet during the financial crisis so uncertainty in the UK has not yet had a cost – the UK multinational community has also showed patience with UK legislators in not exercising another EU fundamental freedom and moving out of the UK with no significant tax cost because they have been prepared to trust the UK government's invitation to help the UK CFC regime move in a positive direction.

In a world where CFC uncertainties do not exist, looking at what impact the acquisition of a target will make on your group's effective tax rate depends in large part on what contribution you think that tax synergies can make. Devising a post-acquisition restructuring strategy, even when perhaps you have little knowledge of the target's detailed structure, will thus play an important part in the bidding process.

In pricing the transaction, the commercial negotiators will accordingly be looking not only: -

(a) at the underlying cash flows and what they are worth in terms of the contribution to group earnings and thus market capitalisation after tax; but also
(b) at what synergies or costs savings will arise from the merger – including, most importantly, the ability to drive down the effective tax rate in the target so that, even with no underlying income growth, earnings can make a bigger contribution to group profitability after the merger than they did to the selling group before. A tax saving can then be used to enhance value in the deal.

The acquisition tax team must, therefore, look at the structure of the target group, identify where profit making operations lie, how group funding operates, where IP is owned and what tax assets exist.

Armed with this information – and also a general understanding of the extent to which the structure can be unwound without significant tax cost or allowed to continue to exist without creating your own significant CFC issues – you can then look at the scope for reorganising the target group so as to make better use of tax losses or other tax assets by consolidating your operations with targets in a particular jurisdiction or improving income flows by avoiding withholding taxes.

You will also want to look in detail at what you can do to move more portable or passive income out of underlying operating subsidiaries into a more benign regime under your own control.

It is in this context that the acquirer with the lowest effective tax rate in its own group and with the least pernicious CFC regime will be able to outbid its less favoured international competitors with confidence.

Various factors contribute to the effective tax rate of a multinational group. At the top of the group, the host jurisdiction will have its own tax rate and policy on taxation of overseas earnings – with the UK, this gives you a corporate tax rate of 28% and, since the changes in 2009, an exemption regime on foreign dividend income to go with the participation exemption (substantial shareholding exemption) for gains arising disposals of shares in trading subsidiaries and a good treaty network/EU membership to avoid or reduce incoming withholding taxes.

Down at the bottom of the group, operating companies located in developed jurisdictions will be managing their own tax bills as best they can – probably with a lot of focus on funding (trying to comply with local thin capitalisation rules etc), transfer pricing (inwards and outwards) and development and ownership of intellectual property (licences in of any group brand names, R&D cost sharing etc). A post-acquisition supply chain restructuring may, however, make sense there.

The top and bottom contributions to the group effective tax rate are, therefore, effectively fixed – there will be things that you can do but you will always be operating within the constraint that anything that is left within charge to tax will be taxed at a developed country rate.

If, therefore, your aspiration is to drive down the group rate, you will have to focus on the middle bit of the group – where there are likely to be greater opportunities to locate mobile income (such as finance income, IP income and income from low cost manufacturing operations in developing countries) in intermediate holding or other companies located in an environment that is more tax friendly.

Location, location…

Finding the right place for these more portable operations is easy – the difficult bits are moving income out of the operating companies into a low tax area that may not have such a good treaty regime and also, most importantly, making sure that the host jurisdictions (or topco) CFC regime is sympathetic to your general strategy of driving down foreign taxes and does not seek to fill the vacuum by claiming the offshore income as its own.

Tax advisers on this side of the Atlantic are beginning to flex their muscles as the financial crisis thaws and issues like this become material again. The government that comes in after the UK election on 6th May will need to be quick off the mark in spelling out the direction in which the CFC regime is heading and when it will arrive.

The UK has many advantages as a holding company jurisdiction but multinationals based in the UK will not long be able to suffer a relative lack of competitiveness either in their acquisition strategies or in the after tax earnings per share as compared with their multinational peer group.

Behind the firm hand of the ECJ in ensuring compliance with EU fundamental freedoms for our CFC regime lie the equally strong and effective forces of competitive capital markets (potentially making UK groups prey to overseas competitors with more beneficial overall tax regimes) and the real power of UK based companies to choose another place within the EU to locate their top holding company (an opportunity which many US groups might now be looking at rather jealously).

TAX JOURNAL
CITY COLUMN

Encouraging progress on CFC discussion

Steve Edge
Slaughter and May

While many will say that the devil is always in the detail and also that there are still areas where work remains to be done before the policy becomes completely clear, all the initial signs are that the proposals in the discussion document will be welcomed by the UK multinational community as consistent with the messages that have been sent out since 2007 to "watch the direction of travel". So far, the journey seems to be taking us to a good place.

The discussion document expresses itself to have the very ambitious "aim of enhancing UK competitiveness while providing adequate protection of the UK tax base".

This should, of course, be the aim of all tax policies but none are more at the sharp end of the UK's overall tax structure than this.

Tax competitiveness

What does competitiveness mean in this context? The most competitive tax system is, of course, one that does not exist. Given that that is not a possibility for almost all developed jurisdictions (in that taxes need to be raised to support the infrastructure that, in turn, supports business), competitiveness must then be a relative term.

For some, it will mean the domestic tax rate – which is why the UK has seen a drift of some of its general insurers offshore in response to competitive pressures coming from established offshore insurance centres like Bermuda. Capital and the ability to absorb risk is critical for any insurance company – and one that suffers no tax when reinvesting profits back into the business will always be able to compete more effectively with other companies that are reinvesting their profits after tax. While there are obvious constraints on showing that substance is appropriately located to manage risk, the practical aspects of running a reinsurance business offshore are much easier than they are with other less portable businesses.

For our national champions or UK-based multinationals, domestic tax rate is important too. If the UK had a domestic tax rate that was way out of line with its global peer group, capital would be attracted away from UK-based public companies because it would be obvious that they had to run so much harder in order to deliver the same net returns to shareholders that more lowly taxed competitors could deliver.

But the corporate tax rate is not usually the decisive factor. Multinationals will look at the total tax and non-tax package.

As a traditionally mercantile economy with a global financial centre and a general infrastructure that provides great support to UK-based multinationals, the UK would have to have a very <u>un</u>competitive tax system to drive people away.

Advantages of UK

All the basic features of a first-rate multinational tax regime are there – there is no withholding tax on dividends, there is an excellent treaty network, the interest allocation rules following the introduction of the worldwide debt cap are bearable, we now have general dividend exemption, the substantial shareholdings exemption is not as generous as other participation regimes but it is good enough and the corporation tax rate is relatively a bit higher in global terms than it used to be but it is not beyond the pale.

Pity about the stamp duty, many would have said, but otherwise it looked as if we had a tax package that would encourage existing multinationals to stay and might even incentivise others who were attracted by the total package or were being badly treated in their host jurisdiction to come and join the party too.

CFC policy

The critical item missing from the above list, however, is the CFC regime. When the UK CFC regime came in in 1984, it was clearly targeted at simple and fairly limited tax avoidance such as putting capital offshore in what were described as "offshore money boxes". As the business world became more international, however, the CFC regime re-focused and became directed at different forms of tax avoidance (as perceived by the government) until it started to become fair to wonder whether the global reach of the UK's tax arm had over extended itself.

At its heart, multinational tax planning is very simple. Your business operations have to be located where they can be run most effectively from a commercial point of view – that will often be in developed countries. You then have either to accept whatever general tax regime your head office or host jurisdiction throws at you as you earn and repatriate domestic and overseas profits <u>or</u> seek to change it by political influence <u>or</u> move somewhere else. If, therefore, you are to make any significant impact on your global effective tax rate by which you will be judged as against your international peer group, you need to do it by having pools of income which are taxed at lower rates than those imposed by the main developed jurisdictions.

Moving income into a low taxed jurisdiction – by having manufacturing operations based there or setting up finance companies or brand owning/supply chain companies so that profits can be moved to a more benign regime - is a common technique. Where significant profits can be attracted to capital assets that are more easily portable than others, achieving that will be a simpler process than moving headquarters or significant operating facilities.

Any jurisdiction that seeks to challenge that form of international tax planning whilst other jurisdictions do not is automatically putting its own competitiveness at risk in a critical area – and it was no surprise, therefore, that many saw the 2007 consultative document (under which all offshore passive income would have been immediately subject to UK tax) as an invitation to find another home.

The 2007 paper was even more surprising given the EU pressures on the UK government which meant not only that a really strict CFC regime within Europe was unlikely to be enforceable but also that the UK was unable to follow the US in putting up barriers to prevent people leaving

(not the greatest of adverts for a supposedly competitive and friendly tax jurisdiction in any event).

National Champions

There is, of course, a major policy question for the government behind this. Is it fair that a company that just operates in the UK should pay UK tax on all its profits as they arise when a company that carries on exactly the same business internationally can enjoy all the advantages of being based in the UK without paying the same level of current tax? The answer to this is that it probably isn't fair but, unlike their domestic equivalents, our national champions have a choice and might find that the attractions of another jurisdiction are too good to miss. A realistic and not overly harsh CFC regime would be viewed by many as a reasonable price to pay for having the other economic benefits associated with national champions.

In effect, however and whether by its own good policy management or by EU diktat, the UK is saying that it is OK to allow multinationals to operate offshore and reinvest profits offshore without paying UK tax so long as some basic anti-abuse rules are followed (back to 1984 in some respects).

If we can get there, then we will have a regime to be proud of and will not only be able to stem the outflow but may also gain inflow - as well as being a favoured jurisdiction when decisions are being taken as to where the new top company should be located in a merger. It is critical for the UK's mercantile economy that we continue to win more than our fair share of those decisions.

Cause for optimism

UK-based multinationals should be encouraged by the discussion document because it shows that staying and trying to change things for the better (particularly when going would risk significant amounts of business disruption) is often the better first option.

The distance travelled since 2007 is enormous (if one takes both proposals at their face value). It seems clear that the policy is now to encourage UK-based multinationals to develop their overseas interests rather than to see overseas profits as another source of current taxation.

The indications of this are: -

- an exempt activities regime that is likely to be more relaxed – recognising in particular that intra group activities are not all bad;
- a likely white list of good jurisdictions – whether that is published as such or simply grows up in practice over time (interesting to see where Luxembourg features);
- a complete shift in the motive test process so that the presumption is no longer that some activity not carried on here is being conducted overseas for tax avoidance reasons;
- special provisions for businesses like reinsurance;

- special provisions for finance companies (which are probably the most significant generators of pools of offshore passive profits) – with sensible limitations through a fat cap regime to prevent the UK carrying more than its fair share of global debt and also a warning gesture in the direction of upstream loans; and
- the UK royalty box (announced in the PBR) and proposed lighter regime for offshore profits from intellectual property which will be particularly welcomed by the global brand owning companies and others in the pharmaceutical and information technology sectors.

In terms of persuading more people to make a UK holding company a destination of choice (whether by relocation or following a merger), memorialising the practice of having a grandfathering period to allow someone whose structure was set up without UK CFC rules in mind to rearrange their affairs after arriving before the UK regime kicks in make eminently good sense.

So, the direction of travel has been excellent and worth waiting for.

Work still to be done

The more difficult areas where nettles may still have to be grasped are: -

- the end result of *Cadbury/Vodafone* and the definition of precisely how much substance will provide a passport to freedom within the EU – where the answer must be generally acceptable and avoid further debilitating litigation;
- quite what is to be done about so called "foreign to foreign" transactions where something is done that does not immediately impinge on the UK tax take but simply moves tax furniture (be it capital or income) around outside the UK;
- how exactly the new user friendly motive regime is to operate in practice so as to achieve consistency in outcome and avoid the often fruitless search by HMRC for the proverbial smoking gun; and
- probably most important of all, the detail around the proposals announced to date.

But, overall, the glass must be at least half full and probably more.

This article was originally produced for the 8 February 2010 issue of the Tax Journal

Letter of advice to a US client making a new inward investment into the UK and seeking to fund part of the investment through local debt

Dear ______________

Relief for interest in the UK

You have asked me to write to confirm the points we recently discussed in relation to the proposal to fund part of your new UK investment through debt:-

(i) the basic rule is that most group and non-group interest and other financing costs shown in your local accounts will be deductible on an accruals basis (as will corresponding negative exchange differences) – though there are special rules which are currently under review which defer relief for connected party interest that has been accrued but is not paid within 12 months of the year end;

(ii) this basic rule is modified for debt that has special features such as a very long or no fixed term, certain conversion rights and certain rights which are dependent on the results of the underlying business. You will probably not need to worry about most of these but points to watch in particular for a US inward investor are the anti-perpetual rule which means that you must have a fixed term of less than 50 years and the fact that some rating or performance related interest adjustment provisions may be deemed to be profit linked. Where you fall within these provisions, the interest is deemed to be a dividend and so is non-deductible in full;

(iii) once you have got over this hurdle (so that, in principle, you have good debt), then our thin capitalisation regime comes into play. This applies both to debt that comes from the parent or another affiliate and to debt where there is a guarantee or some other form of financial support (explicit or implicit) that is provided by the parent or an affiliate in order to enable the finance to be made available to the UK company making the investment. We have no fixed thin cap rules or safe harbours etc. The requirement is for you to be able to show that, if your local company was wholly independent and not able to rely on external support, it would be able to borrow the funds in question on the basis of its own assets and related cash flow. Interest cover is usually the critical factor but HMRC often look at the level of debt and also its ratio to underlying earnings or to equity as a secondary test. It is possible to pre-clear this and negotiate the equivalent of an APA. HMRC are knowledgeable and astute in these areas – the discussion usually revolves around the robustness of the underlying business, future projections (businesses that have income that is likely to increase sharply will obviously do better than others) and also the extent to which comparisons can be made with the parent or other companies carrying on a similar business and with similar levels of debt. The great feature of our system, however, is that agreed debt levels can be tailored to your specific circumstances.

The thin capitalisation process will, therefore, determine whether or not your new UK business has what HMRC regard as the "appropriate level of debt" in pure financing terms for the business carried on here.

Deductibility of interest on that debt cannot then be assured, however, because you also need to tick each box on the following tests that are designed to restrict UK interest deductibility in particular circumstances:-

(a) Section 787 ICTA 1988 – this gives HMRC the power to deny interest deductions where tax relief is the "sole or main benefit" derived from the funding in question. It usually only applies where money has gone round in a circle so there is no real funding. In your case, I think you can safely not worry about this rule because the money is being raised to fund a real investment and making that will be the main benefit you obtain from the borrowing;

(b) Basic paragraph 13 – this is an anti-avoidance rule introduced in 1996 and primarily directed at UK tax dilutive structured finance transactions where an interest deduction was balanced out by non-taxable income or gain so that it could be said that the "main purpose or one of the main

purposes" of the transaction was to obtain a "tax advantage". Historically, this provision has rarely been used – though it has been interesting to see HMRC attempting to use it where US groups have geared up subsidiaries prior to an IPO or where they have funded large HIA dividends back to the US. Again, we do not really need to worry in this context because the funding is clearly being raised for a good business purpose and deployed in buying an asset that will generate taxable profits in the UK. We are clearly not in aggressive structured finance territory. There is an equivalent anti-avoidance rule that would pick up tax-motivated forex planning and disallow any derivative losses – but again not something that should concern us;

(c) Extended paragraph 13 – as this sub-heading suggests, paragraph 13 is now to be extended so that HMRC can look not just at the immediate use of proceeds of a loan but also at broader arrangements surrounding it to see whether or not tax has played a significant part in the decision to raise debt. This is likely to be a much more potent weapon for HMRC – and it is potentially fraught with uncertainty because again it is a "one of the main purposes" test (so that you can have an overriding business purpose, as you do here, but still be caught because UK tax considerations have significantly shaped what you have done). There is also no satisfactory definition of what "a tax advantage" means (it is defined broadly as any form of tax relief with no qualitative distinction between tax relief that would naturally arise with any commercial transaction and incremental tax relief that arises as a result of special structuring). Like any blunt instrument, the new provision is thus potentially uncertain in its effect. It will clearly be effective against structures where tax is playing a predominant or driving role. What is less clear (because of the uncertainty in the scope of the phrases "a main purpose" and "a tax advantage") is how it will be applied where a very largely commercially driven project benefits from normal tax planning processes which produce a better result in interest or other finance related cost terms but do not, at the end of the day, change the commercial motivation or end result. Neither the extent to which tax thinking can play a role but not become important enough to be a main purpose nor the appropriate comparator for deciding what is "normal" and what is "an advantage" in tax terms is at all clear. If we get a thin cap clearance, however, I would be surprised if the extended paragraph 13 was a problem. I would expect any issues to be raised as part of normal thin cap enquiries;

(d) Anti-arbitrage – These are, you may recall, the provisions that caused such a scare on your side of the Atlantic when they were first announced. They apply where, because of the use of either a hybrid entity or a hybrid instrument, interest expense that leaves the UK is not being recognised as fully taxable in another jurisdiction. When they were brought in in 2005, HMRC were at pains to say that they had not intended them to be rules which resulted simply in the UK collecting tax that other jurisdictions were neglecting to collect. On the contrary, they said that hybridity created an incentive to put more debt into UK structures (because it was effectively a one way option) and these rules were designed to stop that incentive resulting in the UK picking up more debt than it would otherwise have done. There are some detailed guidance notes which say that funding for new investment is OK. But these guidance notes are now four years old and have not been revised since they were hurriedly introduced. Unanticipated circumstances thus have no clear answer. In the absence of guidance, the legislation is very broad and once again we have the same difficulties with "a main purpose" and "tax advantage". Particular areas of sensitivity are using the UK as a holding centre for third jurisdictions and trying to insert leverage into a structure when debt has fallen below appropriate levels either in terms of your global allocation of debt or even as regards an existing thin cap agreement. The message is not to use the UK as a regional holding centre if you have to use hybrid entities or debt to achieve your objective and also to keep UK debt levels at the appropriate level because you will never be allowed to catch up if you de-leverage too much. There is a clearance process but I am afraid it has been rather difficult and unpredictable – and many of my clients have found it impossible to understand why one part of HMRC can sign off on the amount of debt in the UK as being appropriate having regard to thin cap and the paragraph 13 rules described above whilst another bit then gives them pain and grief under the anti-arbitrage rules. Many have decided that the better strategy is simply not to apply

for a clearance rather than raise their heads about the parapet and invite questions that might not otherwise arise. I am afraid this area has not been a happy one for the UK over recent years; and

(e) Worldwide debt cap – These are the new rules that have just been announced. There is a heavy consultation session going on at present – and it is far from clear whether or not the proposals will survive this. They were originally conceived (we think) as a means of preventing foreign subsidiaries of UK groups making upstream loans back to the UK to avoid remitting dividends (something which you would deal with by making an upstream loan a deemed dividend and taxing it but EU equality rules are making us move on to an exemption system for dividends so that would not work) but seem now to have extended their brief so that they are also anti-debt dumping rules. Quite why an additional set of rules is needed to prevent people putting debt into the UK for tax planning reasons I do not know, but having the UK bear only its fair share of global debt within the group is now apparently the policy. That brings two problems in its train. First, there is, I am afraid, a huge administrative burden. Secondly, the way the rules operate is to compare UK tax deductible interest with a global accounting number. Rather than being able to take a single number from a consolidated return in the UK, you have to delve into individual returns to find the total interest expense (plus related financing costs such as forex on borrowings) of all the UK tax resident companies within a 75% group. That then has to be compared with the net interest expense number taken from your global consolidated accounts (i.e. non-UK interest expense less all group interest income, both UK and non-UK). Any UK excess is then at risk of disallowance. Certain business interest costs and income (e.g. in third party financing businesses and insurance) are excluded from these calculations and the rigidity of the rules means that preparing your annual global return will, I am afraid, be quite a business. There is some talk of having a gateway that will save you from all this but no one has yet come up with something workable. My hope is that any gateway will allow anyone who has a thin cap agreement justifying the amount of debt they have in the UK to escape this new regime – because that seems to me to satisfy the “appropriate or fair share” aspect immediately and otherwise we end up in a situation where events elsewhere in your group (for example a major disposal that creates surplus cash/removes debt) could have a late breaking impact on UK deductibility. This very much cuts across what I have always thought was the great attraction of our thin cap rules, namely that they were tailored to meet individual cases and look at the UK sub-group on a notionally independent basis. As I said, these rules are under consultation and many hope that their introduction will be postponed or abandoned because the only thing that is certain about them at present is that they will add a huge administrative burden to all multinationals based in the UK or operating here and will almost certainly be arbitrary in restricting deductibility for a number of inbounds.

If I had ended this note at paragraph (c) above, then I suspect you would have been reasonably happy. A good business purpose for raising the money and an ability to obtain certainty for debt that was appropriate to your specific business in the UK would have left you few anti-avoidance challenges and comfortable with the outcome as to how much interest would be deductible here.

The anti-arbitrage rules and, if it comes in, worldwide debt cap regime have, however, very much taken the gloss off this by introducing uncertainty and unfairness. Anti-arbitrage is capable of being cleared - though we have had some patchy experience. If the worldwide debt cap rules come in, however, you will be subject to an enormous administrative burden, face potentially arbitrary results and, most worryingly, be in a position where there is nothing you can do in advance to remove the risk that changes in your debt profile elsewhere in the world could turn interest expense that would otherwise have been deductible here and easily covered by a thin cap agreement as appropriate to the UK business into something that is simply disallowed. Ironically, UK multinationals who might be said to be the original target for these rules are more likely to be able to survive them because there are exclusions for genuine third party debt and also rules under which intra-group interest income is not taxed where interest would otherwise have been

disallowed under the debt cap regime. For you, as with most inbounds, these points are unlikely to offer any great practical protection.

Apologies for the length of this but I felt you needed to understand the detail and nuances. A quick summary for your CFO would be as follows:

(A) the position on financing the new UK investment with debt is complicated and we will face some ongoing uncertainties;

(B) because we are making a new investment, a number of the difficult UK anti-avoidance rules will not apply to us at the outset but may come back into play (particularly if we use hybrid entities or debt for US planning) if we re-finance to restore debt levels to market levels. We will thus have to keep things constantly under review;

(C) the good news is that we can get an advance pricing agreement tailored to our facts that may run for five years. This will take 3 to 6 months to negotiate; but

(D) the bad news is that a new worldwide debt cap regime in the UK may restrict UK interest expense simply because, however appropriate the amount we finance may be to the business we are carrying on there and despite the advance pricing agreement that our debt levels are acceptable, the debt is deemed to be proportionately excessive by reference to our global ratios. The fact that exchange differences are included in this calculation and that a change in our global position at the end of the year (because we make an acquisition or sale) may tip the UK balance for the whole year are the two most worrying features of this.

I hope that the above is clear – if not exactly encouraging – and would be happy to answer any supplementary questions that you have.

Yours sincerely,

THE PRESIDENT'S EXPORT COUNCIL
WASHINGTON, D.C. 20230

December 9, 2010

President of the United States of America
The White House
Washington, DC 20500

Dear Mr. President:

Our economy stands at an integral moment when growth is essential to our future. One of the best ways to ensure future growth is to expand our exports, particularly in fast growing economies. So that the United States might better compete, an important consideration of the National Export Initiative is to address the serious fiscal challenges that limit our country's ability to maximize the scale of our exports. Congress and the White House must work to develop a plan to meet those challenges. Current policy projections show unsustainable growth in government deficits and a key contributor to these deficits is federal non-interest spending. Our nation's economic security and American living standards depend on slowing the growth in federal spending and ensuring an annual balance between federal revenue and expenditures.

Critical reform of the corporate income tax system should be part of a fiscally responsible comprehensive tax reform and budget package. Critical action must be taken now to incent substantial private sector investment, which offers sustainable advantages over similar expenditures of public sector funds. U.S. companies have large capital reserves sitting on the sidelines due to the unprecedented uncertainty of the current public policy and political climate. A strong correlation exists between business investment and jobs, thus unlocking this capital for investment in the U.S. economy is in everyone's best interest. We respectfully submit the recommendations below for consideration:

- Reduce the combined (federal and state) corporate tax rate to the OECD average or less;
- Create an international tax system in which U.S. corporations can compete well with those in other OECD nations;
- Enact a permanent research and development credit that is competitive with other OECD incentives; and
- Create additional temporary tax incentives to invest in capital equipment.

Significant tax reform is needed to address these deficiencies and allow American workers and companies to compete effectively in domestic and international markets, to create jobs, and to achieve a higher standard of living for all Americans. As other nations pro-actively work to design tax systems to attract businesses and capital investment they improve the competiveness of their companies and workers. In the following portion we address these issues in more detail.

1. Corporate tax rate reduction – A significant corporate tax rate reduction is needed to both help US companies compete abroad and attract investment to the United States, encouraging foreign companies to invest here. Increased capital investment brings more

employment and higher wages for U.S. workers. Increased U.S. production expands exports around the world. A lower corporate rate would reduce the advantage of using debt financing over equity financing by reducing the benefits of interest deductions. It would reduce the incentive for businesses to operate in noncorporate form, such as partnerships or LLCs. It would also reduce pressure on transfer pricing because it would reduce the incentive to have income in low tax rate jurisdictions. In a 2008 report by economists at the OECD, who measured the relationship between different taxes and economic growth, they determined that the corporate income tax is *the most* harmful tax for long-term economic growth. This is because capital and income are the most mobile factors in the global economy and, thus, the most sensitive to high tax rates. Because capital is mobile but workers are not, labor bears a disproportionate share of the burden of corporate taxes – as much as 70% by some estimates.

In 2010, the average corporate tax rate in the OECD (excluding the U.S.) is 25.5 percent, including sub-central taxes. The corporate tax rate in the United States, including state income taxes, is 39.2 percent (calculated by the OECD as a 35 percent federal rate and a deductible state rate of 6.47 percent). Holding the state tax rate constant, the United States would need a federal corporate rate of approximately 20 percent to match the 2010 OECD level. Future tax reductions already announced in several OECD countries mean that our trading partners will continue to gain a competitive advantage in this area unless the United States undertakes a significant federal corporate tax rate reduction. Finally, it is worth noting that OECD countries that have lowered corporate rates have generally done so in combination with some broadening of the corporate income tax base.

2. Territorial-type tax system - The rest of the world increasingly uses territorial systems under which foreign earnings - taxed once in the foreign country – can be brought back for reinvestment in the domestic economy without incurring additional home country tax. Within the OECD, 25 countries use these territorial systems, with the United Kingdom and Japan adopting territorial systems in 2009. The United States, along with only five other OECD countries (Chile, Ireland, Korea, Mexico and Poland) use so-called worldwide tax systems in which foreign earnings are subject to domestic tax when remitted to the domestic economy. Importantly, all five nations have a much lower corporate tax rate than the U.S.

Expansion abroad by U.S. companies is vital for establishing export platforms for U.S.-produced goods and expanding the scope of domestic investments in research and other high-paying headquarters' operations. Economic analyses show that foreign operations of U.S. companies are complementary to their domestic operations – operations abroad expand domestic operations. A competitive territorial tax system for the United States should broadly follow the practice of our trading partners and should not be designed to raise new revenue, or to destabilize the U.S. corporate tax base, but rather to make the US tax system more competitive with its major trading partners.

3. Research and development incentives (R&D Tax Credit) - For U.S. companies to increase exports, they must be at the forefront of technology and intellectual property development. No longer can the U.S. claim sole superiority in this area, as a large

number of countries currently offer the critical operational pre-requisites for conducting research and development (R&D), including factors such as a strong customer base, educated workers, protection of intellectual property, and government support. The competition for these dollars is fierce, and the tax code is an effective instrument for encouraging the spending of these dollars. Unfortunately, the U.S. is falling behind. Even before the existing R&D credit expired, the U.S. tax incentive was only 24th among industrialized nations. Your Administration has proposed, and the U.S. should adopt, a permanent R&D tax credit that taxpayers can rely on. In addition, to encourage incremental investment in intellectual property development and ownership, many countries have recently enacted regimes providing advantaged treatment for intellectual property. These regimes offer reduced taxation of income from the exploitation of intellectual property created and owned in-country. The U.S. should consider a similar regime, expanded to include all intellectual property that is important to the U.S. economy.

4. **Additional Investment Incentives** – For five of the last eight years Congress has extended tax incentives to enhance first year depreciation on capital expenditures for small and large companies ('bonus' depreciation). While constructive and significant, these incentives alone have not increased business investment as much as desired given the economic downturn. Extending investment incentives until the economy more fully recovers or the corporate tax rate can be reduced would allow for advanced planning in corporate capital expenditure budgets and greatly enhance these incentives. In addition, a full expensing regime (as proposed by your Administration), or alternatively an investment tax credit of equal value, would significantly increase capital expenditures and GDP based on economic studies. This would encourage firms to make investments that would not be undertaken under today's tax code.

Finally, we appreciate the thoughtful considerations put forth by the bipartisan leaders of your deficit commission. Although this group opposes raising corporate taxes simply to raise revenue, we believe a full review of the tax code and responsible corporate tax reform that meets the objectives above is in order. We will continue to review the general proposals recently outlined and any additional recommendations published by the Commission.[1]

Sincerely,

Jim McNerney

[1] Please note that this letter has been prepared by the private-sector appointed members of the PEC.

THE PRESIDENT'S EXPORT COUNCIL

Eisenhower Executive Office Building
Washington, DC

Thursday, December 9, 2010

[Excerpt of Proceedings related to Tax Reform]

[…]

PRESIDENT OBAMA: Everybody gets a little nervous. But this is obviously a top priority. I mentioned China not because it's unique, but because obviously the size of its market makes it an important partner in trying to get better enforcement. We've actually seen them make some gestures towards improved enforcement, but I'm looking forward to seeing the specific recommendations.

On tax policy, I have indicated my interest in dealing with the current structure. Is there a way for us to lower corporate tax rates, go to a territorial system, broaden the base? The challenge on this, and I just want to preview for you what I think is going to be a tough discussion, is how do we do it in a relatively revenue-neutral way?

It doesn't have to be dollar-for-dollar, but it can be a $2 trillion proposition, which on a couple of the recommendations that we've seen, when we've priced it out, have just blown a hole through the budget. In these difficult fiscal times, we've got to do it in a way that means somebody is giving up something. So I just want to plant that thought in your head.

[…]

MR. SEIDENBERG: If you don't mind, I wanted to make sure we had a chance to address the tax issues while Larry and Austan are here. So if you could keep a secret, which I assume you can, what you'll see over the next several weeks is the business community indicating that the economy seems to have a little life to it.

This is one of these indications where many companies are saying they're beginning to see orders, they're beginning to see a little bit of activity. So the question becomes, how do you sustain it? The stuff that has been--free trade, the tax deal, all the other initiatives that you've put forward--are very solid, so just let me offer, from the BRT's perspective, just a comment on this.

Take something like bonus depreciation or any of these kinds of strategies. They're helping to stimulate a little activity. What's most important is to set these rules in place for 3 to 5 years. What you'll find is, all these small businesses will react to what the large companies do in one year. But if we say we're going to have a program to spend capital over three or four years, it will have a ripple effect across the economy that's really extraordinary. So to me, the elements of what the President has proposed is terrific. Where you can create the certainty over time, you're going to get an even more powerful, I think, multiplier there.

The other thing I would say, the question I was going to ask the President, is his comment about revenue neutrality. So this is where you create -- not intentionally. This is where you have a discussion about uncertainty, because on one hand we do these things to create, and then next thing we do is we talk about what the neutrality is.

So just a thought: for every incremental dollar of capital, incremental above what people would have spent, jobs get created. So if we can get comfortable that the business community, the administration, the Congress is showing the American people that we're taking a risk on the future of the country and we're putting capital to work, jobs will get created without any question.

Just an example on the ones you're just talking about. We're opening up a data center in a location in Upstate New York, creating 300 jobs. Not a single transaction in that data center serves the U.S. They serve transactions in Latin America and in Asia. So we have people walking around that plant who think they're serving the Chinese or the Taiwanese or the Argentineans. So I know everybody worries about, the public doesn't understand. They get it. If you put a plant, if you put work in their community, they're globalists in about two seconds, I guarantee it.

(Laughter)

MR. SEIDENBERG: So the issue is not hard if we just do the work. So my only comment on this as we

go forward, I think you guys have done great recently. I think we're moving in the right direction. Let's keep taking the uncertainty out of this discussion. These planning cycles have three-, five-year horizons to them. We have to figure out how to pay for it, I've got it, but incremental capital will absolutely create jobs, no question. Ask any business guy that and he'll tell you that.

[…]

MR. SUMMERS: Let me just make three comments, if I could, just of things that I'm struck by in the discussion, and answer Ivan's question.

First, I think we always need to remember that trade is not just the export of widgets and other manufactured goods, and that will increasingly be the case. We know about 30 percent of Harvard's sales of higher education services to students go to foreigners. I look around and I see others here and it's going to take longer to outsource Harvard than it is to outsource most other things.

I was wondering, listening to the conversation, whether we should start talking about the internationalizing of the American economy because it's got the words "American economy" in it and it smacks less of outsourcing. There is a huge set of opportunities, and as best I can tell we are infinitely more organized to promote the sale of manufactured goods abroad, infinitely more organized to stand up for investment rights here, than we are to attract patients to our hospitals, students to our universities, tourists to our resorts.

It's something I know Dick Friedman has pushed on, it's something I've tried to push on. But there's important new legislation that Senator Reed legislated in the travel area, but I think it is the single largest opportunity in export promotion and that commercial diplomacy for people to come here and do things is a vast opportunity. It implicates a lot of issues, it implicates the visa system, for example.

But if you ask me as I leave what the biggest gap in our potential competitiveness agenda is, it is in that area. So I would just hope -- and I know this group is totally on board, but I would just hope that people both in and out of government would get a second observation on taxes. Nothing I say is going to hugely surprise you. I usually think of myself as young, but I was kind of active as an academic expert, pushing things during the 1986 tax reform, so I guess I have a pretty long memory on this stuff.

The case for investment incentives is compelling. Equipment investment, in particular, is highly correlated with economic growth. That's why the thing I personally worked hardest on in this latest tax deal was the expensing provisions, which, by the way, have the virtue that while they put money into the economy in 2011, they reduced the deficit in 2015. But there are obviously issues of competitiveness as we think about the tax system.

But hear me. Hear me if you want to succeed: S&P corporate profits are 60 percent higher this year than they were two years ago. Sixty percent. The country has a major deficit problem over the next five years. You will find massive enthusiasm in Washington and you will find yourselves pushing on an open door if the business community, as a collective, is able to formulate a revenue-neutral theory of how the tax system's competitiveness can be improved.

If the business community formulates a wish list, plus a bunch of claims about how economic growth will generate the extra revenue that do not score, that is not a strategy that, in my judgment, is very likely to get to the end successfully. And so the revenue neutrality here really is the coin of the realm, and I would just urge that those of you who I think rightly feel that there are enormous potential benefits from competitiveness, pay close attention to the question of the revenue impacts of the proposal and mobilize the necessary kind of advocacy that is fully analytic around that. I think with that there's a real chance of succeeding. Without that, I would be very surprised if at the end of the day the effort to bring about reform was successful unless there was real attention to the revenue cost issues.

The third and last comment I'll make is, what is going to define--you've heard me say this before--this quarter century in economic history, in all likelihood, is going to be the major change in the balance of economic weight from the traditionally rich world, to the emerging world. We just need to orient all of our strategies.

I had a chance to speak to the new Congressmen who in the orientation program and I was asked to talk about trade. I said to them, if you remember only one thing from what I say, remember this: the United States has a largely open market. Most other emerging markets don't, and substantially don't. When we enter into a trade agreement, we cannot fall very far from the basement, which is where we are. Therefore, the benefits are highly asymmetric, because even if you judge these things on purely mercantilist grounds, their trade barriers are falling much, much more than our trade barriers.

If we could get that point out, that these agreements are as asymmetric as they are and that will be much more true as we start doing business with the emerging markets, I think we can make a substantial contribution to the progress we are making. To put it differently, there's not a law right now that says you're not allowed to move to India, or you're not allowed to move to China, or you're not allowed to move to Korea. There's no law like that right now. A trade agreement isn't making it easier to do that. What a trade agreement is doing, is making it easier to stay here and produce for there.

So we need to find a way to change the debate about trade to whether agreements are good deals for America, not a broad referendum on whether globalization is a happy thing or not, because it's not going to stop whether we do or do not have trade agreements. What is going to be decided is whether we're going to be a serious participant and whether we're going to cede the ground to other countries. Those are my final three thoughts.

THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

The Moment of Truth

DECEMBER 2010

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RECOMMENDATION 2.2: ENACT CORPORATE REFORM TO LOWER RATES, CLOSE LOOPHOLES, AND MOVE TO A TERRITORIAL SYSTEM.

The U.S. corporate tax is a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment. Corporations engage in self-help to decrease their tax liability and improve their bottom line. Moreover, corporations are able to minimize tax through various tax expenditures inserted into the tax code as a result of successful lobbying.

Without reform, it is likely that U.S. competitiveness will continue to suffer. The results of inaction are undesirable: the loss of American jobs, the movement of business operations overseas, reduced investment by foreign businesses in the U.S., reduced innovation and creation of intellectual property in the U.S., the sale of U.S. companies to foreign multinationals, and a general erosion of the corporate tax base.

Reform of the corporate tax structure should include the following:

2.2.1 Establish single corporate tax rate between 23 percent and 29 percent. Corporate tax reform should replace the multiple brackets (the top being 35 percent), with a single bracket as low as 23 percent and no higher than 29 percent.

2.2.2 Eliminate all tax expenditures for businesses. Corporate tax reform should eliminate special subsidies for different industries. By eliminating business tax expenditures – currently more than 75 – the corporate tax rate can be significantly reduced while contributing to deficit reduction. A lower overall tax rate will improve American business competitiveness. Abolishing special subsidies will also create an even playing field for all businesses instead of artificially picking winners and losers.

2.2.3 Move to a competitive territorial tax system. To bring the U.S. system more in line with our international trading partners', we recommend changing the way we tax foreign-source income by moving to a territorial system. Under such a system, income earned by foreign subsidiaries and branch operations (e.g., a foreign-owned company with a subsidiary operating in the United States) is exempt from their country's domestic corporate income tax. Therefore, under a territorial system, most or all of the foreign profits are not subject to domestic tax. The taxation of passive foreign-source income would not change. (It would continue to be taxed currently.)

As with the individual reforms, a number of details and transition rules will need to be worked out. However, the code should look similar to the following illustrative proposal:

Figure 9: Illustrative Corporate Tax Reform Plan

	Current Law	Illustrative Proposal (Fully Phased In)
Corporate Tax Rates	Multiple brackets, generally taxed at 35% for large corporations	One bracket: 28%
Domestic Production Deduction	Up to 9% deduction of Qualified Production Activities Income	Eliminated
Inventory Methods	Businesses may account for inventories under the Last In, First Out (LIFO) method of accounting	Eliminated with appropriate transition
General Business Credits	Over 30 tax credits	Eliminated
Other Tax Expenditures	Over 75 tax expenditures	Eliminated
Taxation of Active Foreign-source Income	Taxed when repatriated (deferral)	Territorial system
Taxation of Passive Foreign-source Income	Taxed currently under Subpart F	Maintain Current Law

THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD

Tax Reform Report

August 2010

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VI. ADDRESSING INTERNATIONAL CORPORATE TAX ISSUES

As noted above, the U.S. has one of the highest statutory corporate tax rates among developed economies, and the difference between the U.S. tax rate and the tax rates imposed by other developed countries has increased over time as other countries have lowered their rates. The relatively high U.S. tax rate is particularly important for U.S. MNCs because they are subject to the U.S. corporate tax on their worldwide income, regardless of where it is earned. As a result, U.S. MNCs operating in lower-tax jurisdictions face higher statutory tax rates than their competitors. Tempering this burden is the fact that the U.S. corporate tax is paid only if and when a corporation repatriates its foreign-earned income, for example as a dividend to its parent corporation. In contrast, the income earned by U.S. corporations domestically is subject to the U.S. corporate income tax at the time it is earned. In practice, most MNCs take advantage of deferral and defer the repatriation of a significant fraction of their foreign-earned income for long periods of time, often indefinitely. Deferral therefore reduces the effective tax rate on foreign-earned income, mitigating the tax disadvantages U.S. MNCs face when operating in foreign jurisdictions compared to their foreign competitors. Another consequence is that U.S. MNCs face lower effective tax rates on their foreign-earned profits than on domestically-earned corporate income.

Many experts and business representatives argued that the high effective corporate tax rate in the U.S. discourages MNCs from choosing the U.S. as a site for the production of goods and services or as a headquarters for their global activities. Moreover, we heard concerns that the U.S. system places U.S. MNCs operating in other countries at a cost disadvantage relative to their business competitors in those jurisdictions. Both of these concerns are exacerbated by the fact that in addition to having lower statutory tax rates, most other developed countries also exempt from corporate taxation all or most of the overseas income earned by their corporations. In contrast, the U.S. exempts such income from taxation only as long as it remains abroad.

Other experts argued that the difference in the effective tax rates between income earned at home and income earned overseas provides U.S.-headquartered MNCs incentives to shift taxable profits to their foreign subsidiaries to delay taxation, and encourages costly and wasteful tax planning measures to do so. As corporate tax rates in other countries have declined and as global markets have grown, the incentives and opportunities for U.S. MNCs to shift profits abroad have increased, straining the already complicated system of laws and enforcement that attempts to regulate these activities. Experts also cautioned that such tax avoidance efforts reduce the domestic tax base and reduce corporate tax revenues.

Most experts emphasized the need for changes to the current rules for taxing the foreign income of U.S. corporations to address the above concerns. But experts differed on what changes should be made because of their evaluation of how changes would affect the following, sometimes competing, policy goals: increasing the attractiveness of the U.S. as a production location for U.S. and foreign companies; reducing the tax disadvantages of U.S. MNCs operating in low-tax jurisdictions compared to their foreign competitors; reducing the incentives for U.S. MNCs to shift activities and reported profits abroad to avoid paying U.S. corporate tax; reducing the costs of administration and

compliance; and reducing the erosion of the U.S. tax base and the loss of corporate tax revenues that result from tax avoidance measures.

a. The Current U.S. Approach to International Corporate Taxation

As noted above, the U.S. uses a worldwide approach to the taxation of corporate income earned by U.S. companies overseas. The basic principle of this approach is that all of the income earned by U.S. companies anyplace in the world should be subject to the U.S. corporate income tax. But the current U.S. system also allows U.S. companies to defer payment of the tax on most of the overseas active income earned by their foreign subsidiaries until it is repatriated, for example as dividends to the parent corporation. U.S. tax is not deferred on passive investment income (such as portfolio interest) earned abroad or on other easily moveable income of foreign subsidiaries under the so-called "subpart F" anti-deferral rules. Profits or losses of foreign branches of U.S. corporations (rather than subsidiaries) are subject to immediate U.S. tax just as if the profits or losses accrued domestically.

To prevent the double taxation of income earned by a U.S. company by both the government of a foreign country in which the U.S. company is operating and by the U.S. government, current U.S. tax law includes provisions to allow a credit for foreign income taxes. Under these rules, a U.S. company is allowed a foreign tax credit for foreign income taxes paid by it and by its foreign subsidiaries on earnings repatriated to the United States. The foreign tax credit is claimed by the U.S. company on its U.S. tax return and reduces its U.S. tax liability on foreign source income. (See Box 1 for a discussion of the foreign tax credit.)

As a result of deferral and foreign tax credits, the U.S. corporate tax paid by U.S. MNCs on foreign source income in 2004 was only $18.4 billion. A relatively small part of that revenue was derived from dividends paid by foreign subsidiaries to their U.S. parents. Foreign source royalties, as well as foreign source interest and income from foreign subsidiaries not eligible for deferral under the current system, represent a much more important source of tax revenue than dividends. Even with foreign tax credits, U.S. multinationals have a strong incentive to keep their overseas earnings outside the U.S. as a result of the interplay between the high U.S. statutory corporate tax rate and deferral. In 2004, when Congress allowed companies to repatriate overseas income for a limited amount of time at a reduced corporate effective tax rate of 5.25 percent, the amount of repatriated income jumped from an average of about $60 billion per year from 2000-2004 to about $360 billion in 2005. In 2004, U.S. multinationals had over $900 billion in unrepatriated overseas income. Even after repatriating over $360 billion in 2005, U.S. companies reported over $1 trillion of permanently reinvested earnings on 2008 financial statements. Most of the business people we spoke with predicted that a significant portion of this income would be repatriated to the U.S. if there was another temporary tax holiday with a reduced rate or if there was a reduction in the corporate tax rate.

b. Box 1: The Foreign Tax Credit

The foreign tax credit rules are complicated and include several significant limitations. In particular, the foreign tax credit is applied separately to different categories of foreign income (generally distinguishing between "active" and "passive" income). The total amount of foreign taxes within each category that can be credited against U.S. income tax cannot exceed the amount of U.S. income tax that is due on that category of net foreign income after deductions. In calculating the foreign tax credit limitation, the U.S. parent's expenses (such as interest) are allocated to each category of income to determine the net foreign income on which the credit can be claimed. The allocation of expenses to foreign income is intended to assure that credits for foreign taxes do not offset U.S. tax on domestic source income. The portion of expenses allocated to foreign income therefore reduces the amount of foreign tax that can be credited that year.

This foreign tax credit limitation, however, allows active income subject to high foreign taxes (usually active earnings of foreign subsidiaries distributed to U.S. parent corporations as dividends) to be mixed with active income subject to low foreign taxes (including royalties or interest from affiliates). Thus, if earnings repatriated by a foreign subsidiary have been taxed by the foreign country in excess of the U.S. rate, the resulting "excess" foreign tax (i.e., the amount of foreign tax on the earnings that exceeds the U.S. tax that would be owed on the dividend) may be used to offset U.S. tax on other, lower-taxed foreign source income in the appropriate category. This method of using foreign tax credits arising from high-taxed foreign source income to offset U.S. tax on low-taxed foreign source income is known as "cross crediting." One consequence of cross-crediting is that if a U.S. parent corporation develops an intangible asset, such as a patent or trademark, and licenses the rights to its subsidiaries operating in foreign countries, the royalty income generally would be considered active and the U.S. tax on that income may be offset by excess foreign tax credits on other active income subject to high foreign taxes.

If a U.S. parent does not have or expect to have excess foreign tax credits from earnings in a high-tax country, it may have an incentive to structure its affairs so that the rights to such an intangible are owned for tax purposes by a foreign subsidiary in a low-tax country. This may be accomplished through use of an R&D expense cost sharing arrangement, which allows the U.S. parent corporation to retain legal ownership of the intangible rights for intellectual property law purposes but for tax purposes allows the foreign subsidiary to be treated as owning an undivided interest in the intangible. It is not necessary to pay a royalty to the U.S. parent for an intangible whose costs have been shared; however, the U.S. parent loses its U.S. deduction for the portion of R&D expense that is shared. The foreign subsidiary may use the intangible or sub-license the rights to affiliates that make use of the intangible and earn returns attributable to the cost shared intangible. It generally is possible to achieve a deduction in the country of operation and income in the lower-taxed country, while avoiding any U.S. tax under the "subpart F" anti-deferral rules.

Proper allocation of earnings between a U.S. parent corporation and a foreign subsidiary necessarily requires putting appropriate fair market prices on services, products and transfers of intangible rights exchanged between the two. If these "transfer prices" are too high or too low, earnings may be incorrectly allocated and U.S. tax may be avoided by shifting earnings to a lower-tax country. This is the so-called transfer pricing issue. The incentive to manipulate transfer prices is related to the difference in effective tax rates between countries involved in a transaction. In the cost sharing arrangement described above, if rights to an intangible are cost shared after the intangible has significant value, the party receiving the benefit should pay for pre-existing value (a "buy-in payment"). This is one of the most difficult transfer pricing issues to administer and enforce, and highlights the challenges facing governments in applying national tax systems to cross-border transactions.

The United States is the only major developed country economy that uses a worldwide (with deferral) approach to the taxation of corporate income. Other developed countries use a "territorial" or "dividend exemption" approach that taxes only the domestic income of their corporations and exempts all or a significant portion (e.g., 95 percent) of their overseas income from domestic taxes. (Both the U.K. and Japan recently switched from a worldwide approach to a territorial approach.) Additionally, all of the developed countries with the exception of Japan have a lower statutory corporate tax rate than the United States. In contrast to the worldwide system used in the U.S., in territorial systems there is no (or very little) additional domestic tax imposed on exempt overseas income when it is repatriated. A territorial system therefore provides an even greater incentive and opportunity for a company to reduce its domestic corporate taxes by reporting profits abroad and deductible costs at home than the U.S. approach. However, the magnitude of the additional incentive is subject to debate, with some arguing that it is actually quite small because the current U.S. system already provides territorial-like treatment for unrepatriated earnings. Others point to the willingness of U.S. corporations to repatriate substantial foreign earnings in 2005 in response to a temporary 5.25 percent effective rate as evidence that the implicit costs of deferral are more sizable.

A simple example shows the difference between the worldwide approach used by the United States and a territorial approach. A U.S. company with a subsidiary in Ireland, where the corporate tax rate is 12.5 percent — among the lowest in the OECD — pays U.S. tax on the profits earned from active business operations in Ireland, adjusted by a foreign tax credits for foreign taxes paid in Ireland (to ensure the earnings are not double taxed), when the profits are repatriated into the United States. Thus, if the income earned by the Irish subsidiary is repatriated, the tax rate, adjusted for applicable foreign tax credits, is increased from 12.5 percent to the statutory U.S. corporate rate of 35 percent. A French company with an Irish subsidiary also pays the Irish tax of 12.5 percent on income from active business operations of its Irish subsidiary. In contrast with the United States, if the income earned by the Irish subsidiary is repatriated, the French company only pays French tax on 5 percent of the repatriated profits when these profits are repatriated to France. In such a case, the tax rate on the French subsidiary is the Irish rate of 12.5 percent plus a small additional French tax.

As the preceding example indicates, the after-tax result of the U.S. worldwide with deferral system and a territorial system is similar if foreign earnings are not repatriated. Indeed, some experts suggested that with deferral the U.S. system is very similar to some territorial systems used elsewhere. Financial accounting rules preserve this pattern in that they do not require accrual of the U.S. tax on repatriation of earnings if the company makes an election to treat the earnings as permanently reinvested, but that similarity disappears if the U.S. company wants to pay dividends from the foreign subsidiary to the parent in order to finance investment in the U.S. or pay dividends to shareholders.

c. Economic Effects of the Current U.S. Approach

i. Effects on the Location of the Economic Activities of U.S. Multinationals

There are two contrasting views about how U.S. international corporate tax rules affect the production and employment of U.S. MNCs at home. One view rests on the belief that the foreign operations of U.S. multinationals are a substitute for their domestic operations, in the sense that increases in foreign operations come at the expense of domestic operations. According to this view, factors that reduce the cost of foreign operations, including lower taxes on foreign source income, increase the incentive for American companies to shift production, investment and employment to lower-cost foreign locations. Under this view, reducing the relative tax burden on the foreign source income of U.S. MNCs increases the relative cost advantage of their overseas activity and encourages them to move investment—and jobs—abroad, reducing employment and production at home. By this logic, increasing the relative tax burden on the foreign source income of U.S. multinationals would encourage them to relocate production and jobs back to the U.S.

There is evidence that supports the view that cost differences are sometimes a significant factor behind MNC decisions to substitute overseas employment for domestic employment. Studies have found that U.S. employment correlates positively with foreign country wages, indicating that domestic and foreign labor are substitutes, and that higher foreign costs increase employment at home. Other studies find that the sign of the relationship varies by country and likely depends on the type of foreign activity being undertaken by the U.S. company.

A contrasting view is that the foreign operations of U.S. multinationals are a complement to their domestic operations—that is, that employment and other economic activity at foreign subsidiaries correlate positively with domestic employment and activity. According to this view, the foreign subsidiaries of U.S. multinationals increase employment, output, investment and R&D in the U.S. both by enhancing the efficiency and cost competitiveness of U.S. multinationals and by increasing their sales in foreign markets, many of which are growing much more rapidly than the U.S. market. In this view, the foreign operations of U.S. companies generate jobs and activity at their domestic operations. According to this view, factors that increase the attractiveness of foreign operations, including lower taxes on foreign source income, will increase the economic activity of U.S. MNCs both overseas and at home, and also increase the use of equipment and inputs produced by U.S. suppliers.

There is also evidence that supports the view that the foreign operations of U.S. MNCs complement their domestic activities. Recent studies have found positive relationships between both the domestic and foreign employment of U.S. MNCs and between their domestic and foreign investment levels.

On a firm-by-firm and industry-by-industry basis, there is likely to be significant heterogeneity in the relationship between domestic and foreign activity. For many businesses, the ability to substitute domestic activities for foreign activities in order to serve foreign markets is limited by what

they produce. For example, firms that require a local presence to exploit U.S. innovation or expertise to serve foreign markets, firms whose business revolves around natural resources located abroad, firms that require a retail presence or whose business requires face-to-face relationships with consumers, and firms that produce goods that are costly to transport are often unable to serve foreign markets from their domestic locations and to substitute domestic employment and investment for overseas employment and investment. Indeed, in 2007, 19 percent of U.S. exports of goods were intra-company exports from a U.S. parent to a foreign affiliate. Firms in such sectors and carrying on such activities often have significant administration and R&D activities in the U.S. to support or complement their foreign operations. In contrast, firms that produce high value-to-weight goods and goods that are easy to transport are better able to serve foreign markets through exports from U.S. locations. For such companies, the relative cost of investing abroad (including taxes) is likely to be a more important determinant of decisions about whether to locate production and employment in the U.S. or overseas.

ii. Effects on the Costs of U.S. Companies and their Foreign and Domestic Competitors

The combination of lower foreign corporate tax rates and the territorial system of corporate taxation used by other countries reduces the cost of production for foreign firms competing with U.S. companies outside of the U.S.—thus raising the relative cost of U.S. MNCs operating in lower-tax foreign jurisdictions. Although deferral reduces national differences in effective corporate tax rates, such differences may still place U.S. MNCs at a relative disadvantage in international markets and may be influencing company shares in global markets and preventing global production from being allocated to the most efficient companies.

The U.S. worldwide/deferral approach to corporate taxation favors foreign firms operating in their own country compared to U.S. firms in that country. Foreign and U.S. firms both pay corporate taxes in that country—on average at lower rates than in the U.S.—but U.S. firms pay an additional tax on repatriation of those profits. The same is true when U.S. and foreign companies compete in a low-tax third country; foreign firms operating in such a country (e.g., a French firm in Ireland) pay the third country rate, but the U.S. firm pays an additional tax when it repatriates its earnings to the U.S. Overall, the territorial system lowers the cost of doing business by foreign firms in low-tax third countries compared to U.S. firms. However, because U.S. MNCs have been successful in reinvesting their income abroad and deferring U.S. taxes, this tax disadvantage may be small. Nevertheless, U.S. companies that do not remit foreign earnings due to the U.S. repatriation tax bear costs that arise from tax-induced inefficiencies in their financial structure—costs that their competitors based in territorial countries do not bear.

The U.S. worldwide/deferral tax approach also puts U.S. MNCs at a disadvantage in the acquisition and ownership of businesses in other countries compared to foreign companies that operate under a territorial approach. For example, a foreign company can pay more than a U.S. company to acquire a firm in Europe or in a low-tax third country because the net-of-tax profits resulting from the acquisition will be higher for the foreign company than for its U.S. competitor.

In domestic markets, however, both U.S. MNCs and their foreign counterparts benefit from the lower effective rates applied to their foreign-source income and a lower cost of capital, and can spread their overhead costs over a broader base of sales than can purely domestic firms. Moreover, multinational firms may also benefit from reduced domestic taxes through tax planning and transfer pricing to shift domestically-earned profits to lower-tax foreign jurisdictions. Such tax avoidance opportunities are not available to purely domestic firms.

iii. Erosion of the Business Tax Base through Transfer Pricing and Expense Location

Because of the relatively high U.S. corporate tax rate and the ability to defer foreign-earned income indefinitely, U.S. companies have a strong incentive to shift profits abroad to delay payment of their corporate taxes, and to deduct the domestic business expenses incurred in support of their foreign operations against their current domestic earnings. For example, two of the most important methods that U.S. MNCs use to avoid taxes relate to the location of debt and to the location of valuable intangible property. In the first example, a corporation issues debt in a high-tax location (e.g. the U.S.) and uses the capital to generate active income abroad, which is then deferred. This practice, sometimes called "interest stripping," allows businesses to reduce taxable income from their domestic operations immediately while deferring the payment of taxes on their foreign profits. In the second example, a corporation transfers a valuable intangible asset, like a patent or copyright, to a subsidiary in a low-tax jurisdiction without appropriate compensation. The company then exploits the intangible asset through the subsidiary without appropriate royalty payments to the domestic parent. The company benefits from deducting the costs of developing the intangible in the U.S., the high-tax country, and reporting profits from exploiting the intangible in the low-tax country. U.S. MNCs also have a strong incentive to classify passive income earned overseas as active income because deferral applies to the latter form of income and not to the former. Furthermore, the current system of foreign tax credits allows firms to use foreign tax credits received for profits earned in high-tax countries to offset taxes due on profits earned in low-tax countries or to offset taxes due on other kinds of income, like royalties. This system provides additional incentives to manipulate the location of profits (and the type of earnings) attained abroad to qualify for foreign tax credits.

Policing transfer pricing is challenging both because of the intrinsic difficulty of assigning prices to intra-firm sales that are not observed the way arm's length transactions can be and because of the complexity and number of related-party transactions that occur within MNCs. Thus, changes in the tax system motivated by the goal of improving the "competitiveness" of the foreign subsidiaries of U.S. multinationals with respect to their foreign competitors may also have the effect of increasing the incentive for U.S. MNCs to reduce the taxes they pay on the income they earn in the U.S. Indeed, a part of the tax expenditure for maintaining deferral in the current system or for shifting to a territorial system is the reduction in taxes paid by U.S. MNCs on their domestically-earned income.

iv. The Costs of Administering and Complying with the Current U.S. System

Most experts agree that the current hybrid U.S. system that combines a worldwide approach with deferral embodies the worst features of both a pure worldwide system and a pure territorial system from the perspective of simplicity, enforcement and compliance. In a pure worldwide system, all income is subject to the same tax rate, eliminating the necessity of distinguishing active from passive income (and the complexity of subpart F) and of distinguishing domestic and foreign sources of profits (and therefore the need to police transfer pricing). Hence, costly tax planning to shift income to low-tax havens or to re-characterize passive income as active income is significantly reduced. And so is the need for enforcement. However, even in a pure worldwide system, a foreign tax credit system is still required to ensure that companies are not subject to double taxation. (And the foreign tax credit system is complicated.) Moreover, in a pure worldwide system without deferral there would be a greater incentive for U.S. multinationals to shift their headquarters abroad and reorganize as foreign companies to avoid the high U.S. corporate tax rate on foreign income.

In a territorial system, foreign active income is generally not subject to domestic tax but foreign passive income is. The location of profits and the source of income are very important because some income is taxed at the full domestic rate (35 percent in the U.S.) and some income is taxed potentially at zero. Thus, in a territorial system, there typically are rules to differentiate active from passive income (like subpart F under present law), and rules to differentiate profits earned at home from profits abroad (including transfer pricing rules). A foreign tax credit system is required, but only for passive income and other foreign income not eligible for exemption (e.g., royalties). In a pure territorial system, depending on the difference in effective tax rates on domestic income and foreign income eligible for dividend exemption, firms have strong incentives for tax planning, and spend time and money doing it.

The U.S. hybrid approach, like a pure worldwide approach, requires a broad foreign tax credit system to avoid double taxation. But deferral effectively provides territorial-like treatment to active earnings until repatriated, generating the same incentives for tax planning and transfer pricing as a territorial system. Plus, only active income may be deferred while passive income may not. Therefore, the current U.S. system requires a complete foreign tax credit system (including expense allocation rules), subpart F anti-deferral rules for passive income, and onerous transfer pricing enforcement, while generating strong incentives for tax planning and avoidance by businesses. In short, the current U.S. system combines some of the more disadvantageous features from both pure worldwide and pure territorial systems.

The incentives generated by the current system encourage a great deal of costly tax planning by firms and necessitate a significant amount of costly enforcement and compliance activities by the IRS. Moreover, the provisions to address problems created by deferral, foreign tax credits and expense allocation rules, and to differentiate passive and active income contribute significantly to the complexity of the corporate tax code. According to one study, large companies reported that 40 percent of their tax compliance burden arises from the taxation of foreign source income. And the IRS maintains that the international provisions for taxation of corporate income are among the hardest to administer and enforce.

Most experts agree that the current rules for taxing the foreign income of U.S. corporations should be reformed, but there is disagreement about how. In the remainder of this section, we summarize the pros and cons of three basic kinds of reforms that we discussed with experts during our work on international corporate taxation: moving to a territorial system similar to those of other developed countries; maintaining a worldwide approach but at a lower corporate rate and without deferral; and tightening or ending deferral with no change in the corporate rate. We also discuss the implications of maintaining the current system with deferral and a lower corporate tax rate.

v. Option 1: Move to a Territorial System

The proposal and its advantages:

The United States could adopt a territorial approach similar to those used by most other developed economies and exempt from U.S. taxation the active foreign income earned by foreign subsidiaries or by the direct foreign operations of U.S. companies. (Transition rules might be imposed to limit the potential windfall from eliminating the tax that would have been paid when and if accumulated and deferred profits currently held abroad are repatriated.)

Moving to a territorial system would eliminate the incentives of U.S. MNCs to keep income earned from foreign operations abroad rather than repatriating this income to the U.S., reducing the implicit costs companies incur to avoid repatriation. Moving to a territorial system would therefore improve the efficiency of corporate finance decisions.

Adopting a territorial system would mean that the foreign subsidiaries of U.S. MNCs would face similar effective tax rates to those faced by their foreign competitors headquartered in countries with territorial systems. This would reduce the cost of doing business in countries that have lower tax rates for U.S. multinationals relative to their foreign competitors in those foreign markets.

A territorial system would also enhance the ability of U.S. multinationals to acquire foreign firms and would eliminate the incentives for U.S. multinationals to merge with or sell their foreign operations to foreign companies for tax reasons. Elimination of these distortions to the ownership of capital assets would help ensure that those assets were managed by the most productive businesses.

To the extent that foreign operations complement the domestic operations of U.S. MNCs, moving to a territorial system that reduces their costs and increases their shares in foreign markets would boost their production, investment, and employment in the U.S.

Moving to a territorial system could also provide some simplification benefits by eliminating the need for foreign tax credit provisions (except those that apply to passive income and other non-exempt income).

Disadvantages:

The principal disadvantages of adopting a territorial system derive from the fact that in such a system the differences in tax rates applied to repatriated foreign earnings versus domestic earnings and active versus passive income would increase, strengthening the incentives for firms to shift income offshore through transfer pricing and expense shifting, and encouraging active tax planning

(as long as the U.S. corporate tax rate remains significantly higher than the rates imposed by other countries). As noted above, however, the incremental effect of these increased incentives compared to the current system with deferral may be modest. Addressing these disadvantages of a territorial system in order to protect the U.S. domestic tax base and maintain tax revenues would place pressure on the current tax administration and compliance regime and could require rules and regulations that differed significantly from those of other countries.

In particular, to maintain corporate tax revenues (from both domestic and international profits) under a territorial system, critical (and technical) details would need to be resolved, including: the share of foreign corporate income exempted from U.S. taxes; the U.S. tax treatment of U.S. business expenses incurred by U.S. companies to support their foreign operations; and the U.S. tax treatment of royalty or passive income earned abroad by U.S. corporations.

The revenue consequences of these design decisions are material. According to rough estimates from the Treasury, a simplified territorial system without full expense allocation rules would lose approximately $130 billion over the 10-year budget window. In contrast, a territorial system with full application of expense allocation rules could be revenue neutral or could raise revenue depending on the behavioral responses of corporations and the ability of the IRS to police transfer pricing and expense allocations. Indeed, earlier studies from the JCT, Treasury, and the Congressional Budget Office (CBO) have scored territorial tax systems with expense allocation rules based on the current rules used for the foreign tax credit as raising between $40 billion and $76 billion over 10 years. Differences in these estimates result from differences in behavioral assumptions, the details of the proposals, and the data used to make these estimates. The wide variation in revenue effects highlights the importance of complex specification details and the incentives created under different regimes.

A reform that maintained the current effective tax rate on the domestically-earned income of U.S. MNCs would require increased attention to transfer pricing enforcement and the rules regarding the location of expenses. For example, to maintain revenue neutrality, tax deductions for interest and other administrative expenses of U.S. MNCs used to finance operations abroad would need to be disallowed so that they could not be used to reduce domestic taxable income. This would limit any simplification benefits of reform. Moreover, a territorial system that included expense allocation rules with rigorous enforcement would remain very different from the territorial systems of other developed countries. Most countries using territorial systems do not "allocate and disallow" domestic business expenses in this way either by design or because their rules are undeveloped. In a system with stringent allocation rules, many U.S. firms could still face higher costs of doing business in foreign jurisdictions than their foreign competitors. Similarly, shifting to a territorial system while retaining the current rules on royalty income without a reduction in the U.S. corporate tax rate would mean that royalty income from foreign sources would be taxed at a higher rate than royalties paid to foreign firms operating from lower-tax jurisdictions.[15]

15 A territorial system would impose a higher effective U.S. tax rate on foreign-source royalty income, providing firms with a greater incentive to reclassify royalty payments (and other non-exempt income) as exempt active income. Currently, royalties are mostly sheltered from tax using "excess" foreign tax credits. Shifting to a territorial system would eliminate these excess foreign tax credits.

A number of foreign governments with territorial systems attempt to recoup revenue by taxing a small portion of the foreign source active income of their corporations (typically by exempting around 95 percent of repatriated earnings from tax). The U.S. could adopt such an approach to recoup some of the lost revenue from moving to a territorial system. This would reduce the administrative and compliance costs of a territorial system compared to one that used a complicated expense allocation system like that currently used for the foreign tax credit. Revenue losses could also be reduced by denying exemption for income earned in a low-tax country (a "tax haven") that does not have a minimum effective corporate tax rate.

A territorial system that resulted in lower effective rates on foreign-earned profits could also affect the location decisions of U.S. multinationals. To the extent that production overseas is a substitute for domestic economic activity (or in industries where this is true), adopting a territorial system could encourage the movement of production, employment and investment out of the U.S. to lower-tax jurisdictions. A territorial system that raised effective rates on royalty income from U.S.-domiciled intangibles could encourage firms to shift intellectual property and research and development abroad.

Finally, a territorial system would retain or exacerbate many of the incentives for inefficient behavior in the current worldwide system with deferral: incentives for shifting income to low-tax locations by distorting transfer prices or paying inadequate royalties; incentives for using related-party transactions (where transfer pricing can be used to reduce taxes) rather than arm's length transactions; and incentives for altering the location of tangible and intangible assets.

vi. Option 2: Move to a Worldwide System with a Lower Corporate Tax Rate

The proposal and its advantages:

This option would impose a pure worldwide tax system and end deferral as part of a larger corporate tax reform that lowered the U.S. corporate tax rate to a level comparable to the average of other developed countries. If the statutory corporate rate were lowered to a rate at which, on average, U.S. MNCs experienced no change in the effective tax rate they currently face on income earned abroad the reform would be "burden neutral" for this category of income (though as discussed below there would probably be individual "winners and losers"). One estimate of the required burden neutral corporate rate for this reform is 28 percent. This option would result in a significant overall revenue loss because the lower corporate rate would apply to both domestic and foreign income and to all U.S. corporations regardless of whether they have foreign operations. To reduce or avoid this revenue loss would require revenue increases elsewhere, for example by broadening the domestic corporate tax base as described above under Option Group B. (Lowering the corporate tax rate would also have efficiency benefits in the domestic context, as described in Option Group A.)

Moving to a worldwide system and ending deferral would have significant benefits for simplification, compliance, enforcement, and efficiency. By eliminating deferral for active foreign income, all income would be taxed at the same rate regardless of where it is earned (domestically or internationally), or whether it is passive or active income. The subpart-F anti-deferral provisions and

most rules to differentiate passive and active income could be simplified or eliminated. The system of foreign tax credits would be maintained to avoid the double taxation of foreign-earned income, but it would be possible to simplify the system by eliminating the allocation of expenses.

Moving to a worldwide system without deferral would also reduce many of the incentives for tax planning and tax avoidance, and therefore would require less complex and onerous anti-abuse provisions and less enforcement. Incentives to engage in income shifting, for example through transfer pricing, would be eliminated, reducing planning and compliance costs at businesses and requiring less oversight from the IRS.

Another advantage of this proposal is that it removes incentives for a number of inefficient behaviors. First, because all income is taxed currently, firms would no longer have a U.S. tax incentive to keep cash abroad to avoid repatriation, improving the efficiency of corporate financing decisions. Second, as mentioned, there is no incentive for U.S. multinationals to engage in income shifting through expense location or transfer pricing, and this would reduce the distortions that arise from incentives to use related-party transactions, to locate tangible and intangible assets in alternative locations for tax purposes, or to favor certain financing choices (like domestic debt) over other choices.

Finally to the extent that the foreign economic activities of U.S. MNCs substitute for their domestic economic activities, this option would encourage production, investment and employment in the U.S.

Disadvantages:

A difficulty with this approach is that lowering the tax rate to the required burden-neutral level (around 28 percent) would either necessitate significant base broadening through the elimination of other corporate tax credits and tax deductions, or a substantial loss of corporate tax revenue. Ending deferral would itself permit a revenue-neutral reduction in the corporate rate by about 1.5 percentage points.

Although cutting the corporate rate to the burden-neutral level while ending deferral would result in no change in the average tax rate on foreign income, some firms with such income would face tax increases and others tax reductions. For example, firms operating primarily in low-tax countries benefit more from deferral than companies operating in high-tax countries, so ending deferral would raise taxes more on the former group of firms. Thus, this option would introduce greater country-by-country heterogeneity in the competitiveness of U.S. firms depending on the tax rates of the countries in which they operate, and U.S. MNCs would face greater tax disadvantages in lower-tax countries compared to their competitors headquartered in countries with lower corporate tax rates and/or with territorial systems. Other firms likely to be negatively affected by ending deferral even with a burden-neutral reduction in the corporate tax rate include those able to use transfer pricing to move profits abroad—for example, those transferring hard-to-value intangible assets or services.

Under this option, U.S. MNCs would still face competitive disadvantages on foreign operations in jurisdictions with corporate tax rates below 28 percent. This option would also retain the incentives for foreign firms to acquire U.S. companies or their foreign subsidiaries. Although these in-

centives would be limited to some extent because the gains from the sales of subsidiaries are subject to U.S. taxation, this option would reduce the ability of U.S. firms to compete in the acquisition of foreign firms that face lower effective tax rates.

Indeed, the incentive for foreign firms to acquire the foreign subsidiaries of U.S. MNCs would likely increase because those foreign subsidiaries would be more valuable in the hands of foreign firms than in the hands of the U.S. MNCs. Further, this proposal would increase incentives for foreign firms to acquire U.S. MNCs outright and then use transfer pricing to shift profits to lower-tax jurisdictions, raising concerns over transfer pricing enforcement of foreign MNCs operating in the U.S. Preventing this outcome would require continued enforcement efforts under the transfer pricing rules. Thus, transfer pricing rules would remain important for these firms and, to a lesser extent, for U.S. tax administrators.

vii. Option 3: Limit or End Deferral with the Current Corporate Tax Rate

Given the high U.S. corporate tax rate, under a pure worldwide tax system without deferral, U.S. MNCs would face a higher effective tax rate compared to foreign MNCs headquartered in countries with lower corporate tax rates, territorial tax systems or both. Deferral offsets much of this disadvantage by approximating the effective rates faced in foreign jurisdictions. With deferral the foreign operations of U.S. corporations are taxed comparably to the foreign operations of their foreign competitors operating in the same foreign tax jurisdictions. As a result of the "time value of money" advantage of postponing tax payments, deferral allows the foreign source income of U.S. corporations to be taxed at a lower effective rate than it would be if it were earned in the U.S. This creates an incentive for U.S. corporations to keep their foreign earnings abroad as long as possible and distorts their investment and business decisions.

The proposal and its advantages:

Maintaining the system of deferral for U.S. MNCs to allow them to enjoy similar tax rates to competitors when operating in foreign jurisdictions comes at a significant revenue cost—approximately $180 billion over ten years. Ending this tax expenditure would raise considerable revenues, enough to reduce the corporate rate by about 1.5 percentage points, relieving the economic distortions of the corporate tax along a number of margins.

For those who see the foreign activities of U.S. MNCs as a substitute for domestic activities, deferral both reduces jobs, production and investment by U.S. companies at home and encourages these activities abroad, as well as allowing U.S. companies to avoid taxes. By this logic, limiting or eliminating deferral would cause U.S. MNCs to substitute domestic for foreign activities, would reduce tax avoidance, and would increase tax revenues.

Like the burden-neutral reform discussed above, this option would simplify the tax system, reduce incentives for income shifting and tax planning and avoidance, and would therefore improve international enforcement and reduce administrative and compliance costs. It would be easier to

enforce than the current system because it would leave little incentive for transfer pricing or the use of tax havens.

Disadvantages:

Without a substantial reduction in the U.S. corporate income tax rate, however, this option would impose a significant burden on U.S. multinationals, raising the effective tax rates on income earned at their foreign subsidiaries relative to the rates that apply to their competitors in lower-tax countries, and hampering their ability to bid for and purchase foreign assets in lower-tax jurisdictions. At the same time, ending deferral would make it more attractive for foreign firms to acquire the foreign assets of U.S. companies. To the extent that the foreign activities of U.S. MNCs complement their domestic activities, deferral increases jobs, production and investment at home and limiting or eliminating deferral would reduce the competitiveness of U.S. companies, would decrease jobs, production and investment in the US, and would reduce corporate tax revenues over time.

viii. Option 4: Retain the Current System but Lower the Corporate Tax Rate

The proposal and its advantages:

This option would lower the corporate rate as in Option 2, but within the current tax system, which taxes the active foreign earnings of U.S. MNCs only upon repatriation. The efficiency benefits of a lower corporate tax rate for all U.S. corporations regardless of where they earn their income are discussed in the earlier section of this report on corporate taxation. At the same time, deferral would offset much of the disadvantage U.S. firms face when operating in low-tax countries. Because of the lower corporate rate, the difference in tax rates between income earned domestically versus income earned abroad would be reduced, reducing the incentives for transfer pricing and expense location and the disincentive to repatriate foreign earnings.

Disadvantages:

This option would reduce revenues by lowering the rate and would retain the tax expenditure of deferral (at a lower cost), but would not provide many of the simplification and efficiency benefits of Option 2. Both the complexity of the current system and the incentives to locate profits abroad and defer repatriation for tax avoidance would be retained.

Simple, Fair, and Pro-Growth:

Proposals to Fix America's Tax System

Report of the President's Advisory Panel on Federal Tax Reform

November 2005

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Simplifying the Taxation of International Business

The Simplified Income Tax Plan would update our international tax regime by adopting a system that is common to many industrial countries. As explained in Chapter Five, our tax system taxes all income of U.S. corporations regardless of where it is earned and provides a limited tax credit for income taxes paid to foreign governments. Many of our trading partners use "territorial" tax systems that exempt some (or all) of business earnings generated by foreign operations from home country taxation. France and the Netherlands, for example, exempt foreign dividends. Canada, on the other hand, exempts foreign dividends from countries with which it has tax treaties from home taxation. Canada effectively administers a territorial system because it has tax treaties with many countries.

To understand the tax implications of territorial and worldwide systems, consider a simple example. A French multinational company and a U.S. multinational company both have subsidiaries with active business operations in another country, Country X, that imposes a 20 percent tax on corporate income. The U.S. corporate income tax rate is 35 percent. Assume that both companies earn $100 from their operations in Country X and immediately send the profits home as a dividend.

Both the U.S and French subsidiaries pay $20 of tax to Country X on their $100 of earnings. However, the U.S. company faces a "repatriation tax" on the dividend, but the French company does not. The U.S. tax bill of $35 on the $100 of foreign earnings is reduced to $15 because the company receives a credit of $20 for the taxes already paid to Country X by its subsidiary. This means that the U.S. multinational pays a total of $35 in tax: $20 to Country X and $15 to the United States. The French multinational, on the other hand, pays only $20 in tax to Country X. The French company faces a lower tax rate on investments in Country X than the U.S. company because France has a territorial tax system.

Unfortunately, reality is not as simple as this example portrays it. As explained in Chapter Five, the U.S. multinational does not pay U.S. tax on its subsidiary's earnings in Country X until the earnings are repatriated to the United States. The repatriation tax is elective and, as a result, distorts business decisions. If the U.S. multinational redeploys earnings abroad by reinvesting the $80 in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the foreign earnings. Tax planners can devise elaborate strategies to avoid the repatriation tax, but the strategies employed may themselves be costly and wasteful to the economy.

For some firms, arranging corporate affairs to avoid the repatriation tax involves costly and distortionary activity that would not take place except for tax considerations. As explained in Chapter Five, the combination of deferral and the foreign tax credit creates a situation in which the tax rate imposed on investment abroad differs among U.S. multinationals. For example, a multinational that can defer repatriation indefinitely (or avoid the repatriation tax at no cost) pays no repatriation tax. A multinational that is unable to structure operations to avoid the repatriation tax faces the U.S. tax rate.

Under our current tax system, it is also possible for companies to face tax rates on marginal investments abroad that are lower than host country rates. For example, consider a U.S. multinational that finances additional investment in Country X through U.S. borrowing. If the multinational is able to indefinitely defer tax on earnings in Country X (or avoid any repatriation tax through tax planning) it will face a lower than 20 percent rate on its investment. This is because the U.S. company

gets a deduction at the U.S. tax rate for interest payments with no corresponding taxation of income at the U.S. rate. Although territorial tax systems are designed to impose no home country tax on active foreign earnings, the goal of these systems is not to subsidize foreign investment. For this reason, provisions that allocate expenses associated with exempt foreign income against that income (or tax some otherwise exempt foreign income as a proxy for allocating those expenses) are necessary.

The Simplified Income Tax Plan would adopt a straightforward territorial method for taxing active foreign income. Active business income earned abroad in foreign affiliates (branches and controlled foreign subsidiaries) would be taxed on a territorial basis. Under this system, dividends paid by a foreign affiliate out of active foreign earnings would not be subject to corporate level tax in the United States. Payments from a foreign affiliate that are deductible abroad, however, such as royalties and interest would generally be taxed in the United States. Reasonable rules would be imposed to make sure that expenses incurred in the United States to generate exempt foreign income would not be deductible against taxable income in the United States. Because insuring that related entities charge each other "arm's length" prices for goods and services is even more important in a territorial system than under current law, additional resources would need to be devoted to examining these transfer prices. As is common in territorial systems around the world, income generated by foreign assets – such as financial income – that can be easily relocated to take advantage of the tax rules would continue to be taxed in the United States as it is earned. For example, if the U.S. company in our example was to invest the $100 of foreign profits in Country X in bonds instead of in an active business, the interest earned on the bonds would be subject to immediate U.S. taxation (with a credit for any taxes paid to Country X).

Such a tax system would more closely reflect the international tax rules used by many of our major trading partners. It would level the playing field among U.S. multinationals investing abroad. It would allow U.S. multinationals to compete with multinationals from countries using a territorial approach without having to bear the planning costs that are necessary under today's system. In addition, it would make it easier for American companies to repatriate income earned in foreign nations tax-free and reduce the degree to which tax considerations distort their business decisions. Finally, commentators from both industry and academia have concluded that a carefully designed territorial-type system can lead to simplification gains.

Research on the consequences of adopting a territorial system for the United States suggests that this reform could lead to both efficiency and simplification gains. Economists have found that the financial decisions of corporate managers are extremely sensitive to the tax on repatriations – lower U.S. taxes on dividend repatriations lead to higher dividend payments and vice-versa. This correlation implies that repatriation taxes reduce aggregate dividend payouts and generate an efficiency loss that would disappear if active foreign source income were exempt from U.S. tax. Corporate managers would be able to arrange corporate affairs and financial policies to meet objectives other than tax avoidance if they were freed from worrying about how to time repatriations of foreign income to reduce U.S. taxes.

At first glance, one might assume that exempting active foreign source income from U.S. taxation would lead to a substantial reallocation of U.S. investment and jobs worldwide. A careful study of how location incentives for U.S. multinational corporations may change under a territorial system similar to the one proposed for the Simplified Income Tax Plan provides different results. Researchers found no definitive evidence that location incentives would be significantly changed, which suggests that the territorial system the Panel has proposed would not drive U.S. jobs and capital abroad relative to the current system. This result is not surprising. As explained in Chapter Five, the U.S. international tax system has both worldwide and territorial features. For some firms, the U.S. international tax system produces tax results that are as good or even better than those that would apply under a territorial system. Exempting active foreign-source income repatriated as a dividend from U.S. tax provides no additional incentive to invest abroad if, in response to the current tax system, firms have already arranged their affairs to avoid the repatriation tax. Instead, exempting dividends allows firms to productively use resources that were inefficiently employed under current law. The Simplified Income Tax Plan would produce no less revenue from multinational corporations than the current system, but would be less complex and more uniform in its application.

Additional information regarding the Panel's proposals for a new system of international taxation under the Simplified Income Tax Plan can be found in the Appendix.

Strengthening Rules to Prevent International Tax Avoidance

The Simplified Income Tax Plan also would modify the definition of business subject to U.S. tax to ensure businesses that enjoy the benefit of doing business in the U.S. pay their fair share. Under current law, residency is based on the place a business entity is organized. This rule makes an artificial distinction that allows certain foreign entities to avoid U.S. taxation even though they are economically similar to entities organized in the United States. This rule may give businesses an incentive to establish legal place of residency outside the United States to avoid paying tax on some foreign income. Several large U.S. companies have used a similar technique to avoid taxes under our current system. Recently enacted legislation created rules to prevent existing corporations from moving offshore, but does not prevent newly organized entities from taking advantage of the rules.

To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." The new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort.

Chapter Six: The Simplified Income Tax Plan

Territorial Tax Regime

Under the new territorial regime, income earned abroad by controlled foreign corporations and foreign branches of U.S. corporations would fall into one of two categories: (1) "Foreign Business Income," which would generally be exempt from U.S. taxation, and (2) "Mobile Income," which would be taxed by the United States on a current basis.

Foreign Business Income

Income earned abroad by a controlled foreign corporation (a "foreign affiliate") in the conduct of an active business ("Foreign Business Income") would not be subject to U.S. tax at the business level when repatriated as a dividend. Foreign Business

Income is net income after deductions. The general rule is that any payment that is deductible abroad would be taxed in the United States. Thus, non-dividend payments from foreign affiliates to U.S. corporations (e.g., interest, royalties, payments for intercompany transfers) would be subject to U.S. tax. A hybrid security rule would be required to prevent a payment that is treated as deductible interest abroad from being treated as an exempt dividend in the United States.

The Simplified Income Tax Plan would provide that exempt earnings of foreign affiliates could be redeployed to other foreign affiliates in different foreign jurisdictions without losing the benefit of exemption. There would be no tax on the gains from the sale of assets that generate exempt income and losses from the sales of such assets would be disallowed.

Businesses would not receive foreign tax credits for foreign taxes (including both corporate level taxes and dividend withholding taxes) attributable to Foreign Business Income because this income would not be subject to tax in the United States. As a result, the foreign tax credit system would serve a more limited function than it does under present law.

Income of foreign branches would be treated like income of foreign affiliates under rules that would treat foreign trades or businesses conducted directly by a U.S. corporation as foreign affiliates. These rules would be needed to place branches and foreign affiliates on an equal footing. For example, a rule would be needed to impute royalties to foreign branches. All trades or businesses conducted predominantly within the same country would be treated as a single foreign affiliate for this purpose.

Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called "10/50" companies).

All distributed earnings of foreign affiliates would be subject to the new international tax regime following the effective date, regardless of whether such distributions were paid out of pre-effective date or post-effective date earnings.

Mobile Income

Passive and highly mobile income ("Mobile Income") would be subject to tax when earned. Mobile Income would include foreign personal holding company income (e.g. interest, dividends, rents, and royalties arising from passive assets), certain types of foreign active business income that is not likely to be taxed in any foreign jurisdiction (e.g., certain income from personal services and income from international waters and space), and income from the sale of property purchased from or sold to a related person by a foreign corporation located in a country that is neither the origin nor the destination of that property. Small amounts of Mobile Income (measured using a *de minimis* rule based on a percentage of gross income or total assets) would be ignored for simplicity.

A foreign tax credit would be available to offset foreign tax paid (including withholding taxes) on Mobile Income. The current complex foreign tax credit basket rules would be replaced with a single overall foreign tax credit limitation.

Financial services businesses, such as banks, securities dealers, and insurance companies, earn interest and other types of Mobile Income in the conduct of their active business. Special rules would need to provide that qualifying financial services business income is treated as Foreign Business Income to the extent such income is earned through active business operations abroad. Anti-abuse rules would be needed to prevent passive investment income earned by financial services businesses from being treated as Foreign Business Income.

Expense Allocation

Under the Simplified Income Tax Plan, the active business earnings of foreign affiliates would not be subject to U.S. tax at the business level. Accordingly, business expenses that are attributable to these foreign earnings should not be allowed as a deduction against U.S. taxable income. For example, interest and other expenses incurred by a U.S. business to earn exempt foreign earnings would be allocated to those earnings and therefore disallowed. The question of how to allocate expenses to exempt foreign income is a difficult one. Detailed expense allocation rules similar to current law would be necessary. These rules would inevitably involve some complexity, but could be simpler than current-law expense allocation rules.

Interest expense should only be disallowed to the extent that the U.S. operations of a U.S. multinational are more heavily leveraged than the multinational's foreign operations; that is, interest expense should be disallowed to the extent that the ratio of foreign debt to foreign assets is lower than the worldwide ratio of debt to assets. Therefore, the Panel recommends that interest expense be allocated between U.S. and foreign affiliates under rules similar to those recently enacted as part of the American Jobs Creation Act of 2004.

General and administrative expenses that are not charged out to foreign subsidiaries or otherwise recovered by intercompany fees (such as certain stewardship expenses) would be allocated to gross foreign affiliate income in the same proportion that gross foreign affiliate income of the U.S. multinational bears to overall gross income of the worldwide affiliated group. General and administrative expense allocated to foreign affiliate income would then be further allocated between exempt and non-exempt foreign income, with expenses related to exempt foreign affiliate income disallowed.

The Panel recommends that research and experimentation expenses be allocated between domestic source income and foreign-source Mobile Income only. No research and experimentation expenses would be allocated against exempt foreign-source income because all royalty income associated with those research and experimentation expenses would be taxable at the U.S. rate.

Transfer Pricing Enforcement

In a territorial system, U.S. multinationals would have incentives to use transfer pricing to minimize taxable income generated by domestic operations and maximize lightly-taxed income generated in foreign operations. These pressures also exist under current law, and a large body of rules has evolved to enforce "arm's length" transfer pricing among related parties. Because these pressures are more pronounced in a territorial system, it would be necessary to continue to devote resources to transfer pricing enforcement.

Taxation of Foreign-Source Dividend Income by OECD Countries

Table A.2 provides information regarding the tax treatment of resident corporations on their receipt of direct (non-portfolio) foreign dividends paid out of active business income in OECD countries. Some countries generally exempt such income, while other countries generally tax it with a credit for foreign taxes paid. However, the exact treatment of dividends paid out of active business income varies by country and often is not straightforward. For example, many countries that are classified as "exemption" countries tax some (low-tax) active income currently and exempt other (high-tax) active income. New Zealand and France are examples.

Table A.2. Home Country Tax Treatment of Foreign-Source Dividend Income Received by Resident Corporations	
Exemption	**Foreign Tax Credit**
Australia*	Czech Republic
Austria	Iceland
Belgium	Japan
Canada*	Korea
Denmark	Mexico
Finland	New Zealand
France#	Poland
Germany	United Kingdom
Greece*	United States
Hungary	
Iceland	
Italy#	
Luxembourg	
Netherlands	
Norway	
Portugal*	
Slovak Republic	
Spain	
Sweden	
Switzerland	
Turkey	

Note: In general, tax treatment depends on qualifying criteria (e.g. minimum ownership level, minimum holding period, the source country, the host country tax rate). The table reports the most generous treatment of foreign direct dividends in each case.
* Exemption by treaty arrangement.
# Exemption of 95 percent.
Source: Table compiled from information provided by the OECD Secretariat. Information as of January 2005.

Calculating the Dividend Exclusion Percentage

Under the Panel's proposal, shareholders of U.S. corporations could exclude from income 100 percent of the dividends paid from income of the corporation reported as taxable in the United States. Corporations would report each year on their information reports to shareholders the total dividends paid and the amount which is taxable. For corporations that report all their income in the U.S., 100 percent of dividends paid would be nontaxable to their shareholders. Corporations which earn part of their worldwide income in the U.S. would have to compute the fraction

of worldwide income that is reported as taxable in the U.S. each tax year, and this fraction would be used to calculate the dividend exclusion for dividends paid in the following year. Because of the clean tax base recommended by the Panel, the Panel believes that rules specifying how this percentage is calculated can and should emphasize simplicity over precision. For example, this percentage can be calculated simply by dividing taxable U.S. income each year by worldwide pretax income as reported on the corporation's financial statements for the same year. For simplicity, foreign tax credits on foreign Mobile Income reported as taxable in the U.S. could be ignored in this calculation. Taxpayers who wished to adjust for the difference between accelerated depreciation allowed in the U.S. and book depreciation could be allowed to do so by adding back the difference to U.S. taxable income before calculating the fraction of worldwide income taxable in the U.S., but other adjustments would not be allowed or required.

Disclosure of Foreign Earnings

The Simplified Income Tax Plan would require additional disclosures that would complement the new international tax regime. U.S. businesses with Foreign Business Income would be required to file with their tax return a schedule showing their consolidated worldwide revenues and income before taxes, as reported in their financial statements. The new schedule would disclose the proportion of domestic and foreign revenues and income. In addition, businesses would be required to reconcile the consolidated revenues and income reported on their financial statements with the taxable revenues and income reported on their tax returns.

This disclosure, combined with the exclusion of dividends paid out of domestic earnings, would provide disincentives for corporations to understate the amount of income subject to U.S. tax. A business that understates the amount of income reported on its tax return would increase the amount of tax required to be paid on dividends received by its shareholders. In addition, businesses whose securities are publicly traded would be required by existing disclosure rules to report in their financial statements the proportion of United States and foreign income and revenues computed under tax and accounting rules. This public disclosure would increase the transparency of the business's calculations and provide a better top-down view of a corporation's global operations to shareholders, potential investors, and regulators.

THE INDIRECT SIDE OF DIRECT INVESTMENT

MULTINATIONAL COMPANY FINANCE AND TAXATION

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6. What Governments May Do: Policy Options

The theoretical and empirical work of the previous chapters suggests that taxes have an impact on financial decisions of German multinationals, leading to tax arbitrage to lower worldwide tax rates. First, differences in corporate income tax rates across jurisdictions impact financing structures of multinationals by encouraging companies to shift income from high to low tax rate countries. Second, tax-efficient structures using conduit entities enable businesses to reduce withholding taxes ("treaty-shopping") or to claim two or more deductions for interest expense (leasing or other types of expenditures deductible from corporate income), thereby reducing the worldwide tax paid by multinationals and providing them a tax advantage through low or negative effective tax rates on capital when undertaking cross-border investments.

Given these tax advantages provide a lower cost of capital to those companies that have access to tax-efficiency at the international level, the question faced by governments is what they should do about it. This chapter tries to lay out some policy alternatives, specifically full taxation of affiliate foreign profits accruing to the parent, limitations on interest deductions and international co-operation.

Policy prescriptions for any one country are hard to implement given the interactions among country tax systems. Actions taken by one government alone could result in an inadvertent economic cost to the national economy – "shooting itself in its foot" – which is not very appealing.

A recent German debate over interest taxation illustrates how difficult public policy can be to formulate. A 2006 proposal made by Peer Steinbrück, Minister of Finance, to tax

interest paid on loans from affiliates in low-tax countries was met by hostile reactions from a group of U.S. companies. They argued that the planned taxation of interest payments would be "unique in the world" and "threaten the existence of some companies".[1] This reaction by large multinationals to tax policy related to financial structures is not the first or last time that it will be heard. Whether or not these statements are empty threats, multinationals can vote with their capital to move elsewhere, forcing governments to formulate carefully their optimal international tax policy. Setting international tax policy is not a job to envy.

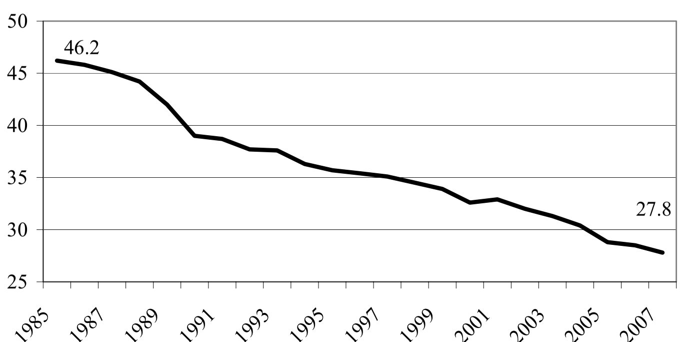
Governments have been reacting to international tax developments with several conflicting strategies to improve capital market efficiency or shore up the tax base in a country. Statutory corporate income tax rates have been plummeting from an OECD-wide average of 46.2 percent in 1985 to 27.8 percent by 2007 (KPMG 2007). Rules impeding the flow of capital across countries have been lightened through double taxation agreements and reductions in withholding taxes. Tax bases have been broadened or new forms of non-profit taxes have been levied on corporations to maintain revenues (Chen and Mintz 2000; Hines 2007). Transfer pricing and debt limitation rules for determining domestic income have been tightened. Governments have also been seeking new approaches at the international level to harmonize corporate tax bases, particularly in the European Union where discussions to harmonize the corporate income tax base among EU member states is ongoing (Commission of the European Communities 2007).

In this chapter, we review various policy approaches to the taxation of international income and the deductibility of financing costs. We begin first with tax policy objectives that a government may adopt and how this affects the international allocation of capital. This is followed by an analysis of outbound and inbound investment issues and the tax treatment

[1] Financial Times, "Minister Hits Out at German Plan to Tax Interest", Friday, July 21, 2006, p. 3.

of interest. We specifically examine whether a country should fully tax foreign source profits on an accrual basis or exempt it with limitations on interest deductibility (the latter is applied by Germany to dividends and capital gains on shares held in affiliates). A final section considers issues related to international co-operation in taxation, including the allocation of a harmonized tax base.

Figure 6.1: Statutory Corporate Income Tax Rates, OECD Average, 1985-2004



Source: Own calculations based on the Appendix and KPMG (2007).
Annotations: Rates include average local taxes as applied to retained earnings. Non-weighted averages.

6.1. International Tax Policy Objectives

For a given level of spending, the question faced by governments is how to design the tax structure, using established objectives as criteria for assessing the best tax structure. Of course, the primary role of taxation is to raise revenues so international tax policy must also

be cognizant of how policies impact on the government's fiscal requirements to fund public programs. Some policies in the interest of other objectives might affect public revenues available to the government, especially in a global economy where multinationals might look towards reducing their worldwide taxes.

Three criteria are typically evoked for tax policy design: efficiency, equity and simplicity. For the tax system to be efficient, it should distort as little as possible economic decisions in the market place. As prices signal how resources should be allocated towards their best use, taxes should minimally distort (relative) prices.[2] For equity, a tax system should impose the same burden on those with similar resources (horizontal equity) and the burden should vary according the ability to pay taxes (vertical equity). Simplicity allows for taxes to be levied at low administrative and compliance costs as well as ensuring that the taxes are enforceable.

With tax design, "neutrality" – similar tax burdens on similar individuals or business activities – is an important economic criterion that, in principle, is consistent with efficiency, horizontal equity and simplicity. When similar tax burdens are imposed on different sources of income earned by individuals or on various business activities, taxes will hardly distort investor and business decisions. They will also treat fairly those who have similar income that comes from different sources. As well, the costs of administration and compliance are reduced by taxes with broad bases and few distinctions among different types of income.

[2] At times, the market price system may not be a good guide to resource allocation when the price mechanism internalizes the benefits or costs imposed by decisions in decentralized markets. Such externalities or spillovers can lead to excessive or under supply of products and services. Pollution is an example of a positive externality whereby actions taken by some decision makers harm others as the pollution is not priced in markets. Research and development is an example of a positive externality or spillover as innovative efforts may benefit others in markets with the innovator receiving no compensation for benefits conferred unto others. Whether one wishes to use the tax system to correct for market failures compared to other forms of government intervention is a separate issue requiring its own analysis. Taxation may not be the best route to correct market failures. In our discussion below, we will not focus on tax policies designed to correct for market imperfections.

If individuals earn income from domestic or foreign sources, the absence of taxing foreign source income could be contrary to both efficiency and equity as individuals could avoid paying income tax. As for taxation of businesses on their domestic and foreign source income, the story is a bit more complex since it raises the issue as to why a business tax should be levied at all, to which we now turn.

6.2. Residence versus Source Taxation

Residence taxation has been defined as taxes levied on the income of individuals resident in a jurisdiction (Musgrave 1969), exempting the income earned by non-residents. Source taxes are applied to income generated in a jurisdiction regardless of whether the income accrues to residents or non-residents. In principle, therefore, source taxes are not levied on foreign source income. Taxing only domestic income is also referred to as a "territorial" tax system.[3]

Two immediate questions are raised by residence and source taxation:

- Why would governments wish to tax income earned in foreign jurisdictions of their residents?
- Why is a business level tax desirable, especially one that is source-based?

Why Tax Foreign-Source Income?

To assess taxes on income earned by residents, governments will typically tax worldwide income of their residents.

[3] Hong Kong applies a source tax on income (with some modification for financial institutions). Taxes are levied on income earned at source in Hong Kong and foreign-source income is exempt. Non-residents are subject to Hong Kong tax on their source income.

The primary argument for taxation of foreign-source income is *capital export neutrality* – equal treatment of different sources of income earned by a resident. Suppose an individual receives a return on assets in the domestic jurisdiction equal to R_d and on foreign assets equal to R_f. Without taxation, the investor is indifferent between domestic and foreign assets as long as $R_d = R_f$. To ensure that taxes do not affect the allocation of worldwide assets held by resident companies, the resident government would impose equal rates of tax on the two assets at the rate τ so that $R_d(1-\tau)= R_f(1-\tau)$, implying that the pre-tax returns are equal ($R_d = R_f$).

Note, however, when a country imposes taxes on foreign-source income earned by its resident multinationals, the effective tax rate on capital will differ on investments in a foreign jurisdiction compared to other companies of different national identity operating there. Within the foreign jurisdiction, the corporate tax system is therefore no longer neutral – pre-tax rates of return on capital will differ – when businesses are differentially taxed according to their nationality even though capital export neutrality is observed as a principle for the capital exporter country (we return to this point below).

If income earned in foreign jurisdictions by resident multinationals is taxed abroad by foreign governments, a country might choose to provide a tax credit[4] to avoid double taxation of such income or provide a deduction of foreign tax from foreign income to determine domestic tax to be paid on income. There is an important difference between these two approaches. As discussed in Chapter 2, a tax credit achieves "worldwide neutrality" in that the investor is indifferent between foreign and domestic assets, taking into account worldwide taxes.[5] The tax deduction method is argued to be consistent with "national

[4] See Chapter 2 for an elaboration of the tax credit system for foreign source income.
[5] Worldwide neutrality is achieved if foreign tax credits in excess of home tax liability are refunded by one of the governments. Note, if foreign taxes are more than the domestic tax rate on foreign source income, a

neutrality" in that foreign tax is viewed as a reduction in income that is no different than the cost of doing business abroad.[6] From the perspective of the capital exporting country, income from foreign investment, net of foreign taxes, is simply what can accrue to investors as domestic income.

Tax Credit: Suppose the foreign tax rate is $\tau°$. A credit would imply that the resident tax on foreign source income is reduced euro for euro by the foreign tax paid on the income. The net foreign tax collected by the capital exporting government where the investor resides is $\Theta R_f = (\tau - \tau°)R_f$. Overall, the investor earns income on foreign assets equal to $R_f(1 - \Theta - \tau°) = R_f(1 - \tau)$, implying the same rate of foreign and domestic tax on foreign source income as on domestic income.[7] From the viewpoint of the investor, worldwide taxes would be neutral between foreign and domestic income.

Foreign Tax Deduction: If a resident government only provides a deduction for foreign taxes, it will levy tax on foreign source income net of foreign taxes: $T(1 - \tau°)R_f$. Overall, the net-of-tax return on foreign source income is $R_f(1- \tau\ (1- \tau°)- \tau°)= R_f(1- \tau)(1 - \tau°)$, which from the perspective of the investor implies that the worldwide tax rate on foreign source income, $(\tau + \tau°\ (1- \tau))$, is greater than the tax rate on domestic income, τ. From the perspective of the national government, however, the pre-domestic-tax rates of return on domestic and foreign capital are the same: $R_d = R_f(1- \tau°)$.

government would then refund the excess of foreign taxes over resident taxes. Governments limit credits to be no more than the domestic tax liability to protect their tax base. However, credit limitations violate the principle of worldwide neutrality.
[6] The national efficiency argument rests on an assumption that foreign and domestic capital investments are substitutes – this is not necessarily the case as discussed below. Alternatively, it might be argued that foreign taxes are the price charged for public services provided by the host country and therefore should only be deductible as an expense from profits accruing to the parent. Generally, the deduction method is not used by capital exporting countries especially with tax treaties.
[7] For a more elaborate description of credit systems cf. Chapter 2.5.

Neutrality is not the same from the perspective of the investor who is concerned about worldwide taxes as it is from the perspective of a national government.

Corporate Taxation as Part of a Residence Tax

Corporate taxation may be seen as a backstop to a residence-based personal income tax. Without a corporate income tax, individuals could hold assets in corporations that could avoid personal taxation that would otherwise apply to accrued income. This especially arises when governments tax capital gains when assets are disposed rather than taxing the capital gains when accruing to residents (accruals result from changes in the market value of assets without necessarily disposing the asset).

The typical reasons for the absence of accrual taxation is that it would force investors to liquidate assets to cover capital gains taxes or create unfairness and inefficiency as the market value of many assets such as private company shares and land can be difficult to measure.[8] However, with capital gains taxes on realizations, investors can avoid taxes on their personal income by leaving assets in the corporation – the income is only taxed when withdrawn from the corporation as distributions or when the investor disposes shares.

As governments often do not tax residents fully on their income, a business level tax levied on profits may ensure that such income is taxed. The business level tax can be reimbursed when profits are distributed to the investor (such as in the case of a dividend tax credit that would reduce personal income tax payments in recognition of the corporate income tax deducted from profits before paid out as distributions).

In the international context, a business level tax on foreign-source income of a business could shore up the taxation of foreign source income accruing to resident owners.

Otherwise, to avoid personal income taxes on foreign-source income, residents might incorporate their foreign assets if corporations are exempt from paying tax on foreign source income. The source tax on corporate income could be turned into a pure residence tax if the government provides non-resident shareholders a refundable credit for corporate taxes levied prior to the distribution of profits.

Is a Business Source Tax Desirable?

In the discussion above on tax crediting, it was assumed that a foreign government could tax the income accruing to non-residents, consistent with a foreign source tax on income generated in its jurisdiction, irrespective of ownership. If a foreign country did not tax source income accruing to non-residents (so that $\tau^{\circ}=0$) then both the tax credit and deduction methods are unnecessary and neutrality is achieved with pure residence taxes applied to worldwide income. Further, a government would not need to refund business level taxes to non-residents as in the case of the residence tax.

Governments impose source taxes such as the corporate income tax in almost all countries.[9] Why do they do so? Three reasons can be given:

- *Benefit Principle*: A source tax may be desired by a government since businesses (and their owners) benefit from public services that help generate profits (such as infrastructure, education etc.). One could argue that user charges or fees could be appropriately assessed to recover the cost of public services but governments may not be able to administer such fees (such as in the case of public goods like

[8] Accrual-equivalent taxation of capital gains could be achieved by imposing a penalty on asset realizations to reflect the benefits of postponing tax. See Auerbach (1991).

security or law and order) or be reluctant to apply them for distributive or political reasons (e.g. tolls to price roads). If public services are provided free or at little cost to businesses, they can generate more profits that should be taxed on a source basis, regardless of whether businesses are owned by residents or non-residents.[10]

- *Inter-nation Equity*: Source taxation may be desired by a government simply to have a greater share of worldwide revenues (Musgrave 1969, Bird and Mintz 2003). As a principle of fairness among nations, a country should have access to a tax base to fund public services. Certainly, with crediting by the capital exporter, source taxes (via corporate and withholding taxes) would transfer revenue from the capital exporting to the capital importing jurisdiction.
- *Equal Treatment of Domestic and Foreign Companies*: Governments may also fear that foreign firms that are exempt from the source-based tax may receive an undue advantage over domestically owned firms.

Given the above considerations, governments levy business taxation, not only to shore up their residence tax, but to ensure some taxation of income that would otherwise accrue to non-residents.

With source taxes, however, a different notion of neutrality applies: *capital import neutrality* which implies that the same tax burden should be imposed on all businesses operating with the jurisdiction. Within a country, assets will be allocated efficiently among businesses that face a common tax rate. This condition will be satisfied if multinationals pay

[9] Some countries do not have corporate income taxes such as Bermuda but they still levy other source taxes including taxes imposed on capital contributions, financial transactions, assets and excise taxes.

only tax to the host state and not to their home governments so that they would be taxed similarly to domestic-owned corporations (and other similarly-exempt foreign multinationals operating in the host state) – their national identity is independent of the tax imposed on asset returns with a source tax. Capital export neutrality, however, will no longer be assured since the multinational could be paying more tax on income derived from investments made at home compared to those made in the host state. Thus, capital import neutrality and capital export neutrality are unlikely to hold simultaneously unless all governments levy the same tax rate.

The issue of capital import neutrality is also linked to a common argument that taxes on foreign source income can impair the *international competitiveness* of resident multinationals – similar taxation of multinationals regardless of ownership, incorporation or effective management and control.[11] If a government chooses to tax foreign source income resulting in a higher tax rate on foreign investments for their multinationals compared to foreign competitors, it can put its multinationals at a competitive disadvantage. The effect of higher taxes is to potentially reduce rents shifted from foreign jurisdictions to the capital exporting country (Janeba 1995), reduce employment in the home market that is complementary with international trade and capital flows or simply cause companies to change residence (see also the survey by Fuest, Huber and Mintz (2005)). On the latter point, economic studies have been conflicting (Smart 2005), some suggesting that greater foreign investment reduces domestic investment (Feldstein 1995) while others suggesting complementarity between foreign and domestic assets (Lipsey (1995), Altshuler and

[10] As mentioned above, the benefit principle would lead to result in which a capital exporter would provide a deduction rather than tax credit for foreign taxes paid by a multinational to host governments.

[11] Desai and Hines (2003) suggest capital ownership neutrality as a third efficiency criterion. In a well-functioning global capital market, multinationals may be widely held directly by shareholders or indirectly through mutual funds from many countries so that residence is really based on place of incorporation or management and control rather than ownership.

Cummins (1998)). Qing and Smart (2006) suggest that income shifting by multinationals allows governments to impose lower taxes on mobile firms while maintaining higher taxes on domestic, non-mobile firms for redistributive purposes.

National Economic Welfare

A large literature has developed to analyze the optimal corporate tax policies with respect to both outbound and inbound investments (see Haufler (2001) and Fuest, Huber and Mintz (2005) for surveys). Without going through all the mechanics involved with welfare models, we provide a modest framework for analysis. Taking a national perspective, economic welfare for a country derived from business production and taxation can be summed up as

$$W = \Pi[k + k_f] + P[K] + \lambda(tk + t_f k_f) + TK),$$

where $\Pi[k + k_f]$ denotes the economic rents that derive from employing domestically owned and foreign owned capital (k) in domestic production that accrue to residents. A large fraction of these economic rents will take the form of local wages. $P[K]$ represents economic profits earned on outbound foreign direct investment (K) accruing to residents. T, t and t_f should be thought of as the effective tax rates on outbound foreign direct investment (reduced by a full or partial credit for foreign taxes paid to other governments), on domestically owned capital in domestic production, and the effective rate on foreign owned capital in domestic production. The cost of public funds is $\lambda \geq 1$, which is only equal to one if taxes were purely on economic profits and not distortionary.

When governments raise the effective tax rates on capital, welfare is affected by impacting on economic profits accruing to residents and tax revenues gained by governments. Taxes on domestic production (t, t_f) could reduce profits accruing to residents

(including income paid to immobile labor), although domestic taxes enable a country to acquire rents that would otherwise accrue to foreign investors. The tax T on outbound investment raises revenues for governments but at the cost of reducing rents obtained from foreign investments, since K and $P[K]$ will be negatively affected by T.

The effect of various policies such as taxation of foreign income with a credit or deduction, limitations on interest deductibility and withholding taxes therefore, have important impacts on economic welfare. Restrictions and withholding taxes, by increasing the effective tax rate t_f, could reduce economic profits earned by residents although they help counteract tax-avoidance that would reduce tax revenues that could be used to fund public services.

As the empirical work had shown, companies may set up conduits in order to avoid withholding tax rates or to achieve tax-efficient financing structures for their investments (especially to increase debt deductions). Governments could close down opportunities for tax avoidance that erode their tax revenues but at the potential cost of losing economic profits from business activities.

The issue of setting withholding tax rates is especially relevant in the presence of treaty shopping. Withholding taxes, if fully credited against foreign taxes, have no effect on investment as the investor is reimbursed by her home country. Effectively, revenues that foreign treasuries would get are transferred to the capital importer via the withholding tax. On the other hand, if withholding taxes are not credited, the taxes could reduce investment and the economic profits that accrue to residents if businesses have a higher cost of capital.

Of course, not all withholding taxes are credited against foreign taxes. For example, if inbound investment comes from a country with an exemption system, host country taxes are final. A withholding tax will then cause the cost of capital to rise for the capital

importing (host) country and potentially lead also to a loss in profits accruing to the domestic economy. If the investor comes from a credit country (deferral or accrual systems), the effect of the withholding tax will depend on whether the parent is in an excess credit position. If it is in an excess credit position, the withholding tax operates on companies similar to the exemption case.

There is a clear trade-off for a capital-importing country in choosing withholding tax rates, weighing losses in economic rents with revenue-raising considerations. In such a situation, the capital importing country should find it beneficial not to counteract treaty shopping possibilities, because these possibilities allow to discriminate taxes between firms that are hurt by the tax and those that are not. If treaty shopping implies a small cost for multinationals (because setting up companies in third countries may trigger costs of lawyers and incorporation), then firms may self select. Firms that expect a full credit for withholding paid to the host country will not be willing to bear the cost of treaty shopping, while firms that expect to have excessive credits will find it profitable to escape the withholding tax by embarking on treaty shopping. By such a self selection mechanism, the host country may be able to fine tune its taxation and tax those affiliates more heavily that, because of crediting, are less affected by the tax.

Treaty shopping of course requires that some countries receive more favorable conditions than other countries. Indeed, a low rate with respect to exemption countries as compared to credit countries may be sensible as multinationals from exemption countries will never be in a credit position with reimbursement of withholding taxes.

6.3. Free Trade Taxation

Another approach to tax policy is to follow the principle of free trade (Slemrod 1995), implying that taxes should not impede the flow of goods, services and capital and should not discriminate against non-residents. Pure residence taxation would satisfy the free trade criterion in that individuals would be taxed on the income earned from domestic and foreign sources (including income earned through corporations) and no source taxes would be imposed by the government, consistent with production efficiency.[12] Alternatively, any source tax imposed by governments would be refunded through tax credit mechanisms to resident and non-resident investors.

Neither of these approaches to tax policy is followed by countries. However, attempts made to reduce taxes that impede the flow of capital and to avoid discriminatory treatment of non-residents would be consistent with the free trade approach.[13] Economists have proposed free trade as a means of increasing the incomes of all countries that specialize in the sale of goods and services where the economy has a comparative advantage. Even unilateral free trade policies have been advocated since economies can achieve a more efficient allocation of resources. Although arguments are given at times for the protection of various industries – such as in the case of assisting infant industries or improving terms of trade in international markets – the use of the free trade principle could be considered as an alternative framework for international tax policy.

[12] Diamond and Mirrlees (1971) showed that the optimal tax structure would have differential consumer taxes but no taxes on production so long as any pure profits are taxed at a 100% rate by the government.
[13] The European Court of Justice has invoked these two principles for EU direct tax systems in recent years.

6.4. A Mixed Bag of Taxes

In the end, governments levy both residence and source taxes. Personal income taxes are applied to income earned both at home and abroad consistent with capital export neutrality. Usually, a credit is given for foreign withholding taxes deducted from payments received from abroad (except for some situations when only a deduction of withholding tax is given such as in the case of Belgium and Norway for direct investments in non-treaty countries).

Corporate income taxes are levied on domestic source income on all businesses, whether domestic or foreign-owned, consistent with the source principle. Governments also levy withholding taxes on payments to non-residents including dividend, interest, royalties and rents, consistent with the source principle. Foreign-source income earned by companies is often taxed on an accrual basis in the case of branch[14] and passive income earned by the corporation with a credit given for foreign tax, which is consistent with the residence principle. Other income may only be taxed when remitted to the parent as in the case of dividends (tax credits are given for withholding and corporate income taxes). Countries alternatively exempt reinvested profits (active business income) earned by subsidiaries in foreign jurisdictions, consistent with the source principle. Countries differ substantially in terms of specific rules so it is by no means simple to talk about a single system for international taxation.

Thus, there is often an efficiency tradeoff implied with the taxation of foreign source income. On the one hand, it creates neutrality between domestic and foreign investment

[14] Germany exempts foreign branch and partnership income from tax if the German investor is incorporated. Exceptions apply if certain passive income is earned in a low tax country. A recent case in the European Court of Justice, *Columbus Container Services* (Request for Preliminary Ruling in C-298/05), is challenging that the "cross-over" German law violates freedom of establishment under the EC treaty on the grounds that a low-tax branch is treated differently than another subject to a higher tax rate.

decisions by residents. On the other hand, it could result in differential taxes on businesses operating in a jurisdiction, impede capital import neutrality and reduce the international competitiveness of resident multinationals. Even if governments are concerned about efficiency, however crudely followed, they may wish to tax foreign income of multinationals simply to protect their own revenue. It is not a perfect world.

6.5. Interest Deductibility: Some Tax Policy Proposals

As discussed earlier in this book, debt financing is one of the significant methods by which multinational corporations can shift income from one jurisdiction to another. Interest deductibility is therefore one of the most difficult problems in international taxation as financial decisions are a legitimate and cost-effective way for multinationals to reduce their worldwide tax bill. The use of direct or indirect financing structures can lower the cost of capital for multinationals that are able to deduct interest expense on leveraged-investments at a more beneficial tax rate (or sum of tax rates) compared to the tax imposed on income generated by the investment. Yet, overzealous governments trying to limit the impact of financial arbitrage on their tax bases could undermine the international allocation of investments if multinationals are caught in a war between governments to limit interest deductions on both sides of the border.

From the perspective of a national government, how can tax policies be framed to deal with interest deductibility? The question is related to the larger issues raised in this chapter – what policies lead to greater neutrality in a very imperfect world? As shown in Table 2.1 in Chapter 2, countries use various approaches. Not all foreign-source income is taxed. Taxation of passive income is applied with varying approaches. Withholding taxes on

interest are applied unevenly and often at very low rates. Limitations are imposed on interest deductions incurred to finance foreign investments but methods vary substantially.

Below, we will consider several policy approaches: reducing statutory tax rates, full taxation of worldwide income, withholding taxes and limitations on interest deductions for outbound and inbound investments.

Statutory Tax Rate Reductions

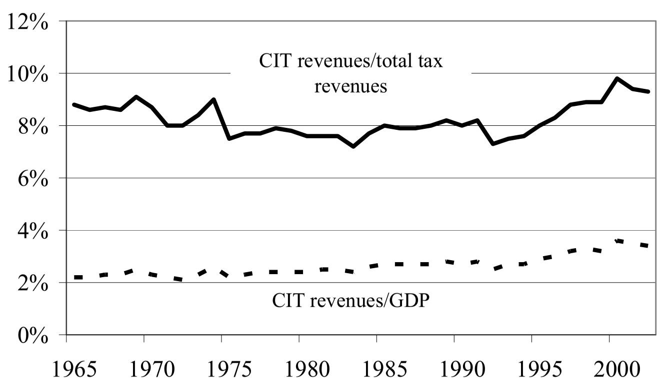
One method by which governments have tried to shore up their corporate tax revenues has been to reduce statutory corporate income tax rates, as discussed above, with offsetting tax policies to make up for revenue losses. With a low corporate income tax rate, multinational companies will shift debt out of a jurisdiction, thereby widening the tax base. However, to the extent that corporations are deducting interest expense twice from foreign and domestic sources for the same investment (as discussed in Chapter 2 and 3 with respect to indirect financing of foreign subsidiaries), the incentive to create structures of this type are less sensitive to the corporate income tax rate.

Even though corporate tax revenue is usually reduced from rate cuts, corporate taxes could increase if the tax base expands proportionately more.[15] This has been the case of Ireland that drastically cut its corporate tax rate to ten percent on manufacturing in the 1970s and in the 1990s on certain financial income (now all corporate income is taxed at a 12.5 percent rate) resulting in higher corporate tax revenues as a share of GDP by 2004. In fact, OECD countries have been able to maintain their corporate tax revenues as a share of GDP

[15] Clausing (2007) estimates that the revenue maximizing corporate income tax rate is 33 percent for the period 1979-2002 – rate cuts when corporate income tax rates are above 33 percent would therefore increase corporate revenues. The revenue-maximizing corporate income tax rate is lower for smaller size countries. Given that corporate rates in 2007 are on average lower than the period examined (see Graph 6.1 above), it might be that the maximum corporate income tax rate is even lower today.

in the latter part of the 20th century despite the rate cuts. At least in some cases this can be explained by the relative growth of the corporate sector.[16]

Figure 6.2: CIT Revenues – Unweighted OECD Averages



Source: OECD Revenue Statistics.

If all countries, however, pursue rate cuts – which has been the general case – then “beggar-thy-neighbor” policies erode corporate taxes and potentially create other problems in the tax system, particularly a shift of income from the personal to corporate sector when personal tax rates are much higher than corporate rates.[17]

Eventually, governments relying on income tax revenues may find it more difficult to raise sufficient funds to fund their public goods and services (Nicodème (2006) and Niznik (2006)). The result may be reductions in public spending – a desired result for those who view that governments are too large anyway – or increased taxes on less mobile bases less

[16] See Weichenrieder (2005) for evidence on Germany and Austria.
[17] See Fuest and Weichenrieder (2002) for an extensive discussion and macroeconomic evidence for a panel of OECD countries. Mooij and Nicodème (2008) provide microeconomic evidence.

subject to international competition for corporate profits. In recent years, some governments have scaled back accelerated deductions for investment to broaden tax bases (see Devereux, Griffith and Klemm 2002, and Chen and Mintz 2000), revised business taxes to be applied to income gross of interest deductions or value-added such as in Italy and Hungary (Chen and Mintz (2000)), increased profit-insensitive taxes (Technical Committee on Business Taxation 1998 and Hines 2007) or relied more on consumption rather than income taxes (as in the case of the recent hike in the German VAT rate from 16 to 19 percent).

Worldwide Taxation

An alternative approach to cutting statutory tax rates to combat income shifting through financial decisions is to move to worldwide taxation whereby resident multinationals would be fully taxed on their foreign source income with a credit (or deduction) given for foreign corporate income and withholding taxes (Alworth 1988, Grubert and Altshuler 2006). At the same time, deferral of residence-based taxes to the time when foreign income is repatriated would be ended. Effectively, this would extend the current tax treatment of branches and passive income, as it is applied in many countries, to all sources of income, including that earned by subsidiaries. It would require rules for consolidation of income on an international basis, thereby requiring threshold rules to determine membership in the corporate group.

Full taxation of foreign source income would achieve two objectives with respect to financial structures. It would eliminate the scope to shift debt deductions from low-tax foreign subsidiaries to the resident parent since the same effective tax rate would apply to both domestic and foreign source (with foreign taxes credited against home taxes). Further,

it would reduce the incentive for resident multinationals to create conduit entities that are structured to achieve multiple deductions for interest expense.

Moving to full accrual taxation on corporate foreign income would, however, face various obstacles for implementation. Worldwide taxation of resident multinationals could put them at a competitive disadvantage, potentially reducing the rents and other benefits accruing to the home jurisdiction from foreign investments.[18] Further, if full accrual taxation is not applied by other countries, non-resident investors who own shares of a resident multinational fully subject to accrual taxation may be spun off to separate holding companies to avoid accrual taxation on their income.[19] Also, full taxation of accrual income of resident multinationals would not counter income-shifting by non-resident corporations that push debt into a high-tax jurisdiction.

As shown in Table 2.1 (Chapter 2), countries have exempted important sources of income from accrual taxation, in almost all cases reinvested profits of subsidiaries and for some, dividends remitted from qualifying foreign affiliates. For countries that wish to attract international holding companies and more generally conduit entities, it is a more promising approach to exempt foreign income than to use a system of worldwide taxation.

An alternative to general accrual taxation is to apply more strictly the accrual approach to passive income (controlled-foreign-corporation (CFC) rules). If interest and other passive income were subject to tax by the capital-exporting country (with a credit for

[18] Altshuler and Grubert (2006) would use the additional revenues from accrual taxation of foreign source income to reduce the corporate rate in the U.S. to improve domestic investment competitiveness.

[19] In recent years, New Zealand has applied full accrual taxation on resident multinationals using a "branch-equivalent" system whereby worldwide income earned by a controlled foreign company (at least 50 percent New Zealand resident ownership) would be taxed on an accrual basis with an exemption provided only for "grey-listed" high-tax jurisdictions. Conduit tax relief has been provided reducing tax on the New Zealand multinational according the share of non-resident ownership of the New Zealand company so that non-resident investors would not be taxed on an accrual basis. New Zealand has recently announced that it will move to a system used by most countries, allowing for a distinction between active and passive income, the latter subject to accrual taxation.

foreign withholding taxes), it would be far more difficult to use some tax structures, such as double-dip indirect financing, to finance international investments. While many countries have established CFC rules for taxing passive income, exceptions have made it easy for companies to avoid the home country tax on passive income.

- The U.S. Subpart F rules are intended to ensure that passive income is fully taxed on an accrual basis. However, with the "check-the-box" system adopted in 1997, a parent can declare a member of a corporate group to be a branch, partnership, subsidiary or other organization for tax purposes.[20] The Subpart F rules have been emasculated since the interest income derived from a loan from one controlled subsidiary to another is exempted by declaring the corporation to be branch or flow-through entity, thereby eliminating the tax on interest received by the subsidiary (see Chapter 2 for discussion of hybrids resulting from the use of the check-the-box provision).
- In the European Union, the *Cadbury Schweppes* case[21] invalidated UK CFC rules on the basis of being inconsistent with the principle of freedom of establishment since they were applied to a non-resident subsidiary in Ireland and not to UK subsidiaries. The Court agreed that the CFC rules are justified to counteract artificial tax avoidance arrangements. The UK has responded by amending the rules to apply the CFC rule only in situations where there is no business establishment and individuals are not employed ("profits from labour are good; profits from capital are bad" (Nias and Ross 2007).

[20] Altshuler and Grubert (2004) found the average tax rate faced by U.S. manufacturers on income earned abroad fell from 25 to 21 percent during the period 1992 to 2000. While it seems that tax competition was the initial reason for a reduction in average rates in the first 6 years, U.S. company tax planning was more important in explaining the average rate reduction from 1998 to 2000, corresponding to the "check-the-box" regulation adopted in 1997.
[21] See European Court of Justice, September 2006, C-196/04. For further analysis, see Nias and Ross (2007).

- Canadian rules applied to foreign accrual property income apply only to passive income, not interest, leasing and other similar sources of income if paid from active business income. With the dividend exemption system (applied to foreign affiliates in treaty countries), it is not difficult to set up indirect financing structures to achieve multiple-dip interest deductions (cf. Box C, Chapter 2). The recent measures to be adopted in Canada will attack double-dip deductions related to this treatment of affiliate interest income as active business income.

In the end, CFC rules are not fully effective in achieving capital export neutrality.

Withholding Taxes

Another approach to limiting the incentive to shift income through financial transactions is to impose withholding taxes on interest income paid to foreign entities that would primarily affect inbound investment in a country. With sufficiently high withholding tax rates that are close to statutory tax rates, little incentive remains to shift debt to high-tax jurisdictions or to use indirect financing structures to achieve low costs of capital. For example, the EU savings directive has led some countries such as Luxembourg to impose withholding taxes on interest paid to individuals resident in other EU countries, although tax avoidance opportunities are still available (Klautke and Weichenrieder 2008).

As discussed in Chapter 2, one difficulty is that withholding taxes are applied on gross income rather than income net of expenses. Without recognizing the costs incurred to make the loan, the withholding tax could make the transaction uneconomic, especially for financial institutions and other traders who earn thin margins on financial transactions.

To make a transaction profitable, the lending rate charged to customers should be increased to reflect the withholding tax. Some studies (Brean (1984) and Huizinga (1994)) have suggested that portfolio interest rates are raised in the presence of withholding taxes (especially on interest paid to unrelated parties), thereby increasing the cost of finance for businesses operating in a jurisdiction that imposes the levy.

For this reason, withholding taxes have often been reduced or eliminated altogether for arm's length (unrelated party) transactions or for interest paid to financial institutions. G-7 countries generally exempt most if not all portfolio or arm's length interest from withholding tax and apply low or zero withholding tax on related-party interest (Ernst & Young 2006). However, by exempting such interest, it is possible for businesses to use back-to-back loans through financial intermediaries with guaranteed debt to avoid higher withholding taxes on related-party interest. Or income might be routed through jurisdictions where withholding taxes can be avoided as we had empirically shown in Chapter 4 with respect to German investment ("treaty shopping").[22] In turn, this could lead to some capital-importing countries to adopt Limitation on Benefit clauses in treaties to limit treaty shopping, although, as discussed above, treaty shopping could enhance rather than diminish welfare.

Other means to avoid withholding taxes are possible. Most countries exempt financial derivatives (swaps, straddles and hedges) from withholding tax (Brazil with its computerized system of withholding being an exception). However, by exempting derivatives, opportunities are created to avoid withholding tax on the underlying income. In the United States, for example, dividend or interest withholding taxes can be avoided by

[22] Germany recently tightened rules to reduce the scope for non-resident investors to avoid payment of German withholding tax. See Ehlermann and Kowallik (2007).

selling a security to a tax exempt institution that would hold the security at the date of payment, selling it back to the non-resident who maintains ownership interest.

Overall, levying withholding taxes to reduce the incentive to place debt in a jurisdiction only affects inbound investment and, given the practical problems, are unlikely to succeed in protecting tax bases without creating economic inefficiency. Other approaches are needed to achieve policy objectives.

Limitations on Interest Deductions

To improve neutrality among businesses and protect the corporate tax base, countries impose limits on interest deductibility for tax purposes. The objective and rules vary depending on whether limitations apply to interest deductibility for outbound or inbound investment. Table 6.1 provides a brief review of some of the approaches used for limiting interest deductions that will be discussed in more detail below.

Table 6.1 Examples of Approaches Used to Limit Interest Deductibility

	Approach	Description	Example
Outbound Investment			
	Tracing	Deny interest deduction traced to investments exempt from domestic tax	- Canada (beginning 2011) interest deduction is traced to investment used for a double-dip interest deduction
	Interest Allocation (worldwide)	Domestic interest expense allocated to foreign profits if domestic debt-asset ratio greater than worldwide ratio	- U.S. (beginning 2009)
	Interest Allocation (water's edge)	Domestic interest expense allocated to foreign profits based on ratio of foreign to worldwide assets	- U.S. (currently) Based on ratio of net foreign assets to sum of domestic and net foreign assets
Inbound Investment			
	Thin-capitalization	Interest expense not deductible in excess of ratio of debt to equity for related non-residents	- Japan (for debt in excess of three times equity)
	Earnings Stripping Rule	Interest expense denied if interest is more than a portion of earnings before interest deductions on related party transactions	- U.S. – interest expense in excess of 50 percent of earnings before interest, amortization and taxes with carryforward provision
General Approach			
	General thin-capitalization	Interest expense denied with respect to money borrowed from residents and non-residents	Australia – interest not deductible in excess of 75% of domestic assets. Allocation and transfer pricing test applied for excess
	Non-statutory Approach	Interest expense denied if not consistent with commercial transaction for related party transaction	Austria and UK

Outbound Investment

With outbound investment, an often stated philosophy is to impose limitations on interest deductions taken against domestic income that is incurred to finance foreign investments that earn "exempt" income, especially dividends and capital gains. While this might be appropriate from a "national" perspective, the greatest share of cross-border capital flows is among countries with a network of bilateral tax treaties. Contrary to the "national"

perspective is the logic that such foreign-source income is not really exempt since it is subject to tax elsewhere. This latter view is consistent with the OECD model treaty which provides taxpayers relief from double taxation by two approaches – a home country imposing a tax with a credit for foreign taxes or the home country exempting the foreign source income from tax. Of course, many countries, even those in the OECD, have regimes in which corporate income may be subject to low tax rates so that a capital exporter's exemption may be based on a false pretense that such income is highly taxed elsewhere.

Further, contrary to the usual view, capital exporting countries that levy taxes on qualifying foreign-source income, including dividends, may actually collect little tax (Grubert and Mutti 1995, Altshuler and Grubert 2001 and Grubert 2001). Since only income remitted to the parent is subject to tax by the home country, a multinational may avoid this tax by repatriating income to bring up foreign tax credits to match home country tax by repatriating income to average high and low foreign tax rates. For example, the U.S. uses a global tax credit system that permits resident companies to add up foreign withholding tax and corporate income taxes related to dividends, interest and other qualifying non-passive income to be part of one basket. The U.S. tax on the global income is calculated as the U.S. tax rate times the foreign source income and subtracting foreign taxes from the tax payment. Some sources of income, such as dividends that are subject to both foreign corporate income and withholding taxes, might be more highly taxed than other sources such as dividends from low-tax countries and royalties and interest that are only subject to foreign withholding taxes, which are often low. By remitting high-tax dividend income with other low-tax income, the multinational can avoid the U.S. tax on repatriated income.

Thus, it is not surprising that many countries levying repatriation taxes on foreign-source dividends also impose interest limitations rules on outbound investment to limit

income shifting from their own to foreign jurisdictions. The scope of particular measures varies considerably as shown in Table 6.1.

Generally, two approaches have been used to limit interest deductions for outbound investment.

The first is a "tracing" approach whereby interest expense incurred to finance foreign investments would not be deductible against foreign source income. In 2007, Canada has introduced a tracing rule that targets interest deductions on debt incurred to finance exempt affiliate investments when the funds are used to finance double-dip interest deductions is denied. The tracing approach, while potentially effective in limiting interest deductions for large transactions, can be avoided by "cash damming" strategies whereby a multinational uses cash flow to finance foreign investments while borrowing money to finance domestic investments.

A second approach is to allocate interest according to distribution of domestic and foreign assets. One approach is the "*water-edge allocation"* approach, currently used by the United States. With this approach, domestic interest expense is allocated to affiliate foreign income by the ratio of net foreign assets to the sum of domestic (gross) assets plus net foreign assets: $(K_f - B_f)/(K_d + K_f - B_f)$. If foreign tax credits are less than U.S. tax on foreign-source income, interest allocation would have no impact on worldwide taxes paid to the U.S. since increased tax on domestic income would be offset by lower tax on foreign-source income (assuming certain conditions hold as discussed above with respect to allocation under worldwide allocation). The more interesting issue arises with the case where foreign tax credits are in excess of U.S. tax on foreign income since the allocation of interest to foreign income will result in an increase in worldwide taxes paid to the U.S. government. Altshuler and Mintz (1995) explicitly modeled the effect of the water-edge formula on the

cost of capital for domestic and foreign investments. Assuming that foreign source income is exempt (or alternatively, foreign tax credits are in excess of home tax liabilities on foreign source income), the effect of the water-edge allocation rule is to increase both the cost of capital for foreign and domestic investment. The higher cost of capital for foreign direct investment is clear; greater investment abroad could result in more domestic interest expense being allocated to U.S. exempt income. As for domestic investment, the cost of capital increases since domestic interest expense incurred to finance the home investment is allocated to exempt foreign income (although the effect is mollified but not overturned by reducing the amount of net foreign assets to total assets). Altshuler and Mintz (1995) found that U.S. multinationals with excess foreign tax credits responded by reducing domestic debt in the U.S. and increasing third-party debt abroad.

A *worldwide allocation* approach, to be adopted by the U.S. after 2009, would be to allocate interest to domestic and foreign income according to distribution of assets on a worldwide basis. If domestic debt-asset ratio is more than the worldwide ratio, domestic interest expense associated with excess debt is allocated to foreign profits earned by affiliates, thereby reducing the amount of net income in determining its foreign tax credit limitation. If foreign tax credits are in excess of the home tax liabilities or income is not repatriated if deferral is provided, allocated domestic interest to foreign source income would result in higher taxes paid by the multinational that can no longer use the allocated interest as a deduction.

While the tracing and allocation methods have been used to limit interest deductions incurred to finance foreign investments, perhaps other approaches might be possible. Mintz (2004b) proposes a "fat capitalization" approach in which interest incurred to finance foreign investment would not be deductible for debt in excess of a given ratio of debt to

equity for related party investments in foreign assets, on a consolidated basis.[23] While this approach would likely be more effective than the tracing approach it does beg the question as to how to determine the appropriate maximum debt to equity ratio since debt financing will vary according to the type of business or asset (banks versus pharmaceuticals or structures versus inventory).

Inbound Investment

With inbound investment, different considerations are involved since interest deductions taken to finance investment in the host country are related to inbound investment largely owned by foreign companies. The aim of interest limitations is to protect the host country corporate tax base although the economic cost is to potentially reduce foreign investment flows.[24] Two types of interest limitations are used: thin-capitalization and earnings stripping rules, as seen from Table 6.1.

Thin-Capitalization: The typical approach to limiting interest deductions is to impose thin-capitalization rules. A company or group of consolidated companies is unable to deduct interest expense paid to non-resident related parties in excess of a given ratio of debt to equity. The disallowed amount may also be treated as a dividend payment and is possibly subject to higher withholding taxes compared to interest withholding taxes. Rules may vary

[23] The current Italian test to limit interest deductions based on investments in subsidiaries being more than net equity of the parent is a version of this approach. Specifically, "under the pro-rata rule, the company's net equity is compared to its investment in subsidiaries (Italian and foreign) eligible for the participation exemption regime. The net equity is subject to certain adjustments designed to account for unpaid capital and uncovered operating losses. If the book value of the investment in subsidiaries eligible for the participation exemption regime exceeds the adjusted net equity, the tax deduction for interest on related and unrelated debts is reduced by the amount calculated by applying the ratio of this excess amount to the amount by which total assets excess adjusted net equity increased by trade payables." Ernst & Young (2006, p. 450). This approach to limiting interest deductions is being repealed in favor of the German-style earnings-stripping rule.
[24] Qing and Smart (2006) derive an optimal thin-capitalization rule balancing these efficiency and revenue considerations.

as to what type of debt is addressed (such as whether guaranteed debt[25] is included) and how equity might be measured (usually retained earnings and shareholder contributions). Some countries may impose thin-capitalization rules more generally affecting both non-resident and resident-related parties, including being applied to pension plans, charities and other exempt entities. Recently, the European Court of Justice ruled that German thin-cap rules applying only to residents of Netherlands and not domestic residents are contrary to the principle of freedom of establishment (discrimination for outbound investments).[26] Germany revised its thin-capitalization rules in 2004 to make them applicable not only to foreign-owned corporations but also domestic firms. As of 2008, these rules have been substituted by an earnings-stripping rule. Some other countries are applying the rule to exempt transactions with resident companies in EU member states.

Most multinationals will avoid the application of the thin-capitalization by keeping their debt below the maximum. If credit-risk-reducing guaranteed debt is not included as part of debt, multinationals could avoid the application of the rule unless well-developed back-to-back loans through banks and other financial institutions are applied instead.

Earnings Stripping Rules: Earnings stripping rules disallow interest expense paid to non-resident related parties in excess of a percentage of earnings before the deduction of interest and taxes. In principle, similar to the thin-capitalization rule, the rule might be applied to a consolidated group of companies and with respect to debt issued to both resident and non-resident related companies.[27] Unlike the thin-capitalization rule, the earnings

[25] Guaranteed debt is a loan provided by a third-party lender (such as a bank) that is guaranteed by the parent. If guaranteed debt is not included in defining related party debt, a parent could avoid the rule by providing a guarantee to the third party lender instead.
[26] European Court of Justice, 12 December 2002, C-324/00.
[27] As noted in Chapter 2, since 2008 Germany's new thin-capitalization rules, using the earnings stripping approach, apply to debt provided by affiliated resident and non-resident parties as well as third-party debt.

stripping rule will limit interest deductions even for low-debt companies when profits are low during downturns or starting up as a new business. Thus, earnings stripping rules usually include carry-back and carry-forward provisions so that unused interest deductions can be used in other years. Further, a "safe harbor" is often provided, which assures that companies with debt below a certain level would not be subject to the earnings stripping rule.[28] Thus, the earnings stripping rule becomes more similar to a thin-cap rule in this sense although overall, it is more complex.

Both thin-capitalization and earnings stripping rules, when effective, could be adjusted to account for variations in financial policy among firms, although such adjustments can be complex.[29] Financial institutions, real estate and utilities tend to be highly-levered businesses, while resource companies tend to be financed more greatly by equity. However, if maximum ratios differ, rules become much more complex to apply especially when determining the appropriate level of debt by type of asset or business activity. Further, when consolidating businesses within a corporate group, the maximum ratio would need to be averaged across members of the group. Of course, greater precision in defining ratios for thin-capitalization and earnings stripping rules provide greater opportunities for tax planning.

Another approach to limiting interest deduction is to impose an allocation method, similar to outbound investment. However, the difficulty of applying the rule is that a host country only taxes the non-resident company's income earned in the jurisdiction, not worldwide income. If the allocation method is applied to subsidiaries of foreign

[28] The U.S. rules include both types of provisions. Interest expense greater than 50 percent of earnings (93 percent for banks) can be carried forward for three years. The safe-harbor debt equity ratio is 1.5 to 1.
[29] In 2003, a proposal was made in the United States to apply the earnings stripping rule using a "safe-harbor" ratio of debt to assets that would be calculated using worldwide information. The safe harbor would be calculated by taking a weighted average of debt-asset ratios applying to specific assets. The debt-asset ratios

multinationals, the authorities would need information about the worldwide assets and debt of the related parties in the corporate group.

General Approaches

Another method to limit interest deductions is to apply a more general approach that would apply to both inbound and outbound investments at the same time (as well as in a domestic context such as borrowing from tax-exempt entities). Table 6.1 describes both a non-statutory approach and a generalized thin-capitalization rule in this context.

Non-Statutory Approach: Using a non-statutory approach, a country could limit interest deductions if the indebtedness is in excess of the amount used in a typical arm's length commercial transaction, an approach used in the UK and Austria, for example. While the UK focuses this approach on international transactions similar to its transfer pricing regime, Austria applies the non-statutory approach more generally in relation to both domestic and international transactions.

Similar to transfer pricing disputes, the non-statutory approach requires a comparison of the indebtedness to a similar arm's length transaction in a commercial context. This approach is fraught with difficulty since it would require finding comparable uncontrolled transactions with similar risk, business activity and other attributes needed to ensure terms and conditions are the same when comparing related and unrelated transactions. It is an approach that requires authorities to challenge financial structures that could take considerable time to prosecute. It is therefore used in a limited number of cases.

Generalized Thin-Capitalization Rules: Another approach that seems to be gaining more interest recently is to apply a thin-capitalization rule to limit interest deductions for

would vary from 98 percent of cash to 50 percent of intangible assets (New York State Bar Association 2003).

debt borrowed from both related and unrelated parties that would affect both inbound and outbound investments.

In 2001, Australia adopted a rule that applies to both "inward entities" (foreign-controlled Australian companies) and "outward entities" (those having foreign-controlled investments or branches). A safe harbor is provided equal to 75 percent of net domestic assets (Australian assets minus certain liabilities). Taxpayers may also seek an arm's-length test and outbound investors may rely on a worldwide leverage test as well. Special rules apply to banks based on regulatory requirements.

As noted in Chapter 2, Denmark adopted for July 1, 2007, a generalized "thin-capitalization" approach to limit interest deductions for both inter-company and third party debt.[30] Since the rules apply to Danish companies that are taxed on a consolidated basis (both domestic and foreign affiliates), the general thin-capitalization applies effectively to all investments and lenders. Germany's and Italy's new rules are another example of a generalized approach applying a deductibility limitation to all debt, including third-party debt.

The generalized thin-capitalization rules could be criticized on the same basis as others in that they do not take into differences in financial policy across industries that reflect business requirements. However, as an approach that focuses on the extent to which debt is used to reduce corporate tax payments, it may be a practical alternative that deals simultaneously with both inbound and outbound investment as well as debt borrowed from domestic tax-exempt entities such as pension plans and non-profit companies.

President Bush introduced the measure in 2006 to apply in 2007 but Congress did not pass it.

[30] The allowable deduction is based on two tests. The first is that interest expense more than 80 percent of earnings before the deduction of net financial expense (no carryforward of unused interest deductions is provided). The second is that interest expense should be less than an amount calculated as a prescribed interest rate times "approved" assets, including net fixed assets, working capital, accounts receivable and one-fifth of the original purchase cost of shares in foreign entities.

6.6. International Co-operation

To limit income-shifting through financial arbitrage, governments could act on their own by moving to worldwide taxation, tightening passive income and anti-deferral rules or imposing restrictions on interest limitation. However, many governments have taken a tolerant view to aggressive action either to encourage outbound and inbound investment or simply follow general approaches taken by other countries. It might simply reflect a "prisoner's dilemma" where a country with more liberal rules is in a better position to attract capital investment.

In recent years, governments have been moving towards international co-operation with the "harmful tax competition" project of the Organization of Economic Co-operation and the "code-of-conduct", "state-aid" limitations, savings and other directives developed by the European Union for its member states. These EU rules have had some impact in limiting special provisions in the EU as countries have responded to challenges made of some special tax structures. Some ring-fenced tax regimes such as Belgian coordinating centers (that presumed a tax on a mark-up over costs rather than tax fully income), Dutch group relief that allows for a deduction of reserves equal to 80 percent of financial services income (with tax free withdrawals from the reserve) and Luxembourg tax-exempt 1929 holding companies are being phased out in favor of more general applications of law. For example, Ireland has adopted a low corporate income tax rate of 12.5 percent rather than special rates for manufacturing and financial service income at 10 percent. Belgium has recently introduced a deduction for the imputed cost of equity finance to replace its coordinating centers. The Netherlands are moving toward lower corporate income taxes but also providing for certain flow-through mechanisms that create incentives to locate group financing benefits.

At times, governments have also been using their transfer pricing rules, based on the OECD guidelines, to limit the scope for financial arbitrage. As part of transfer pricing rules, interest rates charged for related-party debt should reflect the interest charge that would be borne with comparable uncontrolled price transactions. Further, the financing transaction – the degree to which debt is used – should be similar to one that would arise in a commercial arm's length transaction. As discussed above, the UK has no formal rules to limit interest deductions although it uses the transfer pricing regime to limit interest deductions according to a typical "market" debt-equity ratio. Recently, the Canadian revenue authorities have been considering whether (double-dip) indirect financial structures located in certain jurisdictions should be viewed as earning income attributed to a Canadian permanent establishment if the sole reason for the structure is to minimize taxes rather than have an economic purpose.

While various approaches have been taken by governments to curtail financial arbitrage to shore up corporate tax revenues, businesses continue to benefit from regimes that permit income to be shifted from high to low-tax jurisdictions. The U.S., for example, opened the door for double-dip transactions through hybrids when it adopted the 1997 check-the-box rules. Congress does not seem to be interested in limiting this form of financial arbitrage and made it even easier for companies to average high and low-tax sources of income after 2007 by moving to general and passive income baskets rather than the more restrictive nine baskets that in the past have reduced the scope to average high and low tax rates on income repatriated to the U.S. The Canadian government knows well that Barbados indirect financial structures result in double-dip interest transactions and, as discussed, only recently brought in a measure to attack such structures, as discussed above.[31]

[31] Earlier reports from the Auditor-General of Canada raised concerns over double-dip structures. See Canada (2002). A recent paper by Hejazi (2007) suggests that the Barbados tax structures have facilitated international trade by Canadian companies that have benefited from a low cost of capital for their international investments.

UK authorities also do little to limit indirect financing structures although some foreign tax credit rules have recently been tightened to reduce financial arbitrage aimed to reduce worldwide taxes.

Given that governments are reluctant to reduce the scope for income shifting on their own, some experts have argued in favor of international allocation method that would be a far different approach to taxing corporate income.[32] Under an allocation (or apportionment) method, a corporation would be taxed in a jurisdiction by applying the jurisdiction's corporate tax rate to the share ($\alpha[j]$) of worldwide profits allocated to the jurisdiction. When a corporation's reported profits are equal to $\Pi[j]$ for $j = 1..J$ jurisdictions, then jurisdiction i will receive the tax base $\alpha[i] \cdot \sum_j \Pi[j]$. This approach, used in some federations (Canada, U.S., Germany and Switzerland) would limit the scope for financial arbitrage and transfer pricing to reduce worldwide taxes since the distribution weights would be based on some economic characteristics such as payroll or number of employees, property and sales revenues to divide up income (see McLure (1986) and Mintz (2000) for reviews). Allocation methods are not perfect since businesses alter the distribution of their income across jurisdictions by using more employment or capital in a jurisdiction, leading to a lower cost of labor when shifting resources from high to low tax jurisdictions.

International co-operation to develop a formula for allocation would be a significant challenge. Recently, the European Union has been debating the adoption of a common consolidated tax base for European companies whereby some form of allocation would be used to split up profits among EU states (see Martens-Weiner (2006) and Mintz and

[32] Instead of using the separate accounting method whereby an entity's permanent establishment's income is determined based on revenues and costs attributed to a jurisdiction, California used an allocation method to attribute worldwide income of multinationals to the state. Multinationals objected to California having the right to information regarding their accounts in foreign jurisdictions and pursued court action to declare the approach invalid. The Supreme Court validated the Californian approach in *Barclays Bank PLC v Franchise Tax Board* (512 U.S., 129 L.Ed.2d 244, 1994). See Martens-Weiner (2006) for discussion of other cases.

Martens-Weiner (2003)). Since the UK and Ireland have been opposed to tax harmonization, the European attempt at consolidation has stalled. At this point, the European Commission is favoring an EU wide common tax base whereby companies could opt to use rather than comply with the existing separate EU systems. Many issues are being discussed such as determining specific aspects of the tax base, the weights used for apportionment and administrative practices. Some countries, including Germany, are considering a modified approach for a limited number of member states wishing to use an allocation approach among them. If the EU could move towards an allocation method, perhaps, an international approach would be more become more likely to occur.

Given the difficulties of achieving international co-operation, governments have been looking at other approaches to tax businesses. For example, Italy and Hungary have adopted business value taxes[33], which is a form of origin-base value-added taxation: businesses pay tax on their revenues net of business input purchases and depreciation of capital (payroll and interest is not deducted). Some have argued for moving towards a destination-based cash flow tax on real and financial transactions (Meade 1978)[34] whereby international transactions would not be included in the tax bases (Bradford 2004) to avoid transfer pricing and financial arbitrage for shifting income. Some countries have recently adopted corporate taxes on bases similar to cash flows although international income is included (Klemm 2006).

[33] See Bird and Mintz (2000) who suggested using the business value tax for regional business taxes.
[34] The cash flow tax would apply to revenues and financial income net of expenses and changes in net assets (assets less debt). Bradford suggests excluding international flows from the tax base of the corporation.

6.7. Conclusions

With financial arbitrage that results in the shifting of corporate income from high to low tax jurisdictions, governments have taken various approaches to protect their income tax base although the actions have been fairly timid given concerns over corporate sector efficiency. From a public policy perspective, no clear answers can be given as to the "right" policy since tighter rules could move the tax system towards capital-export efficiency whereby multinationals would be indifferent between domestic and foreign investments but at the cost of capital-import neutrality whereby companies would be taxed differentially according to their ownership.

Governments are left with the "third-best" problem of doing whatever they can by ensuring that their corporate income tax base is protected but limiting the extent to which taxation would be a barrier to foreign direct investment. It is not an easy compromise. With the greater international capital flows today, it is more difficult for governments to maintain corporate tax revenues with pressure to cut statutory tax rates. Governments that close international tax loopholes by using approaches such as thin-capitalization rules may pay the price of a reduced investment level (Büttner et al. 2006). However, when compared to high statutory corporate taxes, efforts to safeguard the national tax base by using thin-capitalization rules and earnings stripping rules have the advantage that part of the tax burden does not fall on multinational corporations but can be exported to foreign governments: a corporation that is forced to reduce its leverage in one country and increase it in another country will be partly compensated by reduced taxes in that other country.

This is not to say that the German 2008 reform is without problems. One issue is about credibility. For a country that wishes to credibly signal a good investment climate in the future it may be dangerous to legislate a comprehensive income stripping rule in a way

that makes it easy to subsequently increase tax rates. Another issue concerns the details of the reform. In a last minute change, the allowable interest deduction was formulated as a fraction of earnings before interest, taxes, depreciation and amortization (EBITDA), while the previous plan used earnings before interest and taxes (EBIT) to curb dividend stripping. Restricting the allowable interest deduction by using EBITDA instead of EBIT tends to give a preference to firms with short-term assets and high depreciation, while reducing the allowable interest deductions for firms with long-term assets. The restriction on income stripping is therefore, quite unnecessarily, bought by accepting a distortion to real investment decisions, which would have been absent if the legislation had stuck to EBIT.

Ultimately, governments have two options for action. Either they look towards new forms of international co-operation or pursue other approaches for taxing businesses. International co-operation is slow to achieve, if at all possible. The European Union negotiations over a common corporate tax base illustrate how difficult it can be to achieve international consensus. Unilateral actions taken by a country are therefore more likely to be the basis for reforms. The recent moves by Germany and some other jurisdictions like Denmark aimed to tighten deductions for interest expense or tax more highly worldwide income earned by a parent's affiliates have been accompanied with reductions in corporate income tax rates to encourage more domestic investment. By and large, Germany has been moving in this direction – it seems to be the right course to follow.

Why Not Kenora? Reflections on What Canada's Approach to Taxing Foreign Business Income Is and Could Be

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Abstract

The authors explore specific Canadian tax policy options for broader exemptions or lower tax rates for certain foreign-source income. The case for a broader exemption system for dividends from foreign affiliates and for an exemption on the sale of shares of a foreign affiliate are advanced using as a premise the view expressed by the Advisory Panel on Canada's System of International Taxation that Canada

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should adopt a more territorial approach to the taxation of foreign-source income: a dividend exemption system for all foreign active business income would be a good tax policy choice for Canada because it would be revenue-neutral and would reduce compliance for taxpayers and the Canada Revenue Agency. However, it is only by exempting capital gains (losses) on the sale of shares of a foreign affiliate that the reduced compliance requirements can be achieved. A system that exempts both dividends from a foreign affiliate and capital gains (losses) from those shares could potentially eliminate the need to track exempt and taxable surplus. As with a broader dividend exemption, it is thought that an exemption for capital gains (losses) from the sale of foreign affiliate shares would not result in any material revenue loss for the government. The tax policy decision to exempt the capital gain on foreign affiliate shares and the subsequent changes to the foreign affiliate system to respect the taxation of domestic capital gains may not be easy. The authors offer some ideas on how this goal could be achieved through the review of several examples and the definition of "excluded property." They then explore the taxation of mobile income, such as financing income and royalties from intellectual property, and observe how various provisions in the Canadian tax system and specific provincial legislation effectively encourage multinationals to locate these mobile sources of income offshore. The authors explore how the activity associated with the generation of this income could be brought "onshore" and generate other collateral benefits for the Canadian economy.

Keywords Capital gains; dividend; foreign affiliates; tax policy; excluded property; international taxation; territorial.

Introduction: Taxing International Business Income—Whose Income Is It, Anyway?

Globalization has pushed many countries, including Canada, to re-examine whether and to what extent their international tax rules should include in a domestic tax base income earned offshore. This inquiry is and has for some time been taking place in the United States, the United Kingdom, Australia, New Zealand, and various countries in the European Union.

Typically, the inquiry is framed by a country's existing regimes and precepts for taxing international business income and, in one manner or another, takes into account the burgeoning reality of stateless income. Related to this inquiry is the need to accurately measure domestic and foreign income to avoid distortions in the measurement of each through, for example, reductions in one (typically, domestic income) that somehow relate to earning the other (foreign income). To much the same effect, the Organisation for Economic Co-operation and Development (OECD) continues to confront difficult issues of international income allocation—most recently, through its re-examination of the attribution of profits to permanent establishments and the concomitant re-examination of article 7 of the OECD model tax convention and the relevant commentary,[1] its study of the

migration of businesses or key business elements through business restructurings,[2] and its proposed draft restatement of parts I–III of the OECD transfer-pricing guidelines.[3]

It seems that there is a collective insecurity in the integrity of international tax regimes based on traditional assumptions underlying the measurement of taxable income earned by non-residents that originates in a country's economic environment and markets, the relief allowed for residents' income earned outside the residence country from business and other activities, and the adequacy of tax treaty paradigms to consistently sort out possible competing tax claims. Increasingly, significant components of the income-earning process and the resulting income are conceded to be highly mobile. In international tax policy terms, this means that the proximity of those activities and that income to any particular jurisdiction—whether explained in terms of the source of the income or the residence of its owner—and therefore that jurisdiction's claim to tax the income are less certain because the economic circumstances in which economic activity takes place more and more tend to eclipse the typical standards for making these determinations.

In short, then, globalization invites an inquiry into whether the paradigms for taxing international income are outmoded, or whether, if those paradigms are still valid, their underlying principles and expectations need to be recast to accommodate the continuing objectives of international tax rules.

The point of departure for this kind of inquiry is a country's existing system for taxing international income. As theoretically appealing as it might be to begin with a clean slate, there are obvious and important tax administration, tax policy, and macroeconomic reasons why the past cannot simply be displaced in favour of the better way. In fact, it is difficult to know whether another way necessarily is the better way. And, possibly more importantly, it may be that the existing regime is fundamentally sound—that its history and its underlying tax policy judgments point the way to a renovation of the international tax rules that only needs to be modest in relation to embedded principles that were and continue to be sound and may, in some ways, have been prescient in respect of future demands on them.

The adequacy of Canada's international tax rules most recently has been addressed by the inquiry and report of the Advisory Panel on Canada's System of International Taxation ("the panel"). The panel essentially takes the salient aspects of Canada's income tax law as found, and it makes recommendations about how the international tax rules could be more closely aligned to the demands and characteristics of international business and investment by building on rules and underlying tax policy that are fundamentally sound. Here, we reflect on several key aspects of the panel's findings, relating to expanding the scope of exemption for offshore business income as such and as reflected in the capital value of foreign share holdings.

The panel's report is provocative beyond its immediate terms of reference and conclusions, and a careful reader of the report will have noticed some nuggets of insight that invite the further thinking in which we engage here. We are in-

spired by the panel's report to inquire whether initiatives beyond the traditional or expected limits of how Canada taxes offshore income can be justified and explained with reference to the sorts of considerations recognized by the panel as important to ensure that the tax system's treatment of income earned in international circumstances serves Canada's overall economic objectives. Somewhat cheekily, perhaps, and with deference to David Rosenbloom's similarly motivated insight about the US tax system, we ask the question, "Why not Kenora?"[4]

The Panel: Where It Started and Where It Went

The creation of the panel was announced by Finance Minister Jim Flaherty in November 2007.[5] The panel's mandate was to

- improve the fairness, economic efficiency, and competitiveness of Canada's system of international taxation;
- minimize compliance costs for business and facilitate administration and enforcement by the Canada Revenue Agency (CRA); and
- develop practical and readily applicable changes, taking into account existing rules and tax treaties as well as fiscal implications.

In April 2008, the panel released a consultative document, *Enhancing Canada's International Tax Advantage*,[6] inviting interested parties to make submissions to the panel and participate in a series of round table discussions during the spring and summer of 2008. The panel issued its final report on December 10, 2008.[7]

The panel's final report contained 17 main recommendations. The panel concluded that Canada's current international tax system overall is "a good one that has served Canada well." Accordingly, its recommendations "seek not to reform but rather to improve our existing system."[8]

Two key directives emerge from the panel's final report. The first directive is that the federal government should maintain the existing system for the taxation of foreign-source income of Canadian companies and extend the existing exemption system to all active business income earned outside Canada by foreign affiliates. The second directive is that the government should maintain the existing system for the taxation of inbound investment and adopt targeted measures to ensure that Canadian-source income is properly measured and taxed.[9]

While recognizing that the development of international tax policy entails tradeoffs and practical constraints, the panel articulated six principles that it believed should guide Canadian tax policy makers in formulating Canada's international tax policy today and in the future.[10]

The first principle is that "Canada's international tax system for Canadian business investment abroad should be competitive when compared with the tax systems of our major trading partners." This statement reflects the panel's view that an overriding principle guiding Canada's taxation of outbound direct investment should be to ensure that the Canadian tax treatment of foreign-source

business income does not disadvantage Canadian businesses investing abroad in comparison with their foreign competitors.

The second principle is that "Canada's international tax system should seek to treat foreign investors in a way that is similar to domestic investors, while ensuring that Canadian-source income is properly measured and taxed." In submissions from taxpayers and tax advisers and in round table discussions chaired by the panel during its consultations with the tax community, the panel heard that a level playing field for the taxation of Canadian-source income is an important concern of Canadian businesses. Although no playing field can ever be perfectly level, the panel believed that creating the conditions to ensure that Canadian and foreign businesses investing in Canada compete on similar footing should be a key consideration in setting Canada's inbound tax rules.

The third principle is that "Canada's international tax system should include appropriate safeguards to protect the Canadian tax base." This principle reflects the view that Canada must have robust rules to protect the Canadian tax base and ensure that Canadian-source income is properly measured and taxed.

The fourth principle is that "Canada's international tax rules should be straightforward to understand, comply with, administer and enforce, to the benefit of both taxpayers and the CRA."

The fifth principle is that "[f]ull consultation should precede any significant change to Canada's international tax system." This principle reflects the view that there may be no greater threat to the integrity of any tax system than rules that are too difficult for taxpayers to understand and comply with and for the taxation authority to administer and enforce. Applying the fourth principle is a way of avoiding this problem. The other is to have a more open and productive consultation about proposed tax changes.

The sixth and last principle is that "Canada's international tax system should be benchmarked regularly against the tax systems of our major trading partners." Many countries have changed or are considering changes to their tax systems to better compete for capital, jobs, and growth in the global economy. This principle recognizes that Canada's tax policy must anticipate continuous change in the global environment and retain the flexibility to adapt accordingly to ensure that our system of international taxation stays in step with or ahead of international norms.

We venture beyond the strict limits of the report later in this paper. However, the place to start is with the system we have and how the panel saw it changing, albeit mostly within its existing parameters. To that end, we consider a number of key architectural aspects of the system, and we test the limits of some key elements of the system.

Broadening the Exemption System to All Dividends Received from Foreign Affiliates

Briefly, under the current rules, active business income earned by a foreign affiliate[11] of a taxpayer resident in Canada is not taxable in Canada until it is repatriated

to the Canadian shareholder. If the shareholder is a Canadian corporation, it will be entitled to a deduction equal to the amount of the dividend in computing its taxable income if the affiliate is resident and is carrying on the active business in a country with which Canada has entered into a tax treaty or a tax information exchange agreement (TIEA).[12] If these conditions are not met, the shareholder is entitled to a deduction computed with reference to the foreign income and withholding tax exigible on the underlying income and dividend.[13]

In the final report, the panel concludes that the design of the current system should be altered:

> The Panel believes that the exemption of foreign active business income earned by a foreign affiliate should be viewed as the norm for Canadian tax purposes. Ours is a territorial view which asserts that such income should not be considered part of Canada's tax base. This view is consistent with current international norms—and the reality that little Canadian tax is collected on foreign active business income [under the current system].[14]

The panel's territorial view of the taxing of foreign active business income earned by a foreign affiliate is one of its most important conclusions. This view is the basis for a number of the panel's recommendations—in particular, its recommendation to move to a full exemption system for dividends received from foreign affiliates and for capital gains (losses) realized on the sale of certain foreign affiliates.

A strictly territorial view of the taxing of foreign active business income of a foreign affiliate is different from the design of the current system, which is founded on a worldwide basis of taxation, with foreign active business income of a foreign affiliate being subject to Canadian tax (albeit on a deferral basis) when repatriated to Canada coupled with an actual or effectively presumptive credit for foreign tax that was or could be borne by that income. Although conceptually an overt territorial basis for taxing foreign active business income earned through foreign affiliates would be a new paradigm, it would not be significantly different from the way in which the current system operates in practice.

The panel described how under the current rules Canada's system already largely exempts foreign active business income earned by foreign affiliates and very little tax is collected with respect to dividends from foreign affiliates.[15] The panel concluded that Canada should formally adopt a broader exemption system for foreign active business income earned through foreign affiliates, for the following reasons:

- A broader exemption system would be simpler, reducing the compliance burden for Canadian businesses and the administrative burden for the CRA.

- Broadening the exemption system would be revenue-neutral for the government, as dividends from foreign affiliates are rarely taxed under the current regime.
- A broader exemption system could facilitate repatriation of foreign profits, generating economic benefits for Canadian businesses and their owners.
- Our benchmarking research showed that taxing active business income at its source is consistent with the tax policies (or policy direction) of most other industrialized nations.
- As noted [earlier in the report], concerns that formally adopting a broader exemption system would cause a migration of jobs or investment from Canada are not well supported.[16]

In addition, a broader exemption system would level the playing field for Canadian corporations carrying on active businesses in non-treaty, non-TIEA jurisdictions, many of which are unlikely to sign either type of agreement with Canada in the near future.

These are compelling reasons to move toward a territorial or fuller exemption system. The panel's recommendation is the logical progression of Canada's foreign affiliate system. The panel noted[17] that some commentators maintain that the exemption element in the current system was originally conceived as a proxy for the deferral or foreign tax credit method—that is, if a country's tax system was comparable to Canada's, the deferral method would not result in any further Canadian tax revenue in Canada. Hence, it was simpler to exempt dividends from Canadian tax. In this respect, tax treaties were considered a reasonable way to determine whether the tax regimes of other countries were comparable to Canada's.[18]

The tax treaty requirement, however, while requiring a foreign affiliate to be subject to tax in a treaty country, never required the income earned in that country to bear a level of tax similar to the Canadian tax rate. In any event, this point became irrelevant when Canada began to enter into tax treaties with low-tax jurisdictions or jurisdictions with no comparable tax system.[19] The extension of the exemption system in the beginning of 2008 to all dividends from active business income earned in countries with which Canada has a TIEA was a further example that Canada did not base (or at least no longer based) access to the exemption aspect of its foreign affiliate rules on the degree to which the foreign income was actually taxed. Rather, the extension implicitly acknowledged Canada's willingness to cede taxation of the foreign business income to foreign jurisdictions irrespective of whether the foreign jurisdiction exercises its prerogative to tax such income; if it does not exercise its prerogative, Canada will not impose its tax on the income. In effect, extending the exemption system to TIEA countries meant that Canada abandoned any remaining pretension that its exemption system is a proxy for a foreign tax credit system.[20]

Although the panel supported the Department of Finance's efforts to enter into TIEAs with non-treaty countries, it did not believe as a matter of principle

that the exemption for active business income should be dependent on Canada having a TIEA with a non-treaty country.[21]

Broadening the Exemption System to Capital Gains and Losses from the Sale of Shares of Foreign Affiliates

If there are compelling reasons to extend the current exemption system to all dividends from foreign affiliates without linking the exemption to a tax treaty or a TIEA, are the reasons for extending the exemption system to capital gains (losses) realized on the sale of shares of foreign affiliates equally compelling? The panel believed that the answer to this question is yes.

The Case for Exemption

In its final report, the panel wrote:

> The Panel believes that Canada's exemption system should be extended to capital gains realized by Canadian shareholders on dispositions of foreign affiliate shares (and capital gains realized by foreign affiliates on the sale of shares of other foreign affiliates) where the shares derive all or substantially all of their value from assets used or held principally to earn active business income. The Panel reached this conclusion for the follow reasons.
>
> - Exempting capital gains arising on the sale of shares of a foreign affiliate is appropriate because the affiliate's income would also be exempt from Canadian tax. This treatment is consistent with the view that foreign active business income should be exempt from Canadian income tax.
> - The Panel's benchmarking research confirms that most countries that exempt dividends received from a foreign affiliate from domestic taxation also exempt the capital gain realized on a disposition of the shares of the foreign affiliate.
> - Little tax revenue should be at risk if capital gains realized on dispositions of foreign affiliate shares were exempt.[22]

The panel acknowledged the difficulty that policy makers may have in accepting this recommendation, given the domestic taxation of capital gains arising on the sale of shares of Canadian companies:

> At first glance, exempting gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares may seem inconsistent. This difference can be accepted on the basis that the current rules are out of step with most other countries that have exemption systems and that this approach *could* eliminate another aspect of surplus tracking, resulting in a much simpler system for businesses and the CRA.[23]

The panel could have added that while the current system permits taxpayers to defer Canadian taxation of capital gains arising on the sale of shares of foreign

affiliates (see the discussion below), it permits taxpayers to structure their foreign holdings to permit them to claim capital losses arising on the sale of foreign affiliates against domestic capital gains. From a tax policy perspective, this outcome seems inappropriate.[24]

Further, it is relevant that in its 2010 budget the federal government proposed to alter the definition of "taxable Canadian property" (TCP) found in section 248. Briefly, the budget proposes to amend the TCP definition to exclude shares of corporations, and certain other interests, that do not derive their value principally from real or immovable property situated in Canada, Canadian resource property, or timber resource property.[25] The government indicated that the narrowing of the TCP definition is intended to enhance the ability of Canadian businesses, including innovative high-growth companies that contribute to job creation and economic growth, to attract foreign venture capital. As the 2010 budget papers note, the change to the TCP definition will align Canada's domestic tax rules more closely with our tax treaties and the tax laws of our major trading partners. It will also result in residents of non-treaty countries obtaining a significant Canadian tax saving. Canada is prepared to forgo the tax revenue that would otherwise be payable on the disposition of such property by such non-residents, as it is for all non-residents, for competitive reasons (that is, to attract foreign investment). No doubt Canada expects the resulting additional investment to give rise to economic benefits, including additional domestic tax revenue resulting from the yield of such property, that exceed the cost of the forgone tax revenue on the sale of shares of Canadian companies.

The reasons for narrowing the TCP definition and thereby exempting from Canadian tax gains derived by non-residents from the sale of certain Canadian companies are consistent with the reasons for exempting foreign active business income, including capital gains from the sale of shares of foreign affiliates. In effect, with the changes to the TCP definition, Canada is prepared to forgo taxing indirectly, in the guise of gains derived by non-residents from the sale of shares of Canadian companies, what it is able to tax directly—corporate income derived from the underlying assets situated in Canada of Canadian companies. Similarly, the panel has recommended that Canada not tax indirectly, in the guise of gains derived by Canadian companies from the sale of shares of foreign affiliates, active business income of such affiliates that Canada does not seek to tax directly.

The recommendation to exempt the sale of shares of foreign affiliates from Canadian tax raises three questions:

1) Is it possible to achieve the full benefits of a dividend exemption system if capital gains (losses) from the sale of shares of foreign affiliates are not exempt?
2) Is it possible to exempt the sale of shares of foreign affiliates in a corporate tax system that taxes gains (losses) from the sale of shares of Canadian companies?

3) Is the definition of "excluded property" robust enough (or too restricted) to properly determine whether capital gains (losses) from the sale of shares of foreign affiliates should be exempt from Canadian taxation?

Is It Possible To Achieve the Full Benefits of a Dividend Exemption System if Capital Gains (Losses) from the Sale of Shares of Foreign Affiliates Are Not Exempt?

We observed earlier that the current foreign affiliate rules for taxing foreign active business income effectively operate in practice as an exemption system. As a result, the most significant benefit for taxpayers and the CRA in moving to a full exemption system for all dividends would be to reduce the complexity and the compliance and enforcement burden of tracking exempt and taxable surplus balances of each foreign affiliate in respect of each Canadian corporation.

Specifically, a dividend exemption system would eliminate the need to distinguish whether active business income earned by a foreign affiliate gives rise to exempt or taxable surplus. For Canadian corporations that hold all of their foreign affiliates directly, there would be no need to compute surplus balances for any of their affiliates for foreign affiliate purposes.[26]

However, many Canadian corporations own their foreign affiliates through one or more foreign holding companies. As a result, if capital gains (losses) realized by a foreign affiliate from the sale of shares of another foreign affiliate are not exempt, there will be an ongoing need to at least track the taxable portion of the gain, and the portion of the loss that can be applied against the taxable portion of capital gains, realized by the affiliate.

At this point, it is useful to review generally the current foreign affiliate (including surplus) rules applicable to capital gains (losses) realized by foreign affiliates.

1) Capital gains (losses) arising on the sale of property used or held principally for the purpose of gaining or producing income from an active business will not give rise to foreign accrual property income (FAPI) or foreign accrual property losses (FAPL). If the disposing affiliate is resident in a designated treaty country (DTC), the entire gain (loss) will be included (deducted) in computing the affiliate's exempt earnings and exempt surplus. Otherwise, 50 percent of the gain (loss) will be included or deducted in computing taxable earnings and taxable surplus, which would also be the case if the gain (loss) was FAPI or FAPL.
2) Capital gains (losses) arising on the sale of shares of another foreign affiliate will not give rise to FAPI if the shares are "excluded property."[27] Regardless of whether the shares disposed of are excluded property, 50 percent of the gain (loss) will be included (deducted) in computing the affiliate's exempt earnings for the year, and the other 50 percent will be included (deducted) in computing its taxable earnings. Conceptually, under the

current rules, if the shares disposed of are excluded property, Canadian tax is postponed, not avoided, until the portion of the gain that gives rise to taxable earnings and surplus is repatriated to Canada.

Under a dividend exemption system, there would be no need to track capital gains (losses) arising from the disposition of property that is not shares of a foreign affiliate. This would be a further simplification of the current rules. However, unless capital gains (losses) arising on the sale of shares of a foreign affiliate that are excluded property are also exempt from Canadian tax, there will be an ongoing need to track the amount of such gains (losses) in some manner, whether through the existing surplus rules or through some variation thereon, so they can be taxed upon repatriation. In other words, it would not be possible to achieve a full dividend exemption system.

There are at least two possible ways to track such capital gains (losses).[28]

The first is for each affiliate to track the taxable portion of such gains (losses) (and the related underlying foreign tax, if any) in a separate account. For simplicity, dividend payments by the affiliate would be deemed to come out of this account first. Ultimately, this would mean that dividend payments to Canadian shareholders would be subject to tax to the extent that the paying affiliate has a balance in such an account. This would create a significant disincentive for foreign affiliates to repatriate earnings—a negative feature not present in the current system.

The alternative is to effectively track only *exempt* income of the affiliate (income from an active business, FAPI, and the exempt portion of capital gains). There would be no need for exempt and taxable surplus balances; the affiliate would only maintain an exempt surplus account. As under the current rules, all dividends would be deemed to be paid out of exempt surplus first. Dividends in excess of the affiliate's exempt surplus balance would be deemed to be a pre-acquisition surplus dividend reducing the adjusted cost base (ACB) of the shares of the paying affiliate. Dividends in excess of the ACB of the shares would give rise to a capital gain.[29]

Regardless of the approach used to track capital gains (losses) arising on the sale of foreign affiliates, much of the current complexity in the surplus rules would likely remain. In particular:[30]

1) Taxpayers would still have to compute their surplus entitlement percentage (SEP) in their foreign affiliates and adjust surplus balances for changes in SEP as a result of the acquisition or disposition of shares of an affiliate, or a reorganization involving the Canadian shareholder or one or more affiliates.
2) There would still be a need for subsection 93(1) elections and the related regulations for computing surplus for the purposes of the election when disposing of shares of a foreign affiliate.
3) In a tax system where dividends are exempt and capital gains are taxable, a taxpayer will generally seek to reduce the taxable capital gain by stripping

the value of the company being sold through the payment of exempt dividends. Hence, there may be a perceived need to continue to pursue certain outstanding proposed amendments intended to prevent taxpayers from duplicating or creating exempt surplus in certain related-party transactions.[31]

In summary, a dividend exemption system would eliminate the need to separately track exempt and taxable surplus. This would reduce some of the compliance and administrative burden that taxpayers and the CRA currently endure under the current surplus rules.

However, a full dividend exemption system cannot be achieved if capital gains or losses arising on the sale of shares of foreign affiliates are not exempt. As a result, a substantial amount of the current compliance and administrative burden inherent in the current surplus rules would remain, and the benefits, articulated by the panel and summarized above supporting the exemption of capital gains or losses on the sale of shares of foreign affiliates, would be not be realized.

Is It Possible To Exempt the Sale of Shares of Foreign Affiliates in a Corporate Tax System That Taxes Gains (Losses) from the Sale of Shares of Canadian Companies?

As noted above, there are compelling reasons not to tax capital gains on the sale of shares of foreign affiliates. Such capital gains (losses) represent the future active business earning potential of the affiliate, and since those earnings will be exempt from Canadian tax so should the associated capital gain. Otherwise, Canada would be taxing indirectly what it has chosen not to tax directly. While it is important that the tax system not provide taxpayers with a greater incentive to make foreign investments than to invest domestically, practically speaking it is equally important to understand the revenue loss that may arise pursuant to such a change. It is difficult to obtain reliable data, but many practitioners are of the view that the amount of net capital gains realized by all taxpayers on dispositions of foreign affiliate shares is relatively minimal. An exemption system would certainly eliminate the current planning undertaken by taxpayers to realize losses on shares of foreign affiliates.

The panel noted that most countries that exempt dividends from foreign affiliates also exempt capital gains (losses) from dispositions of shares of foreign affiliates. Many of these countries also exempt domestic capital gains (losses). Canada, of course, does not exempt gains (losses) derived by Canadians on the sale of shares of domestic companies. Should this be a decisive factor in determining whether Canada moves to a full exemption system for taxing foreign active business income? It was not a factor in the design of the Australian system, which exempts capital gains (losses) on dispositions of foreign affiliate shares but does not exempt capital gains (losses) arising on the sale of shares of domestic companies.

It is beyond the scope of this paper to provide detailed arguments in support of or against current Canadian tax policy to tax capital gains (losses) derived from the sale of Canadian companies. However, the conditions and principles for that domestic policy (prominent among them the integration rules regarding the taxation of Canadian individuals and corporations, which seek not only to prevent the permanent deferral of the taxation of income earned through Canadian corporations but also to rationalize the taxation of income earned at the corporate level to take account of shareholder taxation) are different not only from the existing paradigm for taxing foreign active business income, but also from the new paradigm proposed by the panel for taxing such income—namely, a territorial system of taxation of such income, including its proxy in the form of capital gains (losses) derived from the sale of shares of foreign affiliates, whereby Canada cedes complete taxing rights to foreign jurisdictions.

In the domestic context, the principal issues are avoiding unreasonable or permanent deferral of tax on income earned through corporations and avoiding excess taxation of such income, taking into account how shareholders are taxed on distributions by the corporation. The important point is that there is no question about whether the value of Canadian corporations, represented by distributions or realized gains on the sale of shares of the corporation, ought to be taxed. What is at issue is when and at what effective rate such value is fully within the compass of the Canadian tax base, as defined by the Act and supported by relevant tax policy. While a reasonable debate can occur about whether capital gains should be taxed at more modest rates than the income or the income potential they reflect, there is no debate about whether capital gains should be ultimately taxable.

In the case of foreign active business income, the starting proposition is that the income is not in the Canadian tax base. As in the domestic situation, there are competing tax and economic policy considerations that culminate in this result. Simply stated, foreign active business income is not taxed as it is earned, and, provided that it is earned in a treaty or TIEA jurisdiction by a foreign affiliate that is resident in that jurisdiction, it is not taxable at all in Canada upon repatriation after the primary exclusion determination has been made. After the primary exclusion determination has been made, the question becomes, in a sense, whether the system is opportunistic in taxing manifestations of the underlying income simply because it is captured in a capital gain that exceeds the actual undistributed income of the affiliate. To the extent that the Canadian system moves toward a full, or "purer," exemption system, the case for taxing the capitalized value of forecast earnings that, once earned, would not be taxable weakens in the face of the tax and economic policy considerations that would sustain a more thorough exemption or territorial system for taxing foreign business income in the first place.

While it may be appropriate to exempt the sale of shares of foreign affiliates in a corporate tax system that taxes gains (losses) from the sale of shares of Canadian companies, it will be necessary to ensure that the former does not

jeopardize the integrity of the latter and that the Canadian taxation of FAPI is not avoided.

Key Considerations in Exempting Capital Gains and Losses from the Sale of Shares of Foreign Affiliates

To maintain the integrity of a system that continues to tax capital gains (losses) derived from the sale of shares of Canadian companies while exempting those derived from the dispositions of foreign affiliate shares, as well as ensuring that FAPI is subject to Canadian tax, it remains necessary to

- measure safe income relating to foreign affiliates,
- compute the ACB of shares of foreign affiliates, and
- track FAPI earned by foreign affiliates.

In the absence of subsection 55(2), a capital gain arising on the sale of shares of a Canadian corporation could be reduced if the Canadian company paid a tax-free intercorporate dividend prior to the sale. However, subsection 55(2) will not apply to the extent that the dividend is paid from the corporation's "safe income." Under the current rules, the safe income of a Canadian corporation that relates to a foreign affiliate of the corporation is computed under paragraph 55(5)(d) as, essentially, the amount that would be deductible by the corporation if it sold all of the shares of the foreign affiliate for fair market proceeds and made an election under subsection 93(1) in respect of the full amount of the proceeds.

The conceptual issue posed by the adoption of a full exemption system really concerns the safe income notion as a proxy for income that, for whatever reason, is not meant to be taxed again after it has already been taxed. Exempt foreign active business income—actual income and, in the new paradigm, the capitalized value of future foreign active business income—is, in the contemplation of the Act, income that has been taxed; that is, Canada has exacted as much tax as it means to exact even if in cash terms the amount is zero. This effect can be debated either as the manifestation of a macroeconomic policy of competitiveness or generally of a foreign tax credit proxy effect. Either way, the result is conceptually the same.

As the following examples illustrate, under a full exemption system safe income relating to a foreign affiliate would need to be expanded to include not only income of a foreign affiliate but also any accrued gain. Conversely, it should be reduced for any accrued loss on the shares of the affiliate that reduces the accrued gain on the shares of the Canadian corporation.

Further, the examples illustrate that under a full exemption system it would be necessary to continue to track the ACB of foreign affiliate shares to determine which portion of a gain is attributable to shares of a Canadian corporation and which portion is attributable to shares of a foreign affiliate.

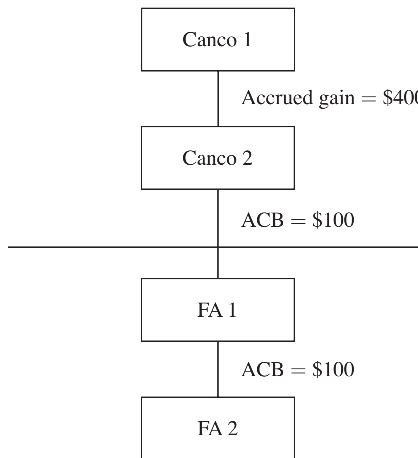
Finally, as under the current rules, FAPI of a foreign affiliate that has been taxed in Canada but has not been distributed to the Canadian corporation must be added to the ACB of shares of a foreign affiliate and must therefore also be tracked. Because FAPI has already been subject to Canadian tax, it should also be included in safe income under a full exemption system.

One way in which a full exemption system could operate is as follows:

- The portion of any gain on the shares of a Canadian corporation would exclude any accrued gain (loss) on the shares of a foreign affiliate.
- Subject to the discussion below, dividends from a foreign affiliate would be included in the safe income calculation of a Canadian corporation.
- FAPI of a foreign affiliate would be included in the safe income of a Canadian corporation.

The following examples are based on the structure shown in figure 1.

Figure 1



Example 1

Assume that the accrued gain on the shares of Canco 2 is $400, that FA 1's value increased to $300 from $100, and that the increase is attributable to $80 of after-tax income and other capital appreciation of $120. FA 1 and FA 2 are controlled foreign affiliates of Canco 2. The shares of FA 1 are excluded property.

The accrued gain of $200 on FA 1's shares is excluded from the $400 gain on the Canco 2 shares (that is, the $200 accrued gain is treated as safe income), resulting in only $200 of the capital gain on the shares of Canco 2 being subject to Canadian tax.

Gain on Canco 2 shares	$400
Safe income: gain on FA 1 shares	($200)
Gain on Canco 2 shares subject to tax	$200

Example 2

Assume that the facts are the same as those in example 1, except that FA 1 has paid a dividend of $80. The $80 dividend is included in the safe income of Canco 2, and the resulting accrued gain of $120 (the gain of $200 is reduced by the $80 dividend) on the shares of FA 1 reduces the $400 capital gain to $200.

Gain on Canco 2 shares	$400
Safe income:	
Dividend from FA 1	($ 80)
Gain on FA 1 shares	($120)
Gain on Canco 2 shares subject to tax	$200

Example 3

Assume that the facts are the same as those in example 1, except that FA 1 has paid a dividend of $120 to Canco 2. The $120 dividend is included in the safe income of Canco 2, and the accrued gain of $80 (the gain of $200 reduced by the $120 dividend) on the shares of FA 1 reduces the $400 capital gain to $200. Here, the dividend exceeds the after-tax earnings of FA 1 and therefore has the effect of reducing the capital gain associated with appreciated assets (there has been a capital gain strip). However, this should not affect the result from a tax policy perspective, because the shares are excluded property and the portion of the dividend that is stripping the capital gain is only reducing a capital gain that would be exempt from Canadian tax in any event.

Gain on Canco 2 shares	$400
Safe income:	
Dividend from FA 1	($120)
Excluded gain on FA 1 shares	($ 80)
Gain on Canco 2 shares subject to tax	$200

Suppose that a dividend greater than the accrued value increase of its shares is paid by FA 1. Should the entire dividend be included in Canco 2's safe income? Given the existing Canadian tax system of taxing domestic capital gains, it is not desirable or appropriate from a tax policy perspective to include the entire dividend in safe income. The exclusion of foreign active business income, whether manifested as undistributed retained earnings or as future earning potential captured by a capital gain, should only create Canadian tax shelter to this extent. To some, this suggests an ongoing requirement to compute surplus balances for foreign affiliates to help guard against this risk, although under a full exemption

system it should only be necessary to track exempt surplus.[32] It seems unnecessary for taxpayers to have to continue to track surplus balances for such a limited purpose.

An alternative approach is to use the affiliate's financial statement income as a proxy or a starting point in determining the amount of a dividend paid by the affiliate that should be included in safe income. This approach could rely on the relevant foreign corporate law and an anti-avoidance rule that will apply if a dividend results in the net realizable value of the assets of the corporation being less than the corporate capital of the affiliate ($100 in this case).[33] Still, this approach would capture only actual realized undistributed earnings. To capture as safe income the capital value increase in excess of actual earnings of a foreign affiliate, there would have to be a deemed disposition of the affiliate's shares at fair market value (FMV). This would put pressure on the "excluded property" definition as an expedient device to determine when and to what extent the value does not represent future capitalized foreign active business income. We comment on this point below.

Example 3 also raises a question about fluctuations in the value of FA 1 after the payment of a dividend. For example, what should the safe income of Canco 2 be if the value of FA 1 drops to $70 some time after the payment of the $120 dividend by FA 1? Should the resulting $30 accrued loss (value of $70 less ACB of $100) on the shares of FA 1 reduce the safe income of Canco 2? If the value of FA 1 were to drop to $70 after the payment of the $120 dividend, it could be argued that the loss of $30 should reduce the safe income of Canco 2. The safe income of Canco 2 before such a reduction would be $120, as represented by the dividend received. The rationale for such a reduction is as follows. If the dividend had not been paid, the FMV of FA 1 would be $190 ($70 + $120) and the amount of the accrued gain on the shares of Canco 2 attributable to FA 1 would be $90. If a dividend of $120 is paid and is included in safe income, then reducing it by the $30 loss ($120 − $30 = $90) restores the appropriate amount of gain or safe income attributable to FA 1.

Example 4

Assume that the facts are the same as those in example 1, except FA 1 earns $5 of FAPI. The shares of FA 1 remain excluded property. The $5 of FAPI is added to the ACB of the shares of FA 1, but the overall value of the FA 1 shares does not increase; therefore, the accrued capital gain on the FA 1 shares is reduced to $195 (value of $300 and ACB of $105).

Gain on Canco 2 shares	$400
Safe income:	
FAPI	($ 5)
Gain on FA 1 shares	($195)
Gain on Canco 2 shares subject to tax	$200

Example 4 illustrates that it is necessary to track FAPI of a non-controlled foreign affiliate so that such income can be excluded in computing Canco 2's safe income in the future. Otherwise, FAPI of a non-controlled foreign affiliate should be subject to Canadian taxation on an accrual basis and should receive the treatment described in example 5.[34]

Example 5

Assume that the facts are the same as those in example 4, but that FA 1 pays a dividend of $5 representing the FAPI previously earned and taxed in Canada. The dividend has the effect of reducing the ACB of the shares of FA 1 by the amount previously added ($5), thereby restoring it to $100. However, the value of the FA 1 shares decreases to $295. The previously taxed FAPI of $5 and the dividend of $5 represent the same amount, and therefore only one of these two tax items should be taken into account as a reduction to the capital gain on the Canco 2 shares.[35]

Gain on Canco 2 shares	$400
Safe income:	
FAPI or dividend	($ 5)
Gain on FA 1 shares	($195)
Gain on Canco 2 shares subject to tax	$200

All of the examples given above are in the context of foreign affiliate shares that are excluded property. This makes developing the system easier, since those gains should be excluded from Canadian tax under a full exemption system. However, the matter is significantly more complicated if the shares of the foreign affiliate are not excluded property.

Example 6

Assume that the facts are the same as those in example 1, but that the shares of FA 1 are not excluded property.

This scenario gives rise to several issues, one of which is to ensure that accrued gains with respect to non-excluded property are not inappropriately stripped with tax-free dividends.[36] One commentator has suggested that this concern can be dealt with by ensuring all dividends (and distributions) from a foreign affiliate reduce the ACB of its shares.[37] If a dividend results in a negative ACB, then the resulting gain will be exempt if the shares are excluded property. If the shares are not excluded property, the resulting gain should be taxable to the extent that it reasonably relates to the appreciation in the value of non-excluded property of the affiliate. In other words, there should be no taxable gain to the extent that the dividend reasonably represents a distribution of earned active business income, previously taxed FAPI, or an appreciation in excluded property of the affiliate. Such a system would never permit a dividend to strip a capital gain: either the

existing accrued gain remains the same because the dividend has the effect of decreasing the ACB of the shares in the same amount as the reduction in the FMV of the shares, or the dividend causes the recognition of a gain because the ACB of the shares is negative.

The discussion above highlights the importance of the "excluded property" definition. The following section explores the degree to which the current definition would still be adequate under a full exemption system.

Is the Current Definition of "Excluded Property" Adequate in Determining Whether Capital Gains (Losses) from the Sale of Shares of Foreign Affiliates Should Be Exempt from Canadian Taxation?

The panel recommended exempting capital gains (losses) realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets.[38] In other words, to be exempt from Canadian income tax, the disposed shares should be excluded property.

"Excluded property" is defined in subsection 95(1) to include property of a foreign affiliate that at a particular time is

- used or held principally for the purpose of gaining or producing income from an active business, and
- shares of another foreign affiliate where all or substantially all[39] of the FMV of the property of the other affiliate is attributable to property that is excluded property.

Under the current rules, FAPI (FAPL) generally excludes taxable capital gains (losses) arising on the sale of shares of a foreign affiliate that are excluded property. If the shares are excluded property, Canadian taxation on any gain is deferred until the underlying proceeds from the sale are repatriated to Canada.

Issues with the Definition of "Excluded Property"

The panel indicated that to maintain the integrity of a broader exemption system, the definition of "excluded property" should be sufficiently robust.[40] At the same time, the definition should not be so restrictive that it inappropriately prevents shares from being treated as excluded property. The panel identified several issues connected with the current definition that should be considered to meet these objectives.

The Multiplier Effect

The panel described how, in determining the excluded-property status of shares of a higher-tier company in a chain of foreign affiliates, the definition requires the taxpayer to first determine the status of the shares of bottom-tier affiliates.

The status of the shares of the next higher-tier affiliate is then determined, taking into account the status of the shares of the lower-tier affiliates that it owns.

The panel noted that this approach could produce anomalous results. For example, if a lower-tier company in a particular chain of foreign affiliates is not excluded property because it owns excess non-active business assets, a cascading effect could result in the shares of the top affiliate in the group not being excluded property even though the non-active business assets in the lower-tier company might be less than 10 percent of all the assets of the chain of affiliates. Conversely, it is possible that a chain of foreign affiliates could have excess non-active business assets, and yet the shares of the top affiliate could still be excluded property.[41]

The panel suggested that this issue could be resolved by modifying the "excluded property" definition to take a more consolidated approach. The panel wrote:

> In applying the excluded property test at any particular level within a chain of foreign affiliates, the property of all underlying entities should be divided into excluded property and non-excluded property. If the value of the group's excluded property comprises all or substantially all of the total value of the group's property, then the shares of the top affiliate would constitute excluded property. Such group determination could be done on a country-by-country basis.[42]

Excluded Property: A "Point-in-Time" Test

A property of a foreign affiliate is determined to be excluded property at a particular point in time. For example, a foreign affiliate could have a temporary investment in excess cash or investment assets that might make it difficult to determine whether the shares of the affiliate are excluded property at that particular time.[43]

An upstream loan by an affiliate to its parent company or an upstream shareholding could make the excluded property analysis problematic. For example, the determination as to whether the shares of the subsidiary are excluded property may be dependent on whether the shares that the subsidiary owns in its parent are excluded property, which may in turn be dependent on whether the shares of the subsidiary are excluded property. As a result, the analysis becomes circular.

On the other hand, there may be circumstances in which the shares of a foreign affiliate are not ordinarily excluded property because the foreign affiliate has excess non-active business assets. It might be possible to undertake a planning strategy to convert the non-active business assets into active business assets for the point in time (for example, at the time of a sale) when the shares of the underlying affiliate need to be excluded property.

The panel suggested that temporary investment assets eventually used in the affiliate's business, to acquire shares of another foreign affiliate, or to acquire active business assets could be deemed to be active business assets. Although not suggested by the panel, planning that inappropriately results in shares of a foreign

affiliate being excluded property only for a particular period of time could be curtailed if the affiliate was required to earn a certain amount of active business income as a proportion of its overall income and/or to own a certain amount of active business assets as a proportion of the total assets over a certain period of time.

The All-or-Nothing Test

Under the current rules, if all or substantially all of the property of an affiliate is not excluded property, the shares of the affiliate will not be excluded property and the entire amount of any gain arising on the sale of such shares will give rise to FAPI. This could be the case, for example, in a situation where 70 percent of the affiliate's property is active business assets.

It might be suggested that this all-or nothing approach is appropriate because to be excluded property, an asset must be used or held principally (that is, greater than 50 percent) for the purpose of producing active business income. Hence, for shares of a foreign affiliate to be excluded property, effectively only 90 percent of its assets must be used more than 50 percent of the time to earn active business income. However, this is an oversimplification: in most cases, assets of a foreign affiliate will be used almost entirely to earn either active business income or FAPI.

A better approach is to determine the amount of FAPI arising on the disposition of shares that are not excluded property only with respect to the inherent gain in the non-active business assets of the disposed affiliate.[44] The gain arising on the sale of the shares should at least be reduced for undistributed earnings that could have otherwise been distributed.

Other Possible Changes to the Definition of "Excluded Property"

If the exemption system is extended to dispositions of shares of all affiliates, the definition of "excluded property" will have to be amended to include shares of foreign affiliates held directly by Canadian corporations.[45]

Finally, it may be appropriate to consider requiring a holding period (for example, one or two years) in order for gains arising on the sale of shares of a foreign affiliate to be exempt. This would prevent short-term speculation in shares of a foreign affiliate for strictly investment-type purposes.

Other Ancillary Changes

One of the concerns with moving to a full exemption system for foreign active business income, including a system that exempts capital gains from the sale of shares of a foreign affiliate that are excluded property, is that there is no ability to tax FAPI earned by a non-controlled foreign affiliate.[46] Currently, such income is treated as taxable earnings and is subject to Canadian tax when such earnings are repatriated to Canada. A full exemption system does not contemplate taxpayers tracking such income to ensure that it is taxed in Canada when paid as a dividend.

The panel acknowledged that a necessary corollary to its recommendation to move to a full exemption system is that FAPI should be taxed on a current basis.[47] This was an important aspect of the panel's recommendation 4.5:

> In light of the Panel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.[48]

Although the panel did not set out a precise recommendation showing how this could be achieved, it did offer certain suggestions.

1) Extend the FAPI regime to subject all FAPI earned by a foreign affiliate to Canadian tax on a current basis.[49] This approach would ensure that FAPI of all foreign affiliates (not just controlled foreign affiliates) is taxed in Canada on a current basis. Some might question whether such an approach is practical, because a taxpayer with less than a controlling interest in an entity may not have enough information to determine its FAPI components. The panel suggested that this problem could be mitigated, for example, by eliminating the base erosion rules for non-controlled foreign affiliates and/or by having a high tax exemption from FAPI for foreign affiliates in, for example, the United States and the United Kingdom (which would likely cover most of Canada's foreign affiliates).[50]
2) Extend the definition of "foreign affiliate." This approach would permit a non-corporate, non-resident entity, such as a unit trust or partnership, to be treated as a foreign affiliate (either as the default rule or by virtue of an election made by the taxpayer) in circumstances where the taxpayer has a 10 percent FMV interest or some other threshold consistent with that of a foreign corporation being treated as a foreign affiliate. This approach would entitle the taxpayer to benefit from the foreign affiliate rules generally with respect to its investment in a non-resident entity, which is often a bona fide substitute for corporations to carry on an active business. It could also better serve to protect the Canadian tax base, particularly if the FAPI regime is extended to all foreign affiliates.

Summary

The current definition of "excluded property" can easily be modified to ensure that it is sufficiently robust to properly capture shares of foreign affiliates that should be exempt from Canadian tax on disposition under a full exemption system. However, some modifications are needed to ensure that it does not become unduly restrictive and defeat the intended objective of the panel's recommendation, which is to exempt active business earnings of foreign affiliates.

These modifications would also support other changes that might be contemplated, particularly with respect to reducing the overlap and complexity of Canada's anti-deferral regimes.

Other General Considerations

In moving to an exemption system for capital gains (losses) on the sale of shares of a foreign affiliate that are excluded property, other matters need to be considered. Those matters are deserving of a more detailed discussion and analysis that is beyond the scope of this paper; they are discussed briefly below.

Impact on Canada's Integration System

Currently, 50 percent of all capital gains realized by a Canadian-controlled private corporation (CCPC) on the sale of shares of a foreign affiliate are included in the CCPC's capital dividend account (CDA). However, there is no addition to the CCPC's CDA with respect to capital gains realized by foreign affiliates on the sale of shares of other foreign affiliates. The policy rationale for the latter exclusion is unclear. Presumably, it would be inappropriate to increase the CCPC's CDA for gains realized outside Canada if the proceeds have not yet been repatriated to Canada.

Under a full exemption system, it would seem inappropriate for the entire capital gain arising on the sale by a CCPC of the shares of a foreign affiliate that are excluded property to be added to the CCPC's CDA. Because the panel did not conclude that the territorial approach should be applied to individuals, whether or not the shares disposed of are excluded property, it makes sense that 50 percent be added to the CDA, because that is what occurs in a domestic context.

Under the current system, no portion of the taxable half of the capital gain goes to the general-rate income pool (GRIP) account for eligible dividends.[51] This amount is instead subject to the refundable dividend tax on hand system if the taxpayer is a CCPC. However, a dividend received by a CCPC from a foreign affiliate that is deductible under section 113 is included in the company's GRIP account, while a dividend received by a non-CCPC from a foreign affiliate is not included in the company's low-rate income pool (LRIP) account. There appears to be no reason to treat differently dividends received by a Canadian corporation from a foreign affiliate under a full exemption system.

Foreign Exchange Gains and Losses on Borrowings To Finance Foreign Affiliates

Under the current rules, foreign exchange gains (losses), including related hedging losses (gains), arising on funds borrowed to invest in a foreign affiliate are taxable (deductible) for Canadian tax purposes.

It is generally recognized that a foreign exchange gain (loss) arising on a particular borrowing is a component of the overall financing cost of the borrowing. Interest on funds borrowed to invest in shares of a foreign affiliate is deductible for Canadian tax purposes. The panel recommended that the government impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates.[52] It

follows, on the basis of the panel's recommendation, that there should be no restriction on taxability or deductibility with respect to foreign exchange and hedging gains (losses) arising on borrowings used to finance investments in foreign affiliates.

Concluding Comments

There is widespread support for the proposition that Canada should extend its current exemption system to all dividends received from foreign affiliates and that the exemption for foreign active business income of a foreign affiliate should not be restricted to treaty or TIEA countries. Such a change would reduce the compliance and administrative burden faced by taxpayers and the CRA under the current system, and would not create a significant tax revenue loss.

However, the benefits of moving to a full dividend exemption system cannot be achieved unless the exemption system is extended to capital gains (losses) arising on the sale of shares of a foreign affiliate that are excluded property. While this might be a more difficult proposition for the government to enact in a corporate tax system that continues to tax gains and losses from the sale of shares of domestic companies, it is not unprecedented. More importantly, it would reflect the system effectively in place today and should not have a significant negative impact on government tax revenues. It will, however, require some attention to mitigate the potential for taxpayers to exploit the system in an inappropriate manner.

Other Dimensions of Canada's Territorial Approach to Business Taxation

Chapter 8 of the panel's report sought to address issues that the government should consider for the long term. These issues either were too broad for the panel to properly address in the short time it was given (for example, the challenges associated with determining the source of income) or were simply outside its scope (for example, the lack of a domestic loss-consolidation system).

One of the issues discussed briefly in chapter 8 related to other returns from foreign affiliates:

> Equity, debt and other capital investments held by a Canadian shareholder in a foreign affiliate are often substitutable. Therefore, absent tax considerations, it could and presumably would make no difference to a shareholder whether its returns are received in the form of dividends, royalties or any combination of such income.[53]

However, the tax system treats those returns differently. As a result, taxpayers seek to structure their investments so that their returns take the form that receives the most favourable treatment regardless of its economic source. At the limit, equivalent economic income is or is not subject to Canadian taxation immediately

or at all, depending on whether it is earned by a foreign affiliate. This dimension of what observably is a system for taxing foreign business income on a territorial basis overtly influenced by the organizational and transaction form is exemplified by how internal group financing income is taxed.

Foreign-Source Financing Income

Section 17

The Canadian outbound system permits the treatment, in many economic respects, of certain debt as equity.[54] Consider the example of a Canadian corporation with a wholly owned foreign subsidiary that operates an active business. A non-interest-bearing loan made to the wholly owned subsidiary will not attract any imputed income under section 17, provided that the proceeds of the loan are used in the active business of the subsidiary. Furthermore, case law such as *The Queen v. Canadian Helicopters Limited*[55] supports the view that interest on borrowed money used to make an investment in a non-interest-bearing loan in such circumstances remains deductible on the basis that the income-earning source—the shares of the wholly owned subsidiary—has been enhanced. This is also the view of the CRA.[56]

If a Canadian corporation makes a loan to its wholly owned foreign subsidiary, then—ignoring the effects of the thin capitalization rules and assuming that the tax rates in both countries are the same—the Canadian corporation will be indifferent as to whether interest is charged on the loan. Interest charges would result in lower foreign tax, because an interest deduction would reduce taxable income in the foreign jurisdiction, but the interest income would be subject to tax in Canada at the same rate. Canadian rules allow for a non-interest-bearing loan with no income imputation. Therefore, if no interest were charged, this would decrease the taxable income in Canada but would increase taxable income in the foreign jurisdiction because there would be no interest deduction (on the assumption that no expense imputation is required). This latter result occurs where, in certain respects, Canada allows debt to be treated as equity and forgoes taxation jurisdiction on the interest income.

The taxpayer's response to the regime permitted under section 17 is to try to obtain a deduction in the foreign jurisdiction and still minimize the taxation in Canada of any resulting income. Given the exceptions in section 17, it appears that Canadian tax policy is, where the financing is for an active business, to forgo the Canadian taxation of this financing income. Viewed in this way, the rules in paragraph 95(2)(a) are entirely consistent with and complementary to those in section 17.

Paragraph 95(2)(a)

The Canadian outbound system permits lightly taxed foreign financing income to be repatriated to Canada without further Canadian taxation. The manner in which this result can be achieved is well documented and involves structuring

loans between two foreign affiliates where the creditor foreign affiliate is subject to a low rate of tax but is nonetheless resident in a country with which Canada has a tax treaty (or a TIEA). The interest income is not considered FAPI where the conditions of paragraph 95(2)(a) apply, and (provided that other necessary conditions are satisfied) will be considered exempt earnings that can be repatriated to Canada as dividends from exempt surplus without further Canadian taxation.

In short, the rules permit the capital required to operate the foreign operations of a Canadian multinational to be split up in various components and placed in various foreign jurisdictions so as to minimize foreign tax. This rule is essentially an income character preservation rule. Its significance is quite profound for this discussion. It amounts to an implicit determination that for the purposes of the foreign affiliate rules, there are two countries—Canada and everywhere else. As long as income is originally business income, it can be transmitted in the form of property income among affiliates as if they were a single entity or a consolidated group from the standpoint of determining when foreign income is taxable in Canada. The essence of paragraph 95(2)(a), by itself and in combination with section 17 and subsection 15(2) and its supporting rules, is to allow Canadian companies to separate and capitalize their foreign operations in a way that excludes their foreign business income from Canadian taxation. This may entail more or less "plumbing," but in principle the plumbing is consistent with the underlying tax policy expectations of the Canadian system.

Bringing the Two Regimes Together

As noted, the two regimes are complementary. Through the exceptions to section 17, Canada forgoes the taxation of financing income associated with the capital needed to finance a foreign active business. By using paragraph 95(2)(a) and the other elements of the foreign affiliate regime, Canadian multinationals are able to minimize the foreign tax associated with that financing income. The issue advanced in chapter 8 of the panel's report is simply to achieve that same result without having to force Canadian multinational companies to set up and maintain foreign financing companies. In simple terms, this outcome can be achieved by offering a low Canadian tax rate on the foreign financing income. The reasons for doing so have a significant practical dimension—namely, to simplify what is currently achievable under the existing system. The reasons for not doing so are numerous and a little more complicated.

A basic principle of tax policy and international tax policy is that a deductible payment in one jurisdiction should give rise to income of the recipient in the other jurisdiction. A system that all but exempts the financing income in the recipient country is contrary to this traditional principle and will attract the attention of other jurisdictions. On the other hand, this principle is not necessarily implemented in other well-known circumstances: for example, if a country's thin capitalization rules apply to deny an interest deduction, it is not likely that the

recipient's country will then exempt the income from taxation. This of course takes into account some quite difficult tax policy territory. As many countries have realized for some time, serious questions arise about whether a quid pro quo of an exemption or territorial system is a prescription to ensure the purity, and the separate measurement, of foreign and domestic income, and in particular to limit the circumstances in which deductions connected to foreign income have the effect of reducing domestic income and the resulting tax. On the other hand, there are significant economic questions that may nevertheless explain and defend such an imbalance if the effect is to support, through tax expenditures, Canadian taxpayers engaged in global economic activity that ultimately enriches the Canadian economy.

A compelling reason to study the taxation of other forms of returns generated by foreign affiliates and the taxation of returns earned directly by Canadian companies from foreign sources, therefore, is to assess how Canada's international tax system can enhance existing (federal and provincial) government programs to spur greater investment in innovation through the development, for example, of centres of excellence in Canada, particularly in the information, technology, and other knowledge-based industries.[57]

Why Do We Care About Reconditioning Our International Tax Rules? How Does This Affect Us at Home? Should We Go Further?

Taxation is not an end in itself. It funds public consumption of public goods; it shapes and influences economic choices to implement government economic planning; and, in the international arena, it assists in marking the boundaries of a country's economic and fiscal interest in relation to its peers. Accordingly, with the work of the panel concerning Canada's existing system for taxing international business income well understood, we can concentrate on why the panel's recommendations are important to the achievement of larger economic goals for Canada, and with this examination in play we can ask whether the boundaries that are generally accepted for this analysis are too limited and in fact too limiting for Canada's fiscal and economic prospects and possibilities.

"Why Not Kenora?" Beyond the Tax Rules: A Model for Taxing Mobile International Income

The panel's report goes some distance to recommend a more or less complete separation of domestic and foreign business income through what amounts to a more complete and internally coherent territorial system for taxing international business income. But even with the implementation of the panel's recommendations, the Canadian system for taxing international business income will remain legislatively and administratively complex.

If Canada has already excluded foreign business income from its tax base, and if there is an observable incentive, even a push, to relocate outside Canada even more income-earning activities that make few practical or functional demands on the physical and legal infrastructure of their destinations, are we not better off modifying the domestic taxation of those activities in a way that stems their migration and even reverses the flow?

Simply put, if we have already conceded the taxation of foreign business income through the exemption aspect of the foreign affiliate regime and the practical implications of taxable surplus that is rarely repatriated as such, is the system—that is, the tax system and the economy more broadly—not presumptively better off if it adopts tax incentives of the sort offered by other jurisdictions to attract this activity? Would we not generate tax, even at more modest rates, when otherwise there would be none by encouraging the income-producing activity, which our present system assists to migrate elsewhere, to come home? Would we not, effectively, transform the offshore into the onshore by creating niches within our tax system that offer much the same tax advantage without the complexity and administrative difficulties, for taxpayers and tax authorities, of organizing those activities outside Canada? Can this be accomplished on a principled basis, without encouraging or falling prey to a race-to-the-bottom mentality?

These questions are, in a manner of speaking, the same questions explored by the panel. We ask them a little differently, but the same policy constraints apply concerning how Canada taxes international income. Accordingly, the answer to all these questions may well be yes.

In fact, to a modest degree, Canadian taxation already has this bent, in the way in which income from international financial centres is taxed under British Columbia, Quebec, and federal regimes. Under those regimes, reduced taxation applies to international financial services income. While the three regimes are not of the same scope, they have the same objective—to retain and encourage the propagation in Canada of highly mobile income-earning activities that could just as well be conducted offshore by Canadians and in any event would otherwise have no reason to be relocated to Canada by non-resident service providers.

The implications of this approach affect both the outbound and inbound scenarios investigated by the panel. That is, Canadian residents and non-residents should be treated equivalently, as the panel notes, with respect to similar income-earning activities. However, through a suitable regime, it is possible to respect that limitation and at the same time offer a business experience in Canada that is sufficiently tax-neutral with traditional offshore analogues that not only would Canadian business opportunities remain in Canada but Canada would become a business destination for non-residents. Moreover, despite the tax preferences that might be offered to the direct activity, a carefully conceived incentive would lead to collateral economic activity that would contribute in the normal way to the tax base—activity associated with robust community services and spinoff business activity that relies on the primary business (in this example, financial services) to exist.

Rethinking Our International Rules: What Sparks Our Interest?

As we noted at the outset, the mobility of income and the activities necessary (or not) to earn it test the adequacy of traditional tax policy parameters and their incorporation in the design of a tax system. Financial income is a case in point. It is highly mobile, and it arises from service activities that in many respects can be performed anywhere—and, electronically, possibly nowhere, according to the jurisdictional tests typically adopted by tax systems. The same could be said for the exploitation, if not the development, of various types of intellectual property—so-called hard and soft intangibles—whether or not legally protectable, and which taxpayers are acknowledged less and less guardedly by tax authorities to be primary value-added drivers within corporate groups.

Be that as it may, transmissions of financial services and knowledge are hard to track and measure, and may be difficult to express in terms of typical objects of taxation and taxable triggers or events. Because of their mobility and, possibly, the few demands placed by the relevant activities on local infrastructure, there is much—even undue—effort directed to securing preferred taxation offshore, and presumably a great deal of effort on the part of tax administrations to try to track this income and determine whether the planning objectives have been achieved.

But is there a way to tax this income that offers much the same advantages as foreign planning—or results in any event in tax reductions that are inevitable if the activities occur outside Canada in foreign affiliates? If so, can the same considerations be the basis of preferring how non-residents engaged in equivalent activities in Canada would be taxed?

What Is "Offshore"? Can "Offshore" Be "Onshore"?

We are inclined, when we speak in tax policy terms, to think of "offshore" as somewhere else. The panel's report reflects a sensitivity to the possible desirability of more entrenched and thorough territorial taxation of business income earned outside Canada. This approach, of course, assumes that offshore business income is defined geographically rather than by its economic characteristics and its connection to other economic objectives, albeit within the basic tax policy paradigm for taxing international income.

But a fundamental rethinking of how to tax mobile international income invites us to think beyond the accepted parameters. Offshore is somewhere else, but not necessarily anywhere else. If we shed the geographic connotations of the terms and think of them as conceptual pockets within the tax regime for taxing particular kinds of income from particular kinds of activities, then "offshore" and "somewhere else" can mean another place, conceptually within—an exception to the usual rules found in—the prevailing tax system.

In that context, offshore income is tax-preferred income that arises from business activities conducted in or having a close nexus with somewhere else.

When international influences affect how income is earned, where it can be earned, and how mobile it is, exceptions setting out the manner and degree for taxing domestic income are warranted. Indeed, these exceptions may be the basis for opportunities to increase both the tax base and the scope of domestic economic activity supporting it. More simply put, what can we buy for the economy with the tax we give up?

This is an easier question to ask and answer, perhaps, if we have already given up the tax bases, in the form of exempt surplus or taxable surplus that is rarely if ever distributed, without anticipating how to get anything in return except possibly increased capital value of ownership interests in Canadian enterprises. But even if this is the case, there is no incentive for similarly situated non-residents to relocate activities to Canada.

An important premise of this tax policy inquiry is why business opportunities and the resulting income would migrate offshore—or, if they are already there, why they would not be redirected to Canada. Unique business inputs and a hospitable legal, regulatory, and commercial environment—which might mean simply that these are not impediments to business—typically would be cited. So would lower-cost taxation. These are the sorts of things that might cause "onshore" to be "offshore" as a practical matter.

But what would be the cost of inverting our thinking to transform the offshore opportunity into one that is onshore for Canadian residents and non-residents alike? If Canada has already ceded the tax base associated with this activity through the foreign affiliate regime, and if it has no claim to activities at present undertaken by non-residents, the tax cost of simply migrating the activity to Canada without material taxation might be quite modest. That of course is an oversimplification, but there are likely economic rents associated with the activity that Canadian taxation might capture in other ways, through modest taxation of the activity itself consistent with bearing relevant public infrastructure costs that support the activity and taxing derivative income through supporting commercial activities that constitute the ordinary trappings of community services.

This outlook seems to offer a plausible basis for further inquiry, and in principle seemingly could operate within the same tax expectations that underlie the foreign affiliate rules.

Canadian Business and Tax Policy Intersect: This Is a Worthy Objective

Business and tax policy cases can be made for asking, "Why not Kenora?" The work of the panel and of the separate Competition Policy Review Panel (CPRP) reveals an underlying sensitivity to this way of looking at how to enhance Canada's competitive edge without an unprincipled sacrifice of the tax base or the adoption of other than self-interested tax and economic policy. In its October 2007 consultation paper, the CPRP offered this observation:

> [T]he goal for Canada should be to make this country the location of choice for the higher-value elements of . . . global value chains—whether led by Canadian firms or as part of others' supply chains—as higher-value productive activity translates into higher wages and salaries, more occupational choice and a better quality of life for Canadians.[58]

In its final report, the CPRP connected objectives such as this to the tax system and, perhaps, an approach to tax policy extending beyond the usual or accepted parameters:

> Tax policy involves more than deciding how much revenue must be raised. An equally important policy issue is the design of a scheme of taxation and its impact on individual and corporate incentives and behaviour.[59]

Almost as if there were a passing of the baton (though of course its report was the product of entirely independent thinking), the panel expressed similar sensitivities in language more closely aligned with tax regulation. In the context of its exploration of the limits of territorial taxation, the panel addressed what might be perceived as legal-entity or jurisdictional expectations of tax systems that are not functionally aligned with how business is conducted, with the result that desirable economic activity in the overall interest of both the economy and the tax system might be frustrated by artificial limitations. For example, the panel observed in its final report:

> [C]ertain of Canada's base erosion rules prevent Canadian businesses from effectively managing their global supply chains. . . . Businesses seek the best location to undertake each activity, whether design, engineering, manufacturing, marketing or after-sales service. . . .
>
> Under global supply chain management, Canadian businesses can take advantage of cost savings associated with outsourcing and manufacturing abroad through foreign affiliates to enable them to compete more effectively globally. . . .
>
> The Panel believes that Canada's base erosion rules and the "investment business" definition should not target income arising from activities that are carried out for bona fide business reasons, enhance the competitiveness of Canadian companies in the global market place and do not aim to erode the Canadian tax base. . . .
>
> [T]he Panel believes that the base erosion rules (and the rules regarding the sales of goods and services between foreign affiliates carrying on active businesses) are not appropriate to the extent they impede the efficient business operations of Canadian companies.[60]

In short, the question is whether Canadian businesses can operate on a global basis from Canada in a way that corresponds to how integrated multinational business is actually organized and conducted on functional lines, but with many of the same tax consequences of operating offshore. Can they retain many if not

most of the tax benefits associated with relocating activities outside Canada and going to the lengths necessary to avoid the pitfalls of too great a Canadian contribution, as the foreign affiliate rules now contemplate that they must, without overall disadvantage to the Canadian tax system in terms of either its underlying principles or the resulting tax revenue?

An Approach: Developing a Model

It is helpful to postulate a model to make these tax and economic policy questions more concrete. Conceptually, one can think of this model as Canadian residents and non-residents alike "outsourcing" to Canada business activities that would or could be conducted elsewhere.

It becomes quickly apparent that to a large extent, through the labyrinth of the foreign affiliate regime that hybridizes exemptions and credit devices effectively to avoid taxation of foreign business income, many of the results of the model are already present in the tax system, albeit at considerable administrative cost and with limitations on the way in which business would more naturally be conducted that may not be warranted by the actual resulting tax, if any. If anything, the increasing disconnection of relief from Canadian taxation from the expectation that income is taxed elsewhere, reflected in collateral effects of the new TIEA regime and the repeal of section 18.2, invite the question whether there is only a pretence in the Canadian tax system of taxing offshore business income or whether Canada has already substantially abdicated this tax claim—so that in effect there is little to lose and possibly much to gain by developing the model.

The Model

The main elements of the model are simple.

1) Identify "mobile business activities" and "mobile income" whose connections to any jurisdiction are hard to discern or assert using the normative tests of tax liability and tax jurisdiction and in which, in one manner or other through tax planning, Canadian business now engages or can be expected to engage. As we have noted, financial services, financing, and the development and deployment of knowledge intangibles are cases in point.
2) Evaluate the extent to which, properly planned, these activities can be "exported" within the foreign affiliate system to result in little if any Canadian tax ever, or at least foreseeably. It is evident that much of the discussion concerning international tax avoidance, both generally and, increasingly, in a transfer-pricing context, is associated with these activities. Correspondingly, these are the kinds of activities that test the practical limits of income source, the quality of business presence (including residence) required by a foreign affiliate to sustain exempt or at least deferred taxation, and the allocation rules that are the framework for tax treaties. One can reasonably

question whether the complexity of tax administration and the demands (and workability and sustainability) of highly structured tax planning, which may not align easily with the natural demands of business, are justified to protect a tax base that is practically non-existent.

3) Modify the taxation of business activities that are collateral to or required by Canadian business and would otherwise be organized in a foreign affiliate group to take place offshore. Such modifications can include selective tax rate reductions or other forms of moderated taxation to act as an incentive to this kind of business being conducted in Canada and in particular regions. Canada is not unaccustomed to using tax rules this way—for example, to attract and increase the intensity of certain research and development activities, both qualitatively and regionally. A premise of this model is that the activity can take place anywhere, with little need for an immediate physical infrastructure; thus, the model may present opportunities for economic development in Canada outside major population and business centres.

Testing the Model: Tax and Economic Questions

The suitability of this approach needs to be evaluated with various threshold tax and economic policy considerations in mind. In some respects, the utility of the analysis is to highlight how difficult, and ultimately unproductive in tax policy or administration terms, it may be to persevere with a system that captures certain offshore income only through contentious jurisdictional or tax-avoidance analysis, and possibly only by succumbing to pitfalls within the current system, associated, for example, with difficult and in some respects indefinite base erosion limitations, which otherwise implies that Canadian tax on the subject income may legitimately be avoided. Also pertinent to this aspect of the evaluation is whether difficult analysis can be avoided by adopting a special tax regime for certain income that could be well enough defined to eliminate the need for confronting international tax jurisdiction and transfer-pricing questions that otherwise would be difficult to resolve but ultimately might be resolved to no materially different end.

The kinds of questions that would ground an inquiry into this model include the following.

1) Will business that would not otherwise be conducted in Canada be relocated here? Answering this question invokes an analysis, in this context, of what constitutes "carrying on business in Canada" and whether the manner in which this will or can otherwise take place, possibly electronically, will give rise to a Canadian permanent establishment. These issues affect both non-residents that are contemplating the pursuit of business in Canada and Canadian multinationals that are trying to gauge the sustainability of their foreign affiliate business and its connections to Canadian group members.

2) Is this a tax base that would not otherwise be here? Whether and how income is taxable is affected by its geographic and qualitative source, and by its attribution to particular presences or loci of operation within a corporate group, in many cases using transfer-pricing considerations. A collateral but relevant question concerns the significance, generally, of corporate tax except as an anti-deferral device. In addition to the arguments advanced about why the model may not sacrifice tax base by adopting a moderate rate of tax for income not otherwise subject to tax is the more fundamental argument that in any event the corporate tax is more of a backup withholding charge than it is a tax. This affects the evaluation of what is given up by not taxing income that in any event may not be taxable. Much offshore planning is dictated by self-help to design customized low effective tax rates. If those rates were available more directly for income that is clearly generated outside Canada, there might be less interest in international structuring, which is often difficult to implement and maintain commercially and difficult to police for tax administrations.
3) To what extent does the Canadian tax system already tolerate a significant measure of base erosion or, to put it more broadly, the export of capital to fund the earning of exempt or long-tax-deferred business income? The Act reflects strong tendencies to allow Canadian taxpayers to export their income-earning potential and the income arising from it. These tendencies are reflected, for example, in the exceptions to subsections 15(2) and 17(1) and (2); subsection 247(7) and proposed subsection 247(7.1); the collateral application of the TIEA regime as a treaty substitute for defining "exempt surplus"; and the repeal of section 18.2. By the same token, however, there are base erosion rules in paragraphs 95(2)(a.1) to (a.4) that create tension with the natural conduct of multinational business and can result in naturally occurring foreign income that is properly transfer-priced according to Canadian tax standards nevertheless being taxed as investment income. As the architecture of the foreign affiliate system and other salient aspects of the Act already demonstrate, genuine offshore business is not to be taxed in Canada and will not be taxed, except possibly by misadventure; therefore, the adoption of the model may give up little while being faithful to the basic tenets of how offshore income is meant to be taxed.
4) Is some tax better than no tax? In principle, any tax on income that has not been earned in Canada or that arises from activity that would not have been conducted in Canada or by Canadians is "found" tax. That is, once Canada has conceded the tax base (to the extent that it would otherwise be present, in the case of non-residents that may not otherwise conduct business in Canada) by exempting or deferring it using the foreign affiliate regime, by attaching no tax-avoidance significance to incorporating what could otherwise be a branch, and by disconnecting Canadian tax relief from any expectation that the affected income is taxable elsewhere, there is little to be lost and possibly much to be gained by incorporating a pseudo-offshore tax regime as part of the Canadian domestic system.

5) Are there collateral benefits if activity that would not otherwise be in Canada is located here? It may be inevitable, but in any event it can be made a condition of the model, that collateral economic activity must arise from support for tax preferences to attract certain kinds of economic activity in and to Canada. This condition has two principal aspects. First, the tax-preferred activity can be defined to require a certain measure of commercial presence or intensity in Canada. Second, and particularly if that were the case, it can be expected that those engaged in the activity will stimulate economic development in the centre where the activity takes place, producing income that is not tax-preferred.
6) What is the fundamental economic and tax policy question? In effect, the foreign affiliate regime's treatment of business income has effects similar to those of a subsidy. It reflects an implicit decision that the tax cost of not taxing offshore business income is compensated for by measures of economic advantage that are not merely speculative or conceptual associated with the prosperity of Canadian businesses as contributors to the Canadian economy. International tax accommodations always reflect this sort of domestic tax and economic policy calculus. In exchanges with other jurisdictions—for example, through tax treaties and the normative concessions found in direct foreign tax credit rules—a manner of reciprocity in the commercial interests of each is expressed through tax rules. In this case, the question might be framed as follows: Does the present value of the expected benefit of tax-preferring certain kinds of business activity, taking into account simplified and more transparent tax administration, exceed the present value of the expected forgone tax? Another way of stating the question as a proposition is that an approach conforming to the model may simply internalize in Canada, with possibly positive economic spillover effects, a subsidy that is already present in the foreign affiliate rules even if it is not readily apparent or commonly understood as such. From a business point of view, the question might be asked: Is there a hurdle or breakeven point at which incremental tax will or will not be seen as a cost that pushes economic activity elsewhere?
7) To what extent will trade regulation affect the adoption of the model? The model makes it more apparent that certain tax accommodations already found in the foreign affiliate regime function in a way similar to subsidies. Historically, this has been a point of debate, expressed in terms of whether an expectation of earning exempt surplus is that the income will be taxed elsewhere according to a tax regime that is comparatively as robust as Canada's, or whether this concession was meant to give Canadian enterprise a competitive boost internationally and encourage other countries to conclude tax treaties with Canada. That debate now seems muted by the functional equivalence of a tax treaty and a TIEA in this context. Nevertheless, a serious analysis of the model must take into account whether extending the approach found to encourage financial centres in certain parts of Canada will raise trade issues that will have to be accommodated by the

design and implementation of the model. That said, the observations of the panel and the CPRP referred to earlier seem to reflect the desirability of this kind of support for Canadian business and for non-residents that might be encouraged to locate high-value-added economic activity in Canada.

8) Can distortions or imbalances among provinces or regions be avoided? The model envisages the creation of zones of economic activity within Canada, possibly (though not necessarily) where certain activity already occurs. An important question is whether adoption of the model will cause shifts within Canada of activities already occurring here, or whether it is more likely to attract new productive activity. The arguments in favour of the model are likely easier to sustain in the latter case.

In the Laboratory: International Financial Centres In British Columbia and Quebec

Canada's experience with international financial centres supplies a useful context in which to test the "Why not Kenora?" proposition. What are the characteristics of a place as an attractive centre for mobile financial service activity? (We know that the same question, with similar answers, could be put for other kinds of mobile business activity.) The answers include low local tax rates; competent support services; accommodations to intragroup financing for a taxpayer's corporate group; limited, if any, further Canadian tax (that is, a composite all-in low effective rate of tax); accommodation of corporate, commercial, and other law; and ways to avoid multiple taxation of the earned income.

Tax systems also have interests in this sort of activity, manifest, for example, in the continuing interest of the OECD through the Global Tax Forum and initiatives to combat harmful tax practices. These include transparency, facilitating colourable tax and general financial practices through limitations on the availability of information coupled with marginal taxation, adviser accountability, and financial institution accountability.

Finally, particularly with the viability of the model as a component of the Canadian tax system in mind, there must be meaningful commercial activity in Canada and, consistent with the proposition that positive economic spillover effects can reasonably be anticipated, activity of a sort conducive to maintaining communities and a tax base greater than that provided by a tax-preferred financial centre.

Other presentations at the 2009 annual conference[61] explain British Columbia and Quebec[62] international financial centres in detail. It is interesting to notice some of the salient characteristics of the international financial centre regimes in both of those provinces in light of this discussion. Both regimes anticipate, and indeed require, the active conduct of meaningful commercial activity in the province, effectively engendering economic activity that might not otherwise occur and spinoff activity that, unlike the income arising from the financial

centre activity itself, is fully taxable. Effectively, for the activities contemplated to benefit, what amounts to an "offshore" within the "onshore" is created. In some respects that are relevant to foreign affiliates under the prevailing rules, the British Columbia regime seems to envisage a wide scope of benefited activities that include—in addition to services associated with leasing, management, film distribution, captive insurance, and patent protection for life sciences and green power generation—activities associated with intracorporate group financing through various kinds of financial activity. The Quebec approach is to allow financial transactions to be drawn from a menu of qualified transactions (including securities transactions, loans, treasury and fund management, and leasing and factoring), both inbound and outbound but requiring a meaningful business (decision-making) presence in Montreal.[63]

The British Columbia and Quebec approaches have common elements pertinent to this discussion. First, they foresee—indeed, they require explicitly and, it seems, by force of circumstances—a meaningful level of real local business activity with measurable levels of commercial presence in terms of employees and decision making. Second, financial activity can include a range of activities not restricted to a financing aspect and, at least in British Columbia, can accommodate intragroup financing. Notably, the kinds of services contemplated by these regimes are the sorts of services that in one manner of another might exist in the context, for example, of subparagraphs 95(2)(a)(i) and (ii), and that need to be monitored regardless of their primary if not their exclusive connection to international business according to paragraphs 95(2)(a.1)-(a.4) and 95(2)(b), modified by subsection 95(3). Nevertheless, the qualitative compatibility of what these centres can do and what, typically, Canadian-owned multinational groups need to have done (and with care can arrange to have their foreign groups do) is striking.

It is worth observing at this juncture that highly mobile and in some cases very valuable activities (those associated with knowledge intangibles) will migrate, or seek to migrate, to the least-cost destination. In any event, international business organizations require holding-company and similar regimes to facilitate business organization. There is some attraction, other things considered, to locating in a jurisdiction that facilitates these objectives using familiar legal and commercial resources. Finally, with a system perspective in mind, the activities encouraged and supported by these provincial regimes are the kinds of activities that can take place anywhere commercially, even within Canada; their location, however, is evidently directed by fiscal considerations.

So Why Not Kenora?

The Canadian tax system already reflects a high degree of territoriality in the taxation of international business income. The panel recommended that this territoriality increase and be made more explicit and simpler to administer.

Multinational corporate groups, operating fully within the expectations of the tax system, can and do structure themselves to displace service, financial,

and knowledge-based activity from Canada, though this kind of planning presents material initial and ongoing transaction costs; risks exposure to the effects of certain base erosion rules that possibly, in principle, should not apply; and introduces material compliance responsibilities for taxpayers and tax administrators. All in all, though, through artful planning invited by the law, both through the foreign affiliate system and inbound through careful definition of Canadian income sources in relation to whether and to what extent a permanent establishment exists, corporate groups can engage in substantial internal service and related activities.

The question, then, is posed: Should Canada facilitate the migration to Canada of stateless income, which in any event is likely not to be taxed, by limiting the tax on this income to the degree that makes arranging to avoid the tax not economic? Should Canada create its own "islands" to accept the internal location of service, financial, and knowledge activities, which in any event exist within multinational corporate groups and are sought to be accommodated by complex planning? Should the force of the panel's recommendations be the point of departure for bringing offshore onshore?

Income arising from financial and related service transactions, and the development and deployment of knowledge, can occur anywhere, and often if not usually will be arranged to be earned legitimately beyond the reach of Canadian taxation. Accordingly, does it make sense to spend tax, which otherwise is not going to be collected, to encourage the relocation of such activities to Canada, possibly in tax-preferred zones, in order to achieve (among other things) collateral economic benefits? In other words, is there a reasonable case to be made that moderating corporate tax rates selectively for income that by its nature is so mobile that it is at home anywhere is sound tax policy, in light of the panel's report and in light of the structural characteristics of the Canadian system that allow the export of Canadian income through Canadian taxpayers' capitalization of foreign affiliates?

A Case in Point: The Innovation Challenge

A compelling reason to consider our proposed model is to assess how Canada's international tax system could enhance existing (federal and provincial) government programs to spur greater investment in innovation through the development, for example, of centres of excellence in Canada, particularly in the information, technology, and other knowledge-based industries.[64]

It is accepted that innovation resulting from research and development (R & D) spending will lead to the development of new technologies and products, improved productivity, and an increase in Canada's ability to compete in global markets. Nevertheless, there is a concern that Canada's current investment in R & D is not adequate and, as a result, Canada is not developing new technologies and products at the level necessary for it to be competitive globally.

The CPRP acknowledged that "Canada is near the top of the OECD in public research funding for R & D"[65] and that it is recognized as having one of the world's most favourable tax regimes to promote R & D, with the federal government

alone providing approximately $4 billion in tax assistance each year. "But with respect to private investment in R & D, Canada ranks only 15th out of 30 OECD countries in terms of business expenditures on research and development . . . although the heavy weighting of resource industries in Canada's economy affects our ranking."[66]

It is unlikely that the federal and provincial governments have the financial ability, in the current economic environment, to substantially increase the current level of tax assistance to spur higher levels of R & D activity in Canada. In any event, it is not clear whether additional assistance—for example, by way of accelerated tax deductions or enhanced investment tax credits—would have a substantial incremental effect, particularly if increasing the level of R & D that companies undertake in Canada means reducing the R & D activity they undertake in other countries, which, while perhaps not providing the same level of R & D assistance offered by the Canadian governments, may provide a more favourable tax regime for commercializing the results of such activity.[67]

Non-tax factors and domestic policies have a significant influence on investment decisions. Also important are rates of tax imposed on profits derived from investment decisions, particularly where an investment is in respect of a highly mobile activity such as the ownership and licensing of intellectual property (IP). Accordingly, the solution to Canada's not generating sufficient R & D activity may lie in a re-examination of its taxation policies with respect to the exploitation or commercialization of the results of R & D conducted in Canada.

In other words, could R & D activity in Canada be increased if the tax system encouraged increased commercialization *from within Canada* of IP developed and owned in Canada by imposing a significantly lower rate of Canadian income tax on royalties and licensing fees earned from outside Canada and on gains realized from the disposition of the IP? Should the tax system also encourage Canadian companies, which have acquired IP outside Canada, to migrate the acquired IP to Canada for further development in Canada and to commercialize it from within Canada?[68]

It is uncertain how much tax revenue Canada would lose by significantly reducing the rate of tax levied on IP developed and owned in Canada and licensed to non-residents.[69] However, the revenue loss would be offset by tax revenues generated from the increase in the tax base that should arise as a result of lowering the tax rate. It is logical to anticipate that the corporate tax base could and indeed should increase. We can foresee several broad developments:

1) Increased R & D in Canada, leading to the development and licensing of more IP from Canada than would otherwise occur.[70]
2) The migration into Canada of IP purchased and currently owned outside Canada for further development in and commercialization from within Canada.[71]
3) Canadian companies deciding not to sell or migrate IP developed in Canada to foreign affiliates for licensing to other affiliates or to third parties.[72]

More importantly, increased R & D and commercialization activity in Canada should enhance Canada's ability to create more centres of excellence[73] and supporting infrastructures, thereby allowing Canada to reap greater economic rewards than would otherwise be the case. Among other things, there should be an increase in other tax bases—personal, consumption, and property. It should also enhance Canada's ability to retain and attract highly skilled workers such as scientists and engineers.[74]

What Are Other Countries Doing?

The OECD recently reported that with increased tax competition, countries are looking beyond lower corporate tax rates to encourage investment and are increasingly turning to targeted tax incentives. This is particularly so with respect to highly mobile activities, such as those giving rise to royalty income.

> Rather than reducing the burden of tax provisions of general application, certain countries prefer to explicitly target tax relief with the aim of encouraging additional [foreign direct investment] at a lower cost in terms of foregone tax revenue. Targeting mobile activities . . . is regarded by some policy makers as an attractive option. In considering reductions in the effective tax rate on the most mobile elements of the tax base, the tax treatment of interest and royalty income is increasingly under review, with some countries indicating the dependence of their future policy actions on the actions of others. . . .
>
> While some countries have so far resisted extending deferral and enabling conversion of normally taxable foreign income into tax free surplus for certain mobile activity, there are indications that policy considerations including the mobility of capital and business calls for more lenient home country treatment are leading many if not most countries towards more lenient treatment, not less, across a broader set of income types, because other countries are doing the same.[75]

There have been several recent developments in other countries regarding the tax treatment of royalties and other fees earned from the licensing of IP owned and developed in the particular country that serve as a useful reference for Canada. A brief summary of these developments follows.

1) *United Kingdom*. In its April 2010 budget, the government stated its intention to propose the creation of a "patent box" whereby income derived from the licensing of patents after April 2013 would be subject to a corporate tax rate of only 10 percent in respect of patents registered after the legislation is enacted. This proposal is intended to strengthen the incentive to invest in innovative industries and ensure that the United Kingdom remains an attractive location for innovation. The government intends to consult with business in time for the 2011 finance bill on the detailed design of the patent box.

2) *France*. Income from patents, including capital gains derived from the sale of patents (other than gains derived from sales to resident and non-resident French affiliates) is subject to tax at a reduced rate of 15 percent, provided that the IP has been owned for at least two years (the holding period is not applicable if the IP has been developed by the French company or branch). The regular French corporate tax rate is approximately 34 percent. Expenses of total development costs are deductible at the normal statutory rate of approximately 34 percent.
3) *Netherlands*. In an effort to stimulate innovation and to enhance its reputation as a hub for technological development, the government in 2007 introduced a tax incentive package, known as the "innovation box," under which income from IP owned in the Netherlands was taxable at a rate of 10 percent (subject to certain limitations). In January 2008, the package was broadened to include a wider range of qualifying activities, but the relief was capped at four times total development costs. Beginning in 2010, the cap for maximum benefits was removed and the tax rate on income derived from qualifying, newly developed IP reduced to 5 percent.
4) *Belgium*. In 2007, the government introduced its "patent income deduction" (PID) regime. The PID regime is intended to increase patent development and ownership through Belgian-based companies or branches. The regime provides for an additional tax deduction calculated as 80 percent of the qualifying gross patent income, thereby reducing the effective tax burden on patent income to just under 7 percent, given the current Belgian statutory corporate tax rate of approximately 34 percent. All R & D-related expenses remain fully deductible, making the effective tax rate even lower. The PID is available not only on the licensing of patents to related and unrelated parties but also on patent income embedded in the price of products sold and services rendered.
5) *Luxembourg*. A new tax regime was introduced in 2008 with respect to certain types of protected IP (patents, domain names, software subject to copyrights, trademarks, designs, and models) developed or acquired after December 31, 2007 by a Luxembourg company from a person that is not a 10 percent directly related entity. This regime provides for an exemption of 80 percent of the net income derived from the licensing (and disposition) of such IP, resulting in an effective tax rate of just under 6 percent on net income and gains derived from such IP. The new tax regime also provides for a 100 percent net wealth tax exemption.

In addition, a number of countries, including those named above, have generous amortization policies for acquired IP. For example, Ireland permits a deduction for acquired patents and registered designs, trademarks and brand names, know-how, domain names, copyrights, etc. over a 15-year period or, alternatively, over the period amortized for accounting purposes.[76]

From Here to There and Back Again: A Concluding Comment

Canada's system for taxing international business income has been more or less territorial since its inception—not merely in its modern incarnation from 1976, but right back to the beginning of income taxation in Canada shortly after the enactment of the original Income War Tax Act.[77] The fact is that Canada does not tax international business income to any material degree, no matter where it is earned. As a result of recent changes to the law concerning TIEAs, this outcome will become more fully entrenched. And if the panel's recommendations find their way into the law, the territorial element of our tax system will be even more pronounced. But we will still have a geographically foreign element, and the tax administration burden that goes with keeping track of it. We ask whether there is another way—one that mitigates the pressures presented by Canadian domestic base erosion in favour of offshore jurisdictions whose economic activity in response to Canadian investment does not have a direct or immediate effect on Canadian prosperity. We ask, "Why not Kenora?"

We imagine "Kenora" to be the manifestation of any "offshore" place that otherwise attracts, with incentives that the Canadian tax system actually offers, the export of Canadian economic activity. We imagine that if that activity took place here, it would require and give rise to a measure of economic infrastructure that would enrich Canadian communities and the Canadian economy generally. We do not know with certainty whether this model will make sense after being subjected to fiscal and economic policy scrutiny, though our prediction is that it might. In any event, the stakes are too high not to give it some attention because we believe that the panel's recommendations should inspire us to take the next steps in re-evaluating Canada's system for taxing international business income.

Notes

1 See Organisation for Economic Co-operation and Development, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, July 2008), and *Discussion Draft on a New Article 7 (Business Profits) of the OECD Model Tax Convention* (Paris: OECD, July 2008). On July 22, 2010, the OECD released updates to the OECD model income tax convention, which include changes to article 7 and the related commentary: *The 2010 OECD Update to the Model Tax Convention* (Paris: OECD, July 22, 2010).

2 Organisation for Economic Co-operation and Development, *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* (Paris: OECD, September 2008). On July 22, 2010, the OECD released its final statement on business restructuring in the form of a new chapter IX of the transfer-pricing guidelines: *Report on the Transfer Pricing Aspects of Business Restructurings: Chapter IX of the Transfer Pricing Guidelines* (Paris: OECD, July 22, 2010).

3 Organisation for Economic Co-operation and Development, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (Paris: OECD, September 2009). On July 22, 2010, the OECD released the final revisions to chapters I-III of the transfer-pricing guidelines: *Review of*

Comparability and Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines (Paris: OECD, July 22, 2010).

4 See H. David Rosenbloom, "Why Not Des Moines? A Fresh Entry in the Subpart F Debate" (2003) vol. 32, no. 10 *Tax Notes International* 895-98.

5 See Canada, Department of Finance, "Government Establishes Advisory Panel on Canada's System of International Taxation," *News Release* 2007-092, November 30, 2007, and "Finance Minister Finalizes Advisory Panel on Canada's System of International Taxation," *News Release* 2007-097, December 11, 2007. For additional discussion on the panel's mandate and background, see Nick Pantaleo, "Advisory Panel on Canada's System of International Taxation Final Report: Enhancing Canada's International Tax Advantage (A Panel Member's Perspective)," in *2009 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2009), tab 4.

6 Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's Competitive Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: Department of Finance, April 2008). For a commentary on the panel's consultative paper, see Nathan Boidman, "Reforming Canada's International Tax: An Interim Report" (2008) vol. 50, no. 7 *Tax Notes International* 613-26.

7 Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's Competitive Tax Advantage* (Ottawa: Department of Finance, December 2008). For a review and discussion of the panel's final report, see Pantaleo, supra note 5; Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 1" (2009) vol. 53, no. 3 *Tax Notes International* 247-60 and ". . . Part 2" (2009) vol. 53, no. 4 *Tax Notes International* 345-60; Brian J. Arnold, "Critique of the Report of the Advisory Panel on Canada's International Tax System" (2009) vol. 63, no. 8/9 *Bulletin for International Taxation* 349-56; and Wallace G. Conway, Brian Mustard, and Nick Pantaleo, "Enhancing Canada's International Tax Advantage—Final Report of the Advisory Panel on Canada's System of International Taxation" (2009) vol. 63, no. 8/9 *Bulletin for International Taxation* 338-48.

8 *Final Report*, supra note 7, at paragraph 1.12.

9 Ibid., at paragraph 3.31.

10 Ibid., at paragraph 3.3. For a more detailed discussion and analysis of the panel's principles, see Pantaleo, supra note 5.

11 "Foreign affiliate" is defined in subsection 95(1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

12 See paragraph 113(1)(a) and the definitions of "exempt earnings," "exempt surplus," and "designated treaty country" (DTC) in regulations 5907(1) and (11)-(11.2).

13 See paragraph 113(1)(b) and the definitions of "taxable earnings," "taxable surplus," and "underlying foreign tax" in regulation 5907(1).

14 *Final Report*, supra note 7, at paragraph 4.21.

15 Ibid., at paragraphs 4.28-4.32, where the panel notes that 92 percent of all dividends from foreign affiliates are exempt from Canadian tax and the likelihood is that little Canadian tax is paid on all remaining dividends.

16 Ibid., at paragraph 4.33.

17 Ibid., at paragraph 4.40.

18 Ibid. The panel heard that basing the exemption originally on the existence of a tax treaty with the country in which the income was earned was actually an inducement for such countries to enter into a tax treaty with Canada. Given that Canada now has 86 tax treaties, such an inducement no longer seems necessary. See ibid., at paragraph 4.42.

19 For example, Canada entered into a tax treaty with the United Arab Emirates in 2002.

20 As at June 30, 2010, Canada has entered into TIEAs only with the Netherlands Antilles, Bahamas, Bermuda, Cayman Islands, Dominca, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Turks and Caicos. The Department of Finance has announced that Canada has entered into negotiations to sign TIEAs with Anguilla, Aruba, Bahrain, British Virgin Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Liberia, and San Marino. All are jurisdictions that have no corporate income tax system or that have low corporate tax rates.

21 *Final Report*, supra note 7, at paragraphs 4.43-4.44. First, there are a number of countries with which Canada has not entered into either a tax treaty or a TIEA. These include, for example, certain developing countries where Canadian mining and resource companies have significant investments, which are not likely to be candidates for Canada to seek a TIEA, at least in the short term and possibly for a number of years. These companies would be at a competitive disadvantage relative to foreign competitors and other Canadian companies with investments abroad. Second, under the current rules, if Canada does not enter into a TIEA with a country within five years following the initiation of such negotiations, the active business income earned by a foreign affiliate in that country will be deemed to be foreign accrual property income (FAPI). The panel believed this to be an unfair and inappropriate result.

22 Ibid., at paragraph 4.52. See the discussion at paragraphs 4.46-4.51 in support of the panel's conclusion.

23 Ibid., at paragraph 4.53 (emphasis added). In making this statement, the panel chose its description very deliberately. While moving to a full exemption system of taxing foreign active business income would eliminate the need for surplus tracking for foreign affiliate purposes (for example, tracking the flow of tax-exempt dividends between foreign affiliates and to Canadian taxpayers), there would still be an ongoing need for tracking certain tax attributes of foreign affiliates for safe income purposes if Canadian shareholders remained taxable on the disposition of shares of Canadian corporations. This point is discussed in more detail below.

24 See the discussion in Organisation for Economic Co-operation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Studies no. 17 (Paris: OECD, 2008), 103, where it is noted that one OECD country moved to exempt foreign capital gains from tax because of widespread tax planning aimed at claiming foreign capital losses against the domestic tax base while escaping domestic tax on foreign capital gains.

25 Currently, the TCP definition includes shares of corporations resident in Canada, as well as real or immovable property (including Canadian resource property and timber resource property) that is situated in Canada. It also includes certain shares and other interests the value of which is, or was within the previous 60 months, derived principally from such real or immovable property. Gains from dispositions of TCP by non-residents, other than TCP that is real or immovable property or shares that derive their value principally from real or immovable property, are generally exempt under many of Canada's tax treaties.

26 FAPI earned by an affiliate that is a "controlled foreign affiliate" (defined in subsection (95(1)) would still be subject to Canadian income tax on an accrual basis. Although this would likely still require an adjustment to the adjusted cost base (ACB) of the affiliate's shares owned by a Canadian corporation, there would be no need to track such FAPI for foreign affiliate purposes. However, there would be a need to track FAPI of a *non*-"controlled foreign affiliate" if such income is not taxed on an accrual basis. The panel suggested that such income could be taxed on an accrual basis. (See the further discussion below.)

27 Defined in subsection 95(1).

28 Otherwise, to avoid tracking, all gains on the sale of shares of a foreign affiliate by another would have to be taxed on an accrual basis. This would clearly be an undesirable and inappropriate result. Aside from giving rise to the practical difficulty of taxpayers having to determine the value of such shares on an annual basis, it would have a very negative impact on the competitiveness of Canadian companies (see the panel's first principle). A compromise is to provide for

a rollover where the funds received on the sale of the shares of a foreign affiliate are reinvested in another foreign active business or shares of another affiliate within a specific period of time, but this would also require some degree of tracking.

29 For a discussion of this approach, see the paper submitted to the panel by Geoffrey S. Turner, "A Possible Framework for an Expanded Exemption System: A Submission to the Advisory Panel on Canada's System of International Taxation," July 15, 2008 (http://www.apcsit-gcrcfi.ca/05/sbrmms/31%20-%20Turner,%20Geoffrey.pdf).

30 See also the discussion in Brian J. Arnold, *Reforming Canada's International Tax System: Toward Coherence and Simplicity*, Canadian Tax Paper no. 111 (Toronto: Canadian Tax Foundation, 2009), and Canada, Department of Finance, "Government of Canada Releases Draft Foreign Affiliate Proposals," *News Release* 2009-120, December 18, 2009 and the accompanying *Legislative Proposals and Explanatory Notes Relating to the Income Tax Act* (Ottawa: Department of Finance, December 2009).

31 See, for example, proposed paragraphs 95(2)(c.1)-(c.6), (f.3)-(f.94), and (h)-(h.5) in Canada, Department of Finance, *Legislative Proposals and Draft Regulations Relating to Income Tax* (Ottawa: Department of Finance, February 2004) and proposed regulation 5902 in the December 2009 *Legislative Proposals*, supra note 30, which replaces proposed regulation 5902 included in the February 2004 proposals. The panel stated that given its "recommendations to broaden the exemption system for active business income and to exempt capital gains and losses arising on the sale of shares of foreign affiliates that are excluded property, these particular proposed amendments should be abandoned, as there would be no need to compute surplus balances" (*Final Report*, supra note 7, at paragraph B.4). Even if the panel's recommendations are not enacted in whole or in part, these proposed changes would increase the complexity of the foreign affiliate rules and would increase the compliance and administrative burden on taxpayers and the CRA. This would be a significant cost to protect, as the panel noted, very few tax dollars and would be contrary to the principles that the panel articulated, which should guide tax policy makers.

32 In this context, recent efforts by the Department of Finance to amend the surplus rules to prevent the premature realization or duplication of surplus of a foreign affiliate would seem to be appropriate to the extent that the resulting surplus exceeds the accrued gain on the affiliate's shares; ibid.

33 Still another approach is discussed below.

34 See supra note 26.

35 In other words, dividends from a foreign affiliate should increase safe income only to the extent that it exceeds previously taxed FAPI.

36 An alternative, in addition to taxing FAPI realized by a foreign affiliate on an accrual basis, is to determine the FAPI of a foreign affiliate on some mark-to-market basis. Aside from giving rise to regular valuation issues, it would be inappropriate to subject a foreign affiliate to such rules if the Canadian corporation is not itself subject to such rules.

37 Angelo Nikolakakis, "Yes, Virginia . . . Reconciling a Broader Exemption System with Continued Taxation of FAPI and Domestic Gains" *International Tax* no. 45 (Toronto: CCH Canadian, April 2009), 12-15.

38 "Active business assets" is defined in the panel's report as assets used principally to earn income from an active business (*Final Report*, supra note 7, paragraph 4.48). "Principally" is generally recognized as meaning more than 50 percent.

39 "All or substantially all" is interpreted by the CRA as meaning 90 percent or more. However, see, for example, *Wood v. MNR*, 87 DTC 312 (TCC).

40 *Final Report*, supra note 7, at paragraph B.24.

41 Ibid., at paragraphs B.26-B.27.

42 Ibid., at paragraph B.28.

43 Ibid., at paragraph B.29.

44 Ibid., at paragraph 4.58. As the panel noted, the Australian system takes this approach.

45 Ibid., at paragraph 4.56.

46 Ibid., at paragraph 4.99.

47 Ibid., at paragraphs 4.91 and 4.104.

48 Ibid., following paragraph 4.105.

49 See the discussion ibid., at paragraphs 4.100-4.102.

50 Ibid., at paragraphs 4.102, 4.125, and 4.130-4.132. An exemption from FAPI in a high-tax jurisdiction such as the United States, where a number of Canadian corporations have a significant number of foreign affiliates, would also greatly simplify any excluded-property analysis that might need to be performed.

51 Briefly, an "eligible dividend" (defined in subsection 89(1)) paid by a corporation resident in Canada is taxed at a lower rate in an individual's hands and is intended to represent income that was taxed at the higher corporate tax rate (that is, income that was not subject to the small business deduction). A CCPC can pay an eligible dividend only to the extent that it has GRIP, while a non-CCPC can pay an eligible dividend to the extent it has no low rate income pool (LRIP). Both GRIP and LRIP are defined in subsection 89(1).

52 See recommendation 4.7, *Final Report*, supra note 7, following paragraph 4.167, and the discussion at paragraphs 4.139-4.167, ibid.

53 Ibid., at paragraph 8.10.

54 See subsections 17(3) and (8), which provide for the circumstances in which income would not be imputed on a debt owing to a Canadian corporation which carries a rate of interest that is below certain prescribed rates.

55 2002 DTC 6805 (FCA).

56 See paragraph 25 of *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues," October 31, 2003.

57 For a thought-provoking commentary on this topic, see "Submission of the Woodbridge Company Limited to the Advisory Panel on Canada's System of International Taxation," July 22, 2008 (http://www.apcsit-gcrcfi.ca/05/sbrmms/32%20-%20Woodbridge%20Company%20Limited.pdf).

58 Competition Policy Review Panel, *Sharpening Canada's Competitive Edge* (Ottawa: Industry Canada, October 2007), 6.

59 Competition Policy Review Panel, *Compete To Win: Final Report* (Ottawa: Industry Canada, June 2008), 63.

60 *Final Report*, supra note 7, at paragraphs 4.115-4.116, 4.121, and 4.124.

61 See Bruce Flexman, "International Financial Centre British Columbia," and John Rooke, "Montreal's International Financial Services Centre," elsewhere in these proceedings. Originally, this part of our discussion was part of that presentation, but its natural connection to the tax policy discussion inspired by the panel's work supporting those presentations fits more neatly into this paper and accordingly has been relocated. British Columbia has been at the forefront in this regard, and under its International Financial Activity (IFA) program companies carrying on qualifying activities (such as management services, treasury, factoring, patents, financing and insuring activities, property leasing, and film distribution) can earn a full refund of provincial corporate income taxes. Following a recent study, enhancements to the program are expected to position Vancouver as a premier centre in the growing clean technology, green economy, and digital media sectors. A recent study by MMK Consulting examined the impact of the IFA program on British Columbia's economy. Among other findings, the study indicated

that the program generated $3.00 to $4.50 in gross tax revenue for every $1.00 of IFA refund paid. See MMK Consulting, *Review of the British Columbia International Financial Activities Program* (Vancouver: MMK Consulting, April 21, 2009).

Other provinces have also introduced tax incentives to promote greater commercialization of IP. For example:

- Ontario's tax exemption for commercialization program provides a 10-year income tax and corporate minimum tax exemption for qualifying corporations that commercialize certain types of IP (for example, bio-economy, advanced health technology, telecommunications, and computer and digital technologies) developed by qualifying Canadian universities, colleges, or research institutes.
- Quebec's 2009 budget introduced a similar 10-year income tax holiday for eligible corporations that commercialize IP developed by Quebec universities or public research centres.

All provinces (and the federal government) provide various tax incentives for companies engaged in film and video production and those seeking to capitalize on the shift to digital media and to distribution on convergence platforms (that is, home computers, wireless handsets, and television).

62 The 2010 Quebec budget proposes to revamp its international financial centre regime. Specifically, it is proposed that the regime be replaced with a refundable tax credit. It appears that Quebec still intends to encourage and prefer this kind of activity, but is refocusing how it delivers benefits in this area in the contemporary business context. In the 2010 budget documents it is observed: "However, over the same period [the period over which IFCs developed], various factors, in particular regarding information technology, have significantly transformed how things are done in this industry. Accordingly, so that the tax assistance granted to this sector responds adequately to the needs of businesses, the IFC regime will be replaced with a refundable tax credit applying to the eligible salary paid to eligible employees of an IFC operator." See Finances Québec, Budget 2010/11, Additional Information on the Budgetary Measures, March 31, 2010, A.53. Certain transition rules may continue the existing system until the end of 2012. It appears that the new rules seek to more directly measure the qualifying activities in Quebec meant to benefit from this incentive, with reference to the activities actually performed in Quebec by relevant employees engaged in those activities. In a manner of speaking, this reflects one of our points about offering this kind of incentive where there is incremental, demonstrable activity in Canada that could be carried out elsewhere, presumably in a way that makes further demands on a community so as to support collateral economic activity.

63 Ibid., respecting proposed changes to the Quebec regime.

64 See the submission to the panel by the Woodbridge Company, supra note 57.

65 Supra note 59, at 92.

66 Ibid.

67 This was illustrated anecdotally in a private conversation with a senior tax official of a Canadian subsidiary of a large global company, who indicated that current government incentives to conduct R & D in Canada were not sufficient to make him go to the "global table" to push for more R & D to be undertaken in Canada by the group's Canadian subsidiary. However, he would certainly do so if the Canadian subsidiary were able to commercialize the products developed as a result of its R & D activities, with the resulting income being subject to a lower rate of tax similar to that imposed by a number of countries.

68 This could be encouraged, for example, by permitting a more generous writeoff for Canadian tax purposes of IP purchased from non-residents.

69 Statistics Canada does not maintain such information.

70 The increased R & D should come from Canadian-based companies and, subject to foreign tax considerations, foreign-based companies.

71 Under existing foreign affiliate rules, royalty and licensing income earned by a foreign affiliate is income from an active business if the affiliate licenses the IP to a third party and the affiliate is carrying on an active business or, alternatively, if the affiliate licenses the IP to another affiliate and the payment is deductible in computing the active business income of the other affiliate. If the affiliate is resident in a DTC, the royalty and licensing income can eventually be repatriated to Canada without additional Canadian tax. Hence, Canadian companies should have an incentive to migrate IP to Canada if the income is subject to foreign tax at a higher rate. There should also be an incentive to migrate IP licensed by an affiliate in a low-tax jurisdiction if the lower Canadian tax rate is comparable to or even somewhat higher than the foreign tax rate, because the Canadian company would avoid having to set up and maintain a costly offshore licensing structure.

72 The panel acknowledged that the current foreign affiliate system makes it attractive for Canadian companies to transfer IP outside Canada and that moving to a broader or full exemption system would put more pressure on Canada's transfer-pricing rules to protect the Canadian tax base by ensuring that such transfers occur at an appropriate value (*Final Report*, supra note 7, at paragraph 7.31). As a practical matter, providing Canadian companies with an incentive to keep IP in Canada by imposing a significantly lower tax rate on income generated from the IP would have the added benefit of avoiding the likelihood of time-consuming and expensive disputes with the CRA over the value of IP that would otherwise be transferred to an offshore affiliate.

73 See the submission to the panel by the Woodbridge Company, supra note 57.

74 For additional details on spillover effects, see, for example, Industry Canada, *Mobilizing Science and Technology to Canada's Advantage* (Ottawa: Industry Canada, May 2007). See also reference below to economic and tax benefits arising from British Columbia's International Financial Activity program.

75 Supra note 24, at 16 and 21.

76 In contrast, in Canada 75 percent of the cost of IP acquired that is an eligible capital expenditure is amortized at a rate of 7.5 percent on a declining basis. Further, under paragraph 13(7)(e), the depreciable cost of IP that is depreciable property acquired from a non-arm's-length person is restricted to the original cost of the IP to the vendor plus half of any gain realized by the vendor even if the vendor is a non-resident of Canada.

77 Nick Pantaleo and Scott Wilkie, "The Canadian Foreign Affiliate System: Are the Surplus Rules Surplus?" International Fiscal Association (Canadian Branch), 2007 Travelling Lectureship Series.

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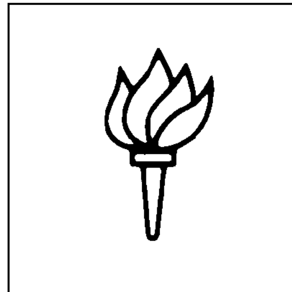

The Rising Tax-Electivity of U.S. Corporate Residence

Daniel Shaviro

October 2010

Electronic copy available at: http://ssrn.com/abstract=1683642

VI. CONCLUSION

In an increasingly integrated global economy, with rising cross-border stock listing and share ownership, it is plausible that U.S. corporate residence for income tax purposes, with its reliance on one's place of incorporation, will become increasingly elective for taxpayers at low cost. This trend is potentially fatal over time to worldwide residence-based corporate taxation, which will be wholly ineffective if its intended targets can simply opt out. Rising electivity is not nearly as great a problem, however, for existing U.S. corporate equity, which to a considerable degree is trapped, as it is for new equity (whether in new or existing corporations).

In the course of this project, I have gotten the sense that rising electivity is not quite as far along as I had thought at the start that it might be. However, if the case for worldwide residence-based corporate taxation is weak to begin with, then even modestly rising electivity may help tip the balance against it. Thus, evaluating where that case would stand in the absence of rising electivity plays an important role in the analysis.

The efficiency case for worldwide residence-based corporate taxation is increasingly discredited. There is, however, a distributional case, based on the point that such taxation helps defend the income tax as applied to resident individuals if, to a sufficient degree, they are willing to invest abroad but only through U.S. entities. In addition, if foreign individuals sufficiently value U.S. incorporation to be willing to pay for a fee for it (beyond that which individual states are willing to charge when they are competing with each other), it may make sense to charge them some sort of fee for using a U.S. entity, though why this should take the form of a residual tax on such entities' foreign source income is unclear. While opinions may differ, in my view these grounds

are sufficiently tenuous that not much (if any) rising electivity would be needed to tip the balance against applying worldwide taxation to new corporate equity.

For existing equity, however, there are powerful transition arguments against providing a "windfall" gain by applying exemption to it even though it was contributed when the worldwide system was in place. The simplest method of avoiding the windfall, without either creating the realistic impression of an ex post capital levy or distorting post-enactment incentives, would be to levy a one-time transition tax on U.S. multinationals. The tax base for this one-time levy would consist of their foreign subsidiaries' accumulated earnings and profits. The tax rate would aim at overall burden neutrality, relative to current law, given that neither deferral nor foreign tax credits would be allowed in computing the transition tax. It appears to be conceivable that such a tax could raise on the order of $200 billion, given the vast amount of U.S. companies' unrepatriated foreign earnings and existing estimates of burden-neutral rates if just deferral or just foreign tax credits were repealed on a going-forward basis. This is hardly a trivial amount, and ought not to be given away just because the prospective arguments for shifting to exemption are thought to be compelling.

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*269 RECONSIDERING THE TAXATION OF FOREIGN INCOME

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I. Introduction

A policy of taxing worldwide income on a residence basis holds enormous intuitive appeal, since if income is to be taxed, it would seem to follow that the income tax should be broadly and uniformly applied regardless of the source of income. Whether or not worldwide income taxation is in fact a desirable policy requires analysis extending well beyond the first pass of intuition, however, since the consequences of worldwide taxation reflect international economic considerations that incorporate the actions of foreign governments and taxpayers. Once these actions are properly accounted for, worldwide taxation starts to look considerably less attractive. Viewed through a modern lens, worldwide income taxation by a country such as the United States has the effect of reducing the incomes of Americans and the economic welfare of the world as a whole, prompting the question of why the United States, or any other country, would ever want to maintain such a tax regime.

The purpose of this Article is to analyze the consequences of taxing active foreign business income, [FN1] and in particular, to compare a regime**270** in which a home country taxes foreign income to a regime in which it does not. In practice, countries typically do not adopt such extreme policy positions. For example, a country such as France, which largely exempts foreign business income from taxation, nevertheless taxes small pieces of foreign income; [FN2] and a country such as the United States, which attempts to tax the foreign incomes of U.S. corporations, permits taxpayers to defer home country taxation in some circumstances, claim foreign tax credits in most situations, [FN3] and in other ways avoid the consequences of full home country taxation. It is nevertheless useful to consider stylized and somewhat extreme versions of territoriality and residence taxation, in part because the older theory that forms the basis of much U.S. policy advocates in favor of an extreme position of taxing worldwide income, and in part because insights drawn from considering extreme examples prove useful in understanding the murky middle to which tax policies naturally tend in practice.

The older wisdom in the international tax policy area holds that worldwide taxation of business income with provision of foreign tax credits promotes world welfare, whereas worldwide taxation of business income without foreign tax credits (instead permitting taxpayers to deduct foreign tax payments in calculating taxable income) promotes domestic welfare. These claims about the underlying welfare economics, introduced by Peggy Musgrave [FN4] and subsequently quite influential, have come under considerable academic fire in recent years. [FN5] Modern economic thinking parts company with Musgrave's analysis in two important respects. The first is that modern scholarship incorporates the impact of economic distortions introduced by taxes other than those imposed on foreign income, which Musgrave's ***271** analysis does not. The second is that modern scholarship incorporates reactions by foreigners to home country tax changes. Capital ownership by foreign and domestic investors is directly affected by home country tax policies, and these ownership effects, properly understood, have

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the potential to reverse entirely the welfare prescriptions that flow from Musgrave's analysis.

The second and third Sections of this Article review the older theory of home country taxation of foreign income, the more modern ownership neutrality concepts, and their implications. These ownership neutrality concepts, which are developed in Desai and Hines, [FN6] offer normative criteria by which to evaluate the desirability of tax systems in practice. The ownership neutrality concepts stress the importance of productivity effects of capital ownership in evaluating the incentives created by tax systems.

Section IV considers the implications of capital ownership for the design of tax systems that exempt foreign income from taxation. In particular, this Section notes that in order to create efficient ownership incentives it is necessary to avoid using simple formulas to allocate general domestic expense deductions between domestic and foreign income.

In an effort to make the ownership issues perhaps more vivid, Section V evaluates rather whimsical systems of residence-based excise and value-added taxation. The same arguments that typically are advanced in favor of worldwide taxation of corporate income apply with equal force to residence-based excise and value-added taxation, and the evident drawbacks of the latter apply equally to residence-based corporate income taxation.

Section VI considers the implications of residence taxation for taxpayer equity and the distribution of tax burdens, noting that equitable taxpayer treatment requires a special regime for the taxation of foreign income, and that the burdens (including the efficiency costs) of taxing foreign income typically are borne by domestic labor in the form of lower real wages. Section VII considers the implications of practical complications, including the reactions of foreign governments and the ability of taxpayers to avoid taxes on domestic income. Section VIII is the conclusion.

***272** II. Older Analytical Frameworks [FN7]

Capital export neutrality (CEN) as defined by Musgrave is the criterion that an investor's capital income is taxed at the same total rate wherever the income is earned. The idea behind CEN is that equal taxation of income earned in different locations effectively removes location-based tax incentives, thereby encouraging firms to locate their investments wherever they generate the greatest pretax returns. Since in a world without taxation firms likewise face incentives to maximize pretax returns and market outcomes are generally thought to be efficient in the absence of taxation, it seems natural to associate CEN with efficient production incentives.

Implementation of CEN requires governments to adjust their taxation of investment returns based on the tax policies of other countries. Since investors always have the option of earning income in their home countries, CEN is satisfied if foreign income is subject to the same rate of taxation as is income earned at home. This is far from guaranteed, since tax rates differ substantially among countries, and the international convention is that countries in which investments are located are entitled to tax investment returns at their own tax rates. Consequently, it falls upon home governments to implement CEN if they choose to do so, by adjusting their own taxation of foreign income earned by their residents. A home government can support CEN by subjecting foreign income to taxation at a rate equal to the difference between the home country tax rate and the foreign tax rate, thereby producing a total (foreign plus home) tax burden equal to the home country tax rate. A home country that taxes worldwide income at the same rate that it taxes domestic income, and permits taxpayers to claim credits for any income taxes paid to foreign governments, effectively implements a system that is consistent with CEN. It is noteworthy that such a system would not permit taxpayers to defer home country taxa-

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tion of unrepatriated foreign income, and imposes no limits on foreign tax credits, so investors subject to foreign tax rates that exceed the domestic tax rate would receive tax rebates from their home country.

The United States currently taxes worldwide income and permits investors to claim foreign tax credits, but U.S. taxation of certain foreign income is deferred until the income is repatriated, and foreign tax credits are limited to prevent high rates of foreign taxation from producing U.S. tax rebates. As a result, the current U.S. tax system does not correspond to a system that implements CEN. Despite this difference, CEN is often used as a basis with which to analyze potential ***273** reforms to the U.S. tax system, [FN8] since CEN is thought to maximize the economic welfare of the world as a whole.

Policies that encourage efficient allocation of investment need not maximize the welfare of home countries, since home countries may not receive all of the benefits of improved resource allocation. The Musgrave concept of National Neutrality (NN) is that home countries promote domestic welfare by taxing worldwide income while treating foreign income taxes simply as costs of doing business. Consequently, a home country tax system that satisfies NN is one in which investors are required to pay home country taxes on their foreign incomes and are permitted to deduct foreign tax payments from taxable income. This system does not permit taxpayers to claim foreign tax credits, since it does not distinguish foreign tax costs from other foreign costs, such as the costs of labor and materials. The fact that foreign taxes represent transfers to foreign governments rather than real resource costs is, by this analysis, irrelevant to the home country.

The analysis of national neutrality suggests that almost all countries treat foreign income far too generously, since permitting taxpayers to claim foreign tax credits--or worse, exempting foreign income from home taxes entirely-- encourages excessive investment from the standpoint of the home country. Since CEN calls for foreign tax credit systems, it follows from the Musgrave analysis that there is a tension between policies that maximize national welfare--NN-- and policies that maximize global welfare--CEN--and that some kind of cooperative agreement might be needed to align national and global interests. There remains, however, the empirical puzzle of why virtually every country fails to pursue its own interest by subjecting after-tax foreign income to full domestic taxation, and in particular why so many countries exempt foreign income from taxation.

Capital Import Neutrality (CIN) is the concept that an investment should be taxed at the same total rate regardless of the location of the investor. Taxation by host countries at rates that differ between locations can be consistent with CIN, since different investors are taxed (at the corporate level) at identical rates on the same income. In order for such a system to satisfy CIN, however, it is also necessary that individual income tax rates be harmonized, since CIN requires that the combined tax burden on saving and investment in each location ***274** not differ between investors. While CEN is commonly thought to characterize tax systems that promote efficient production, [FN9] CIN is thought to characterize tax systems that promote efficient saving. Another difference is that CIN is a feature of all tax systems analyzed jointly, whereas individual country policies can embody CEN or NN. As a practical matter, since many national policies influence the return to savers, CIN is often dismissed as a policy objective compared to CEN and NN.

Several important assumptions are buried inside the analytic frameworks that imply that CEN maximizes global welfare. The first assumption is that home country governments have incentives to maximize the profits of home country firms plus the value of the taxes that they pay to the home government. The second assumption is that foreign tax policies do not respond to home country tax policies. The third assumption is that host governments value inbound foreign direct investment in a manner that is unrelated to their tax rates. And the fourth assumption is that home country taxation of foreign income does not directly or indirectly affect foreign firms.

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Policies that promote the efficient operation of domestic firms also promote domestic welfare when domestic residents have stakes in the success of home country firms, which they can as shareholders, employees, customers, those who sell these firms inputs, or who interact with them in other capacities. The first assumption takes the (tax) residence of home country firms as fixed, and does not incorporate the efficiency cost associated with raising government revenue from virtually any source. The second assumption implies that governments ignore their impact on each other's policies, and the third assumption requires that governments not adjust tax rates in a way that reflects the value to their economies of attracting additional investment. These assumptions have been subjected to critical analysis, [FN10] though there are adherents of CEN who insist that its implications survive these criticisms. [FN11]

***275** The fourth assumption, that home country taxation does not directly or indirectly affect foreign firms, is the least consistent with theory and the most important from the standpoint of its policy implications. [FN12] In fact, there is every reason to expect the actions of domestic firms to affect their foreign competitors; and since domestic firms are influenced by home country taxation, it follows that foreign firms are indirectly influenced. In a competitive market, greater foreign investment by domestic firms is typically associated with greater domestic investment by foreign firms. The NN implication that home countries maximize their own welfare by subjecting foreign income to taxation with only deductions for foreign income tax payments then no longer follows, since from the standpoint of the home country, greater foreign investment by domestic firms does not come at the cost of reduced domestic investment to the degree that foreign investment in the home country rises as a result. Hence there is not a welfare loss from reducing domestic investment, because total domestic investment need not fall when domestic firms undertake greater foreign investment. From a CEN standpoint, this logic also implies that worldwide taxation with foreign tax credits need not promote efficient global production, since the effect of domestic investment abroad on foreign investment at home means that efficiency is advanced by encouraging economically appropriate ownership of assets.

III. Implications of Capital Ownership

This section describes the application of ownership criteria to the taxation of foreign income, and offers an assessment of the importance of capital ownership to economic welfare.

A. Capital Ownership Neutrality

Capital Ownership Neutrality (CON) is a property of tax systems that maintain incentives for efficient ownership of capital assets. Capital ownership neutrality is important to efficiency only insofar as ownership is important to efficiency, a notion that is ruled out by assumption in the Musgrave framework that serves as the basis of CEN and NN. If the productivity of a business asset depends in part on ***276** how it is owned and controlled, then an efficient tax system provides incentives for ownership that maximizes the value of output.

Consider the case in which all countries exempt foreign income from taxation. Then the tax treatment of foreign investment income is the same for all investors, and competition between potential buyers allocates assets to their most productive owners. Allocation on the basis of productivity typically does not imply that all assets would be held by a small number of highly efficient owners, since there are limits to the abilities of owners and managers to maintain the productivity of widespread business operations, and therefore benefits to specialized ownership. [FN13] Efficient ownership entails combining assets in a way that is more productive than alternative ownership arrangements, taking into account the costs of trying to maintain too large or too diverse a

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set of assets under single ownership and management.

If the rest of the world exempted foreign income from taxation while the United States taxed foreign worldwide and granted Americans the opportunity to claim foreign tax credits for foreign income tax payments, then the difference between these tax treatments of foreign income would influence ownership patterns. Foreign investors would have stronger relative incentives to hold assets in low-tax countries, since they benefit from reduced tax rates whereas Americans, who also benefit from lower foreign tax rates, simultaneously receive fewer foreign tax credits for their investments in low-tax locations. Consequently American investments can be expected to be more strongly concentrated in high-tax countries than is true of the rest of the world. As a result, the tax treatment of foreign income distorts asset ownership, moving it away from the pattern that is associated with maximum productivity.

In this example, if the United States were to join the rest of the world in exempting foreign income from taxation then tax systems would no longer distort asset ownership, thereby satisfying the requirement for CON. Capital ownership neutrality, however, does not require that every country exempt foreign income from taxation: Instead what is required is that foreign income be taxed in a similar matter by all countries. For example, countries with differing home tax rates might all tax foreign income while granting taxpayers the opportunity to claim foreign tax credits, and despite the underlying differences in tax rates, such a configuration would satisfy CON. The reason is that investors all face incentives to choose investments that ***277** maximize pretax income, and since this is common across countries, there are no tax-based incentives to reallocate assets among investors from countries with differing tax systems.

Efficient allocation of capital ownership means that it is impossible to increase productivity by reallocating assets between owners. This does not require that assets be equally productive with any owner, [FN14] since what matters is the potential productivity gain to be had by swapping assets among owners. Thus, investors from Country A might have stronger tax incentives to invest in low tax countries than is true for investors from Country B. It follows from the difference between their tax systems that there are potential productivity gains to be had by trading some high-tax investments held by Country B owners for low-tax investments held by Country A owners--and this potential productivity gain is available despite any underlying differences in productivity rates associated with ownership. Hence it is differences in the relative tax treatment of investments in differing locations, rather than absolute differences in the productivity of differing owners, that give rise to asset ownership inefficiencies. Systems that tax foreign income similarly therefore maintain efficient ownership patterns even if their tax rates differ.

The welfare properties of CON emphasize the allocation of ownership of a given volume of business activity between locations whose tax attributes differ. The taxation of foreign income also has the potential to influence rates of national saving and the sizes of domestic firms, though this effect is not explicitly incorporated in the analysis. National saving is affected by a large range of public policies including monetary policy, intergenerational redistribution programs such as social security, the taxation of personal income, estate taxation, and other policies that influence the discount rates used by savers. Business activity is likewise influenced by a host of fiscal, monetary, and regulatory policies. Given these various factors that influence national saving and corporate investment, it is appropriate to analyze the optimal taxation of foreign and domestic income separately from the question of how much governments should encourage capital accumulation and total investment of home-based firms.

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B. National Ownership Neutrality

The importance of ownership to productivity carries the implication that countries acting on behalf of their own economic interests have incentives to exempt foreign income from taxation. This perhaps surprising***278** conclusion reflects that, viewed exclusively from an ownership standpoint, additional foreign investment does not come at the cost of reduced domestic investment, since additional foreign investment reflects a reallocation of ownership rights in which domestic owners obtain foreign assets by swapping domestic assets to foreign owners. As a result, there is no associated reduction in real domestic investment levels, and the effect of foreign investment on domestic tax revenue depends entirely on the productivity of the resulting ownership pattern. To a first approximation there is little effect of additional foreign investment on domestic tax revenue, which is very different from the premise of the Musgrave analysis in which foreign investment comes dollar for dollar at the expense of domestic investment. Countries therefore maximize their welfare by maximizing the productivity of their domestic and foreign assets, which they do by exempting foreign profits from home country taxation. It does not follow that such a policy encourages excessive foreign investment, since the cost of foreign investment is the cost of trading domestic assets for foreign assets, and domestic taxes are built into this cost, since any new owners of domestic assets will have to pay those taxes. Given this implicit cost, a policy of exempting foreign income from taxation effectively subjects all investments to the same tax rate, and thereby promotes efficiency.

Tax systems that promote domestic welfare by exempting foreign income from taxation can be said to satisfy National Ownership Neutrality (NON). It is noteworthy that countries have incentives based on ownership considerations to exempt foreign income from taxation no matter what policies other countries pursue. It is therefore perhaps understandable why so many countries have persisted in exempting foreign income from taxation, since such policies advance their interests--and if every country exempted foreign income from taxation, the uniformity of tax treatment would promote an efficient allocation of capital ownership that maximizes world productivity. To be sure, there are important considerations omitted from this analysis, including the requirement that taxpayers adhere to rules concerning the allocation of income for tax purposes. One concern often expressed about exempting foreign income from taxation is that doing so might encourage taxpayers to report that income actually earned at home was instead earned in low-tax foreign locations. While taxpayers may face such incentives under a system of worldwide taxation with foreign tax credits, presumably the incentives would be stronger if foreign income were entirely exempt from domestic taxation. [FN15] This ***279** problem, to the extent that it is one, is best addressed directly with enforcement of existing and potentially new rules rather than by modifying the taxation of foreign income to accommodate income shifting behavior on the part of taxpayers.

C. Implications of Ownership

The principles of CON and NON are based on the welfare impact of the importance of ownership to productivity in the design of international tax systems. This emphasis on ownership effects is consistent with the modern theory of foreign direct investment, which is based on a transaction-cost approach under which the market advantages of multinational firms arise from the benefits of joint ownership of assets across locations. It is also consistent with the scale of operation of the large and very active worldwide market in mergers, acquisitions, and asset divestitures. Participating firms presumably are willing to assume the costs of ownership realignments because of their advantages. [FN16]

Desai and Hines review the extensive available evidence of the impact of home country tax regimes on patterns of asset ownership by multinational firms, [FN17] including the effects of foreign tax systems on the loca-

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tion of investment within the United States, [FN18] the effects of home country taxes on the distribution of American and Japanese investment around the world, [FN19] and the impact of foreign tax credit and deferral rules on asset ownership. [FN20] The ownership structure of outbound foreign investment likewise appears to be sensitive to its tax consequences. [FN21] And Desai and Hines analyze dramatic ownership ***280** reversals in which U.S. multinational firms expatriate by inverting their corporate structure, reconfiguring their ownership as foreign corporations in order to reduce the burden imposed by U.S. tax rules. [FN22] These and other cases indicate that ownership patterns of foreign affiliates and their parent companies are significantly affected by tax incentives in their home countries.

D. Foreign Investment and Domestic Investment

One of the significant ways in which the modern analysis of taxing foreign income parts company with earlier approaches lies in its consideration of the impact of outbound investment on domestic investment. As noted above, once one acknowledges that greater foreign investment need not entail reduced domestic investment, then the opportunity cost of greater foreign investment changes significantly, and with it, the desirability of taxing foreign income.

International capital market equilibrium implies that the capital account must be balanced over time: Net outbound foreign investment equals net inbound foreign investment in present value. It does not follow, however, from this implication of market equilibrium that greater outbound foreign direct investment triggers greater inbound foreign direct investment, since the capital account can be balanced either through foreign direct investment flows or through portfolio capital flows. [FN23] Hence the degree to which greater outbound foreign direct investment is associated with greater or lesser domestic investment is ultimately an empirical question.

There is a flurry of recent evidence suggesting that greater outbound foreign direct investment may not reduce the size of the domestic capital stock, but instead more likely increases it. This evidence includes aggregate time series evidence of the behavior of U.S. multinational firms, [FN24] aggregate evidence for Australia, industry-level studies of Germany [FN25] and Canada, [FN26] and firm-level evidence for ***281** the United States, [FN27] the United Kingdom, [FN28] and Germany. [FN29] The difficulty confronting all of these studies is that foreign investment is itself a purposive choice, reflecting economic conditions that very likely also directly influence the desirability of domestic investment, making it difficult to disentangle the pure effect of greater foreign investment on domestic economic activity. These studies approach this problem in different ways, drawing conclusions that are accordingly persuasive to differing degrees, although the accumulation of this evidence strongly points to the possibility that greater outbound investment need not be associated with reduced domestic investment.

The study by Desai, Foley, and Hines is instructive in this regard, as it exploits firm-level information and differences in foreign economic growth rates to identify the effects of greater outbound foreign investment. [FN30] U.S. firms investing in foreign countries whose economies grow rapidly tend to exhibit much faster growth rates of foreign direct investment than do otherwise similar U.S. firms investing in foreign countries that experience slow economic growth. [FN31] Hence it is possible to use (firm-specific) average foreign economic growth rates to predict changes in foreign investment, which in turn can be compared to subsequent changes in domestic economic activity. The evidence indicates that, for U.S. firms, 10% greater foreign capital investment is associated with 2.6% greater domestic investment, and 10% greater foreign employment is associated with 3.7% greater domestic employment. [FN32] Foreign investment also has positive estimated effects on domestic

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exports and research and development spending, suggesting that growth-driven foreign expansions stimulate demand for tangible and intangible domestic output.

E. Is Ownership Decisive?

The analysis of ownership incentives carries implications for tax policy that differ sharply from those of allocating a fixed supply of ***282** capital between competing locations. In the standard Musgrave setting, the problem is that tax rates differ between countries. This then leads to excessive investment in low-tax countries, [FN33] and by comparison inadequate investment in high-tax countries. [FN34] The solution offered by the CEN paradigm is to undo international tax rate differences with offsetting differences in home country taxation.

The ownership approach identifies a different set of problems and a different tax policy to address these problems. Distortions to international ownership create their own inefficiencies and thereby threaten productivity in a manner no less real, and certainly no less important, than the inefficiencies that may arise from too many factories appearing in tax havens. A tax system that seeks to implement CEN to correct the problem of investment incentives thereby creates its own set of problems with distorted ownership, and the evidence, both casual and statistical, is that ownership is highly sensitive to its tax treatment.

These issues would be moot if all countries were to discontinue taxing business income at source, but whatever may be the potential efficiency gains of such a reform, governments are unlikely to undertake it in the near future. Hence the more restricted efficiency question concerns the appropriate taxation of foreign business income in a world with many tax rate differences, with activities within a country taxed at many different rates, and therefore many sources of potential inefficiency. In emphasizing ownership rather than other dimensions of business activity, the analysis takes these ownership and control considerations to be of first order importance.

IV. Implications for Expense Allocation

Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. [FN35] Thus, for example, a U.S. multinational firm with ***283** $100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise equivalent U.S. firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While one can, and undoubtedly should, criticize the details of the current U.S. rules governing expense allocation, it must be conceded that the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies CEN. [FN36]

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Taking as a premise that CEN is an unsatisfactory basis for taxing foreign income, and that a country prefers to exempt foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead traced to their uses, as most countries other than the United States currently do with respect to interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country in which they are incurred.

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and $150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the $150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be ***284** entitled to deduct only $75 of its expenses against its domestic taxable income. [FN37] For a firm with a given level of borrowing, greater foreign investment would then be associated with reduced domestic interest deductions, and therefore greater domestic taxes. Hence the home country in fact would impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability.

The fact that a simple-minded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available for this problem: Any system that allocates expenses based on a taxpayer's behavior will have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. [FN38] Hence policies designed to avoid taxing foreign income necessarily must forgo allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, [FN39] so from the ***285** standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

The same point can be considered from the standpoint of the taxpayer. A U.S. multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns--and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its in-

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terest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that, from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Using a system of expense tracing that in practice often entails full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

***286** V. Residence-Based Excise and Value-Added Taxation

The current U.S. system of taxing foreign income includes the proviso that taxpayers are entitled to claim foreign tax credits only for foreign income taxes, and related taxes, paid (or deemed paid) to foreign governments. [FN40] Consequently, the payment of other taxes, such as foreign excise taxes, value-added taxes, property taxes, and many others, does not create an entitlement to claim foreign tax credits. [FN41] In practice, this restriction creates numerous difficulties both for taxpayers, who may be denied U.S. foreign tax credits for payments to foreign governments that bear many similarities to income taxes, and for foreign governments, who are often eager to adopt innovative tax systems but are deterred by the potential noncreditability of the resulting taxes. The rule limiting foreign tax credits to income taxes is quantitatively quite important, as the annual foreign income tax payments of U.S. companies greatly exceed their payment of foreign taxes that do not qualify as income taxes. [FN42]

Why are foreign tax credits permitted only for foreign income tax payments? Various justifications have been offered for this restriction, including, prominently, the argument that the burdens of corporate income taxes fall on owners of capital in the form of lower returns, whereas the burdens of other taxes tend to fall on foreign consumers. [FN43] It is difficult to understand the relevance of tax incidence in this context. In part, this is due to the fact that little was known until relatively recently about the incidence of corporate income taxes, so any legislative restriction based on knowledge of the underlying economics of corporate tax incidence prior to the modern era would have represented a pure stab in the intellectual dark. But more importantly, it is difficult to discern what possible difference even secure knowledge of the incidence of corporate taxation would make to the desirability of permitting taxpayers to claim credits for alternative taxes paid to foreign governments. The justification for taxing foreign income after foreign tax credits presumably lies in some combination of the effi-

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ciency and distributional effects of such taxation from the standpoint of home country taxpayers, to which the ultimate incidence of foreign corporate taxation makes little if any contribution.

***287** A simpler and more direct explanation for the practice of limiting foreign tax credits to foreign income tax payments is the similarity of the taxes involved, since foreign tax credits are used to offset home country taxes that otherwise would be due on foreign income. This logic implies that governments might permit taxpayers to claim credits for foreign excise tax payments that can be used to offset domestic excise tax liabilities due on foreign sales, an entitlement that makes sense only if countries impose worldwide excise taxes on a residence basis. Such a worldwide excise tax regime offers few attractions from the standpoint of national economic policy, but analyzing the properties of such a system offers the prospect of casting useful light on the taxation of worldwide income on a residence basis.

A. Residence-Based Excise Taxation

To take a concrete example of excise taxation imposed on a residence basis, suppose that the U.S. federal government were to levy a $2 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States. U.S. taxpayers would be entitled to claim foreign tax credits for excise taxes paid to foreign governments, so that a firm selling gasoline in a country whose excise tax rate exceeds $2 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a $0.75 per gallon tax would owe $1.25 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding $2 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than $2 per gallon.

What would be the impact of such a home country tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it does not necessarily follow that it would spell the end of foreign gasoline sales by U.S. companies in all low-tax jurisdictions, though that is certainly one possibility. U.S. companies would persist in selling gasoline in those foreign markets in which two conditions hold: (1) that U.S. firms are profitable, and (2) that the same U.S. firms could not be even more profitable (in a present value sense) by selling their operations to foreign petroleum companies who are not subject ***288** to the U.S. tax regime. [FN44] Since U.S. firms may have significant cost or marketing advantages over their competition in certain foreign locations, it is possible that they would be able to remain in business despite the significant tax penalty associated with U.S. residence. In cases without such advantages, and where low foreign excise tax rates imply significant U.S. tax costs, U.S. firms are likely to disappear.

The economic costs of a residence-based excise tax regime are simple to identify. U.S. firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of U.S. firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which U.S. firms sell in foreign markets

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despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes. [FN45]

What possible justification could be offered for a home country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline in country A equals the benefit to consumers in country A, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline. [FN46] Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond ***289** to global efficiency except in the unlikely event that excise taxes are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage U.S. firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration. Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today, destination-based) excise tax on gasoline by $0.10 per gallon tends to be associated with roughly $0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. [FN47] But the efficiency argument--which is identical to the argument used by Musgrave and many subsequent authors to support worldwide taxation--is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: Both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

***290** B. Residence-Based Value-Added Taxation

The analysis of the efficiency properties of worldwide taxation, and the resulting apparent desirability of residence-based excise taxes, applies with equal force to other taxes, such as value-added taxes. Suppose, for example, that the United Kingdom were to tax value added on a residence basis, so the 17.5% British value-added tax (VAT) rate would apply not only to goods and services sold in the United Kingdom (as it does currently), but also to goods and services produced by U.K. resident firms sold for consumption abroad. Again, one can entertain the possibility of a crediting scheme, in which taxpayers would be entitled to credit VATs paid to foreign governments against their domestic tax liabilities. As of 2008 VATs were used by more than 140 countries in

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the world, though not one of them attempts to levy a VAT in this way. [FN48] It is instructive to consider the implications of such a VAT, which offers a clue to why such a design is so unpopular.

The application of such a VAT scheme by the United Kingdom would obviously stimulate an enormous restructuring of British foreign investment. By far the largest destination country for British foreign direct investment is the United States, and the absence of a U.S. VAT implies that the value added produced by the U.S. investment of British firms would be subject to a 17.5% VAT rate for any firms that do not have excess VAT credits from other foreign operations. The British VAT scheme would have less purchase in Europe, given the generally high VAT rates in the European Union, and indeed, the availability of excess VAT credits from European operations might offset a significant portion of U.K. VAT liabilities on U.S. source income for some British taxpayers. But in the circumstances in which worldwide taxation matters--when taxpayers would not have excess foreign tax credits in the absence of active management--the residence-based VAT system would impose significant burdens, and burdens that vary with local VAT rates.

How are taxpayers likely to respond to the introduction of residence-based value-added taxation? The obvious reaction is to shed, or avoid in the first place, ownership of value-added producing activities in jurisdictions where British ownership triggers significant tax liabilities. Again, it does not follow that British firms would maintain no U.S. operations; it is almost certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie CEN and related concepts would evaluate residence-based value-added taxation favorably. Policies***291** that allocate value added around the world based on pretax returns maximize world welfare, so the CEN logic implies that total (host country plus home country) value-added tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can be achieved only by home country tax regimes that offset any differences between domestic and foreign taxation, as in the hypothetical British example. Home country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country value-added taxation at the normal rate. In the British example, a firm producing $100 of value added in a country with a 20% VAT would pay a VAT of $20 to the foreign government and then $14 (17.5% * $80) to the U.K. government. This tax system, says the theory, maximizes home country welfare.

C. Application to Income Taxes

No country attempts to tax sales or value-added on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding analysis. A very similar analysis can be offered for application of the residence principle to worldwide property and other taxation. The reason to analyze these taxes is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: Why is it that residence-based excise, value-added, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise or value-added taxation, with the same (negative) impact on economic welfare. The economic consequences of income taxation seem subtler than those of, say, excise taxation, but this is merely an illusion, since a $10 million tax liability associated with U.S. ownership will discourage U.S. ownership of foreign business assets to the

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same extent whether the $10 million is called an income tax or an excise tax.

VI. Fairness and Distribution

This Part considers some of the fairness and income distribution considerations raised by the question of whether or not to tax foreign income.

*292 A. Fairness

Simple fairness principles can have considerable purchase in tax design, and one of the powerful arguments occasionally advanced in favor of taxing worldwide income is that the failure to do so would produce a system that unfairly burdens taxpayers with domestic income relative to taxpayers with foreign income. [FN49] Even in the absence of widely agreed-upon norms of fairness, this argument has considerable intuitive appeal, and therefore warrants careful consideration.

It is helpful to work through a simple, and somewhat extreme, example in order to identify the salient fairness issues at stake in taxing (or exempting) foreign income. Compare two taxpayers, both earning $100 of pretax income; one earns $100 domestically, where the income is subject to a 35% tax, whereas the other earns $100 in a jurisdiction that does not tax corporate income at all. For simplicity, there are no other taxes in these countries.

In the absence of worldwide residence-based taxation, it appears that the taxpayer with foreign income somehow obtains an unfair advantage over the taxpayer earning domestic income. Both have (by assumption) equivalent if not identical business operations; both benefit from the services that the home government provides; but only the taxpayer whose income has a domestic source contributes resources to the provision of home country government services. In such a setting, and with such reasoning, even the acknowledged equal opportunity of any taxpayer to earn foreign income if desired hardly seems to allay fairness concerns.

On closer examination, however, the pretax situations of those earning foreign and domestic income betray marked dissimilarities. In the example, the taxpayer with foreign business income operates in an environment in which it is necessary to compete with other business interests that are not subject to the same home country tax regime. Consider the case in which competing business interests are not subject to taxes beyond the local source-basis tax, either because their business homes are countries that exempt foreign income from taxation, or because they are domestic firms in the foreign country. The profits of these competing firms are therefore not taxed at all, and competition among these firms therefore drives returns down to a level at which the pretax rate of return just equals the after-tax returns ***293** available elsewhere. Put simply, the zero tax rate in the foreign jurisdiction unleashes foreign competition that reduces the returns that investors can earn locally.

To the extent that investors are affected by local foreign competition, they incur costs that are associated with the competition triggered by low foreign tax rates. For example, foreign investment attracted by low foreign tax rates will tend to bid up real local wages, increasing the cost of business for all investors. As a consequence, it is more difficult than it would be otherwise for a firm to turn a profit in such a country; to put the same matter differently, an investor in a zero-tax country pays an implicit tax in the form of lower returns produced by market competition.

The tax treatment of interest earned on state and local debt offers an instructive comparison. For most tax-

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payers, the exemption of state and local bond interest from taxable income offers a marked benefit, since, minor complications aside, the after-tax rate of interest equals the pretax rate of interest. Does it follow that anyone who invests in state and local bonds receives a significant windfall as a result? Certainly not, since the availability of the tax exemption greatly increases demand for these bonds, increasing bond prices and thereby depressing market yields. With a sufficient number of top-bracket investors, market equilibrium requires that the risk-adjusted after-tax return available from investing in state and local bonds equals the risk-adjusted after-tax return available from other securities held by top-bracket investors. [FN50] Thus the tax exemption for state and local bond interest fails to ignite a groundswell of objection on the basis of fairness.

Fleming, Peroni, and Shay, among others, would distinguish on fairness grounds those implicit taxes paid on tax-exempt debt from explicit taxes that are required to be remitted explicitly to governments. [FN51] Certainly given the intrinsic vagueness of almost any notion of fairness it is impossible to identify a specific characteristic that a tax system must satisfy in order to be fair, and to declare any alternatives to be unfair. From the standpoint of the ultimate distribution of income, the question remains whether an investor who has already paid an implicit tax needs to be subject to an explicit home country tax in the name of fairness. There is the additional considera-tion***294** that many intuitive notions of fairness grapple rather little, if at all, with the extraterritorial nature of worldwide income production. On what fairness basis does foreign income production require domestic taxation? And is it fair for the United States to subject income earned in other countries to U.S. taxation, thereby quite possibly affecting the distribution of income in foreign countries?

The same fairness argument that favors subjecting foreign income to domestic income taxation would also favor subjecting foreign value-added to domestic value-added taxation, foreign sales to domestic sales taxation, and similarly extending other domestic taxes to foreign activities. Why is there not a groundswell of fairness-motivated objection to the territoriality of value-added taxes, particularly in countries such as Denmark and Hungary that boast very high domestic VAT rates? In the case of the VAT, it is obvious that taxes are largely capitalized into the prices of goods sold, so multinational firms do not obtain extraordinary tax benefits from selling in countries with low VAT rates, since competition pushes down final output prices in such places. Expressed differently, one pays an implicit tax on sales in jurisdictions with low tax rates. Exactly the same process applies to income taxes, the only difference being that the implicit taxes are slightly less transparent.

B. Who Pays and Who Benefits?

The analysis of CON and other welfare benchmarks is premised in part on the notion that home countries benefit from policies that improve the productivity and therefore profitability of home country companies. [FN52] While this is not a logical necessity, there are at least two reasons why it is appropriate for the analysis to proceed on this basis. The first is that home country residents typically have strong stakes in the profitability of home country companies through their interactions as owners, workers, suppliers, and consumers. Ownership is the most obvious of these channels: The widely documented “home bias” in asset ownership implies that domestic residents are considerably more likely than others to own local companies and thereby benefit from their profitability. [FN53] Greater profitability is likewise associated with higher wages and other benefits for members of the community. The second reason comes from the analysis of Gordon, who notes that the burden of taxation and its associated efficiency cost ***295** is borne by local factors, such as labor and land. [FN54] If a small open economy attempts to tax foreign income at a nonzero rate, then it discourages foreign multinational firms from investing and the cost of this taxation is ultimately borne by local workers and landowners. [FN55] Hence,

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it is not necessary for local residents to own multinational firms in order to be appropriately concerned about the efficiency with which they are taxed.

It is possible to add some precision to the analysis of who bears the burden of taxing foreign income by considering the incidence of the corporate income tax writ large. In an open economy such as the United States, capital taxes, of which corporate income taxes are only one species, are largely borne by factors that are fixed in the United States. [FN56] In practice, this means that taxes paid by U.S. corporations, including taxes on their foreign incomes, reduce real wages in the United States, doing so both through direct tax burdens and also through indirect burdens in the form of reduced aggregate economic productivity. William Randolph estimates that 70% of the U.S. corporate income tax burden is borne by labor, but this is a lower bound estimate. [FN57] Randolph's model takes world capital supplies to be fixed, [FN58] which is unrealistic. Using a more appropriate specification in which capital supply is an increasing function of real returns, the burden of capital income taxation is borne to an even greater degree by local labor. [FN59]

VII. Complications

Actual tax systems are considerably more distortionary than the stylized versions considered in this Article. Equity-financed corporate income is taxed twice by classical corporate tax systems while debt-financed corporate income is taxed only once, [FN60] investments in certain industries and assets receive favorable tax treatment not available to ***296** other investments, [FN61] capital gains are taxed only upon realization, [FN62] and then at rates that may differ from the rates at which other income is taxed, [FN63] and there are many other income distinctions drawn by the tax system with little economic basis. In addition, activities that generate positive externalities, such as those that produce new technologies with economic spillovers, those that improve the natural environment, or others, may fail to receive appropriate encouragement from the tax system in the form of subsidies or reduced tax rates. The appropriate taxation of foreign income in an environment in which the tax system is already imperfectly tailored to tax domestic income may differ from the system that the government would want to adopt if its other tax policies were optimally designed. [FN64] The analysis nonetheless serves as a useful starting point for the design of optimal tax systems, but it is worth bearing in mind that it is only a starting point.

Tax systems that exempt foreign income have the potential to put more pressure on aspects of the tax system, such as the transfer pricing rules, that allocate income between domestic and foreign source. In some settings with worldwide taxation, the source of income will not matter for domestic tax purposes, hence (domestic, anyway) enforcement of these matters becomes an issue of little consequence. In tax systems that exempt foreign income, the source of income and expense becomes a matter of great importance.

The difficulty of articulating and enforcing a coherent regime that distinguishes domestic from foreign source income is certainly a challenge for those who would base taxation on this distinction. This Article follows almost all of the preceding literature in taking enforcement matters to be outside the scope of the present inquiry, in large part because the traditional case for worldwide taxation is not presented in those terms. [FN65] And indeed, even incorporating the enforcement difficulties that tax systems face, the notion of adopting worldwide taxation for no reason other than the difficulty of enforcing a transfer pricing regime has a strong element of the transfer pricing tail wagging the tax system dog. Certainly transfer pricing is a difficulty, and ***297** should be addressed on its own terms, not by changing every other element of international taxation.

A final issue that is difficult to evaluate, but potentially important, is the reaction of other governments to

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changes in U.S. tax policies. It is standard to assume that changes in U.S. policies do not affect the policies of other governments, but this will not be the case in some competitive situations and if governments react strategically with each other. [FN66] Naturally, this consideration has the potential to change the optimal tax policy from the standpoint of a government seeking to maximize the welfare of its own residents, since it enhances the attractiveness of home country tax policies that encourage foreign governments to reduce their own taxation of inward foreign direct investment. [FN67] Incorporating such spillovers in the choice of optimal tax policies requires governments to determine the direction and magnitude of any effects of home country tax policies on foreign tax policies. [FN68] While the United States is a capital exporter of sufficient size potentially to influence the tax policies of other countries, [FN69] most capital exporting countries are unlikely to have such effects and therefore may not be influenced by this consideration. And even for the United States it is very difficult to estimate the effect of the home country tax regime on foreign tax policies.

VIII. Conclusion

A reconsideration of the taxation of foreign income is long overdue. It is surprisingly easy to grow comfortable with systems that tax foreign business income while providing foreign tax credits, doing so in the vague sense that these systems promote national or world welfare. If instead the opposite were the case, if as a result of taxing foreign ***298** income the welfare of domestic residents is gradually eroded as domestic business operations become less productive and less dynamic, it might not be immediately apparent in what is otherwise a strong and affluent economy. This is a potential danger for large economies that persist in taxing foreign income without regard to the resulting distortions to ownership and productivity. Whereas some forms of international taxation, such as subjecting U.S. firms to U.S. excise taxes on their foreign sales, are transparently inefficient and self-defeating, others, such as the current U.S. regime of taxing foreign income, are no less inefficient, only somewhat subtler in their appearance.

As long as governments persist in taxing business income at source there also will be a need to determine the appropriate residence-based taxation of business income. No single system produces efficient incentives at all margins of behavior, since there are so many business activities that are taxed in so many different ways. It is clear, however, that ownership is very important, and that international ownership is strongly influenced by taxation. In a context of shifting ownership, there are significant costs associated with subjecting active foreign business income to home country taxation, and these costs are not somehow recouped by preventing the outflow of what otherwise would be domestic economic activity, since foreign business operations if anything increase demand for domestic operations. Hence the feared loss of domestic tax base that might accompany exemption of foreign income is illusory. Viewing foreign taxation through the lens of ownership, itself just a small change in perspective on international taxation, has the potential to clarify the issues facing governments that tax business income.

[FNa1]. Richard A. Musgrave Collegiate Professor of Economics and Professor of Law, University of Michigan. This Article draws on earlier work with Mihir Desai, to whom I am grateful for comments and for many stimulating discussions of these topics. I also thank Rosanne Altshuler, Alan Auerbach, Mitchell Kane, Martin McMahon, Daniel Shaviro, Stephen Shay, Michael Smart, and various seminar participants for many helpful comments on earlier drafts.

[FN1]. Worldwide income taxation typically includes the taxation of individual incomes, but, in the interest of

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tackling one issue at a time, this Article puts the specific considerations that apply to individual income tax implications of worldwide taxation and territoriality aside for a more propitious moment. As a practical matter, worldwide taxation of business income by the United States is much more consequential in the sense of revenue collected and burdens imposed than is U.S. worldwide taxation of individual income. As one indication of the relative magnitudes involved, the aggregate foreign earned income reported by U.S. individuals filing Form 2555 in 2001, plus trust income earned in 2002, was $27.9 billion. By contrast, the largest controlled foreign corporations of U.S. corporations reported $160.1 billion of after-tax foreign earnings and profits in 2002. Jeff Curry & Maureen Keenan Kahr, Individual Foreign-Earned Income and Foreign Tax Credit, 2001, IRS, Stat. Income Bull., Spring 2004, at 98; Daniel S. Holik, Foreign Trusts, 2002, IRS, Stat. Income Bull., Summer 2005, at 134; Mike Masters & Catterson Oh, Controlled Foreign Corporations, 2002, IRS, Stat. Income Bull., Spring 2006, at 193. Any unreported income is of course not captured in these figures.

[FN2]. Code Général des Impôts art. 209 (stating that, subject to tax treaties and certain exceptions, only profits from operations in France are subject to corporate income tax); id. art. 209B (providing an exception for controlled corporations located in a country with a preferential tax regime); id. art. 238 bis. OI (creating an anti-abuse provision for French corporations that move assets out of France); id. art. 209 quinquies (allowing a French corporation to be taxed on either consolidated profits or worldwide profits, with consent from the Ministry of Economy and Finance).

[FN3]. IRC §§ 901, 902.

[FN4]. Peggy Brewer Richman [Musgrave], Taxation of Foreign Investment Income: An Economic Analysis (1963); Peggy B. Musgrave, United States Taxation of Foreign Investment Income: Issues and Arguments (1969).

[FN5]. See Michael Keen & Hannu Piekkola, Simple Rules for the Optimal Taxation of International Capital Income, 99 Scand. J. Econ. 447 (1997); Joel Slemrod, Carl Hansen & Roger Procter, The Seesaw Principle in International Tax Policy, 65 J. Pub. Econ. 163 (1997); James R. Hines Jr., The Case Against Deferral: A Deferential Reconsideration, 52 Nat'l Tax J. 385 (1999); Michael Keen & David Wildasin, Pareto-Efficient International Taxation, 94 Am. Econ. Rev. 259 (2004).

[FN6]. See Mihir A. Desai & James R. Hines Jr., Old Rules and New Realities: Corporate Tax Policy in a Global Setting, 57 Nat'l Tax J. 937 (2004) [hereinafter Old Rules]; Mihir A. Desai & James R. Hines Jr., Evaluating International Tax Reform, 56 Nat'l Tax J. 487 (2003) [hereinafter Tax Reform].

[FN7]. This Section and the Section that follows draw on Desai & Hines, Old Rules, note 6, and Desai & Hines, Tax Reform, note 6.

[FN8]. See, e.g., Office of Tax Pol'y, Treasury Dep't, The Deferral of Income Earned through U.S. Controlled Foreign Corporations: A Policy Study 53 (2000), available at http://www.treasury.gov/offices/tax-policy/library/subpartf.pdf; Staff of Joint Comm. on Tax'n, 102d Cong., Factors Affecting the International Competitiveness of the United States 246-48 (Comm. Print 1991); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 455 (1999).

[FN9]. See Thomas Horst, A Note on the Optimal Taxation of International Investment Income, 94 Q.J. Econ. 793 (1980) (identifying circumstances in which the optimal taxation of foreign income corresponds to CEN).

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For a recent statement of the significance of CEN, see Donald J. Rousslang, Deferral and the Optimal Taxation of International Investment Income, 53 Nat'l Tax J. 589 (2000).

[FN10]. See, e.g., Roger H. Gordon & James R. Hines Jr., International Taxation, in 4 Handbook of Public Economics 1935 (Alan J. Auerbach & Martin Feldstein eds., 2002); Gary Clyde Hufbauer, U.S. Taxation of International Income: Blueprint for Reform (1992); see also Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, The David R. Tillinghast Lecture, NYU School of Law (Oct. 26, 2000), in 54 Tax L. Rev. 261 (2001); Koichi Hamada, Strategic Aspects of Taxation on Foreign Investment Income, 80 Q.J. Econ. 361 (1966); Hines, note 5; Keen & Piekkola, note 5.

[FN11]. See, e.g., Rousslang, note 9.

[FN12]. Levinsohn and Slemrod and Devereux and Hubbard analyze the behavior of oligopolistic firms in world markets, identifying the effects of home country tax rules on the behavior of foreign firms that compete with home country firms. Michael P. Devereux & R. Glenn Hubbard, Taxing Multinationals, 10 Int'l Tax & Pub. Fin. 469 (2003); James Levinsohn & Joel Slemrod, Taxes, Tariffs, and the Global Corporation, 51 J. Pub. Econ. 97 (1993).

[FN13]. Mitchell Kane considers the tax implications of a different notion of efficient ownership, which accounts for the differences between the implications he draws for efficient taxation and those of capital ownership neutrality and national ownership neutrality. See Mitchell A. Kane, Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks, 26 Va. Tax Rev. 53 (2006).

[FN14]. Id. at 27 (arguing that only when capital is equally productive in the hands of each investor would there be an efficient allocation of capital ownership).

[FN15]. See, e.g., Michael J. McIntyre, Guidelines for Taxing International Capital Flows: The Legal Perspective, 46 Nat'l Tax J. 315 (1993). There is ample evidence, reported in James R. Hines, Jr., Lessons from Behavioral Responses to International Taxation, 52 Nat'l Tax J. 305 (1999), that tax rates influence the location of reported pretax income.

[FN16]. Johannes Becker and Clemens Fuest analyze the effects of tax systems on incentives to undertake international mergers and acquisitions, concluding that international conformity, and in particular territorial taxation, promotes efficient merger activity. See Johannes Becker & Clemens Fuest, Corporate Tax Policy and International Mergers and Acquisitions: Is the Tax Exemption System Superior? (Ctr. for Econ. Studies & Ifo Inst. for Econ. Research, Working Paper No. 1884, 2007), available at http://ssrn.com/abstract=959991.

[FN17]. Desai & Hines, Tax Reform, note 6.

[FN18]. See James R. Hines, Jr., Altered States: Taxes and the Location of Foreign Direct Investment in America, 86 Am. Econ. Rev. 1076 (1996).

[FN19]. James R. Hines Jr., Tax Sparing and Direct Investment in Developing Countries, in International Taxation and Multinational Activity 39 (James R. Hines Jr. ed., 2001).

[FN20]. Mihir A. Desai & James R. Hines Jr., “Basket Cases”: Tax Incentives and International Joint Venture Participation by American Multinational Firms, 71 J. Pub. Econ. 379 (1999); see also Rosanne Altshuler & R. Glenn Hubbard, The Effect of the Tax Reform Act of 1986 on the Location of Assets in Financial Services

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Firms, 87 J. Pub. Econ. 109 (2003).

[FN21]. Rosanne Altshuler & Harry Grubert, Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy, 87 J. Pub. Econ. 73 (2003); Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Chains of Ownership, Regional Tax Competition, and Foreign Direct Investment, in Foreign Direct Investment in the Real and Financial Sector of Industrial Countries 61 (Heinz Herrmann & Robert Lipsey eds., 2003).

[FN22]. Mihir A. Desai & James R. Hines Jr., Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions, 55 Nat'l Tax J. 409 (2002).

[FN23]. Official transfers also enter the capital account, although these are typically of very small net magnitude.

[FN24]. See Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Foreign Direct Investment and the Domestic Capital Stock, Am. Econ. Rev., May 2005, at 33, 33.

[FN25]. See Christian Arndt, Claudia M. Buch & Monika Schnitzer, FDI and Domestic Investment: An Industry-Level View 27 (Governance & the Efficiency of Econ. Sys., Working Paper No. 212, 2007), available at http:// www.sfbtr15.de/dipa/212.pdf.

[FN26]. See Walid Hejazi & P. Pauly, Motivations for FDI and Domestic Capital Formation, 34 J. Int'l Bus. Stud. 282, 282-83, 286 (2003) (demonstrating that outbound foreign direct investment increases domestic capital stock when directed toward some countries and decreases it when directed toward others).

[FN27]. See Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Domestic Effects of the Foreign Activities of U.S. Multinationals, 1 Am. Econ. J.: Econ. Pol'y 181, 201 (2009).

[FN28]. See Helen Simpson, How Does Overseas Investment Affect Activity at Home? 29-30 (Apr. 2008) (unpublished manuscript, available at http:// www.ifs.org.uk/docs/etpf/simpson.pdf).

[FN29]. See Jörn Kleinert & Farid Toubal, The Impact of Locating Production Abroad on Activities at Home: Evidence from German Firm-Level Data 23 (Eberhard-Karls Univ. Tübingen, Discussion Paper No. 314, 2007), available at http://tobias-lib.ub.uni-tuebingen.de/volltexte/2007/3081/pdf/314.pdf.

[FN30]. See Desai et al., note 27, at 182.

[FN31]. Id. at 192.

[FN32]. Id. at 182.

[FN33]. As Hines and others note, the welfare cost of excessive investment in low-tax countries takes country tax rates to be unrelated to the social value of FDI. See Hines, note 5, at 398.

[FN34]. Id.

[FN35]. Reg. §§ 1.861-8, 1.861-8T, 1.861-9, 1.861-9T, 1.861-10, 1.861-10T (apportioning income, interest expense, and other expenses through a formulary approach).

[FN36]. Daniel Shaviro criticizes U.S. interest expense rules, and observes that, given the problems of world-

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wide allocation, even a country committed to CEN might want to consider tracing interest expenses rather than using a formula to allocate interest. Daniel N. Shaviro, Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals, 54 Tax L. Rev. 353, 356-57 (2001).

[FN37]. We could envision a world in which foreign governments might permit the firm to deduct the other $75 of its expenses against income earned in their country, though this is of course not the world we inhabit. The discussion that follows assumes that governments do not permit deductions for general expenses incurred in other countries, as is indeed the universal practice.

[FN38]. See Shaviro, note 36, at 354.

[FN39]. See notes 24-30 and accompanying text. It is worth emphasizing that a system of CON and NON would subject truly passive foreign income to domestic taxation. See Desai & Hines, Old Rules, note 6, at 950 & n.22. One can think of a parent company using the proceeds from issuing a bond to invest in a foreign affiliate that uses its invested capital to buy the bond. In such a case, either the home country should subject the foreign income to taxation and permit a deduction for domestic interest expenses, or else exempt the foreign interest income from taxation and deny the domestic interest expense deduction. The argument in this Section presumes that the passive foreign interest income would be taxed by the home government.

[FN40]. IRC §§ 901, 902.

[FN41]. IRC §§ 901(b), 902(c)(4)(A); see also Reg. § 1.901-2.

[FN42]. See Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Foreign Direct Investment in a World of Multiple Taxes, 88 J. Pub. Econ. 2727 (2004).

[FN43]. See Karen Nelson 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, 219-24 (1988) (discussing and criticizing the incidence justification).

[FN44]. One method of selling foreign operations to foreign companies not subject to the U.S. tax regime is for a U.S. company to expatriate by inverting the corporate structure to establish non-U.S. ownership of its foreign operations. The adoption of residence-based excise taxation would certainly increase incentives to expatriate, and there is ample evidence that expatriation behavior is sensitive to incentives. See, e.g., Desai & Hines, note 22. The discussion that follows limits its analysis to situations in which domestic firms face sufficient economic or political costs of expatriating that they do not avail themselves of this option.

[FN45]. Desai et al., note 42, offers evidence of the impact of taxes other than income taxes on the volume of foreign activity by U.S. businesses.

[FN46]. This discussion of the example of gasoline excise taxes puts aside one of the primary considerations in taxing gasoline, namely the externalities associated with the environmental, health, congestion, and other consequences of consuming gasoline. To the degree that countries differ in their gasoline excise taxes based on differences in levels of local externalities, then global efficiency requires preserving these differences, and not offsetting them with a residence-based system. But of course the same point applies to income taxes, as noted above and in Hines, note 5, at 398.

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[FN47]. See, e.g., Timothy J. Besley & Harvey S. Rosen, Sales Taxes and Prices: An Empirical Analysis, 52 Nat'l Tax J. 157 (1999); James M. Poterba, Retail Price Reactions to Changes in State and Local Sales Taxes, 49 Nat'l Tax J. 165 (1996).

[FN48]. OECD, Consumption Tax Trends 2008: VAT/GST and Excise Rates, Trends and Administrative Issues 118-19 (2008) (listing the 143 countries using a VAT).

[FN49]. See, e.g., J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income, 5 Fla. Tax Rev. 299, 342-43 (2001). But see Nancy H. Kaufman, Fairness and the Taxation of International Income, 29 Law & Pol'y Int'l Bus. 145, 203 (1998) (criticizing the justification that fairness principles mandate that international income be subject to home country taxation).

[FN50]. As it happens, there appears to be insufficient demand for state and local debt among top-bracket investors, as the implied tax rate from tax exempt bond yields is below the 35% top federal rate. See Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 224 (6th ed. 2009) (ratio of yields generally about 75%). As a consequence, a taxable investor facing a 35% tax rate in most years receives a small windfall from buying state and local debt.

[FN51]. See, e.g., Fleming et al., note 49, at 317-18.

[FN52]. See Desai & Hines, Tax Reform, note 6, at 493.

[FN53]. Cf. Michael J. Graetz & Itai Grinberg, Taxing International Portfolio Income, 56 Tax L. Rev. 537, 551 (2003) (discussing “home bias” in the context of portfolio income).

[FN54]. Roger H. Gordon, Taxation of Investment and Savings in a World Economy, 76 Am. Econ. Rev. 1086, 1095 (1986).

[FN55]. Id. at 1096.

[FN56]. Arnold C. Harberger, The ABCs of Corporate Tax Incidence: Insights into the Open-Economy Case, in Tax Policy and Economic Growth 51, 65 (1995); Laurence J. Kotlikoff & Lawrence H. Summers, Tax Incidence, in 2 Handbook of Public Economics 1043 (Alan J. Auerbach & Martin Feldstein eds., 1987).

[FN57]. William C. Randolph, International Burdens of the Corporate Income Tax 25 (Cong. Budget Office, Working Paper No. 2006-09, 2006).

[FN58]. Id. at 8.

[FN59]. See Don Fullerton & Gilbert E. Metcalf, Tax Incidence, in 4 Handbook of Public Economics, note 10, at 1787, 1833.

[FN60]. Compare IRC § 11 (imposing a tax on corporate income), and IRC §§ 301, 316 (imposing a shareholder-level tax on dividend distributions), with IRC § 163(a) (allowing a corporate-level deduction for interest paid or accrued).

[FN61]. See, e.g., IRC § 38(b) (detailing various favored investments that generate business tax credits).

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[FN62]. See IRC § 1001(a) (requiring a “sale or other disposition”).

[FN63]. Compare IRC § 1(h) (providing capital gains rates), with IRC § 1(a) (providing rates for ordinary income).

[FN64]. For an extended analysis of this point, see generally Hines, note 5.

[FN65]. See, e.g., Lawrence Lokken, Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike), 59 SMU L. Rev. 751, 757 (2006) (discussing CEN as the primary justification for worldwide taxation).

[FN66]. For articles exploring issues related to strategic setting of tax rates on foreign income by imperfectly competitive governments, see, e.g., Eric W. Bond & Larry Samuelson, Strategic Behaviour and the Rules for International Taxation of Capital, 99 Econ. J. 1099 (1989); Martin Feldstein & David Hartman, The Optimal Taxation of Foreign Source Investment Income, 93 Q.J. Econ. 613 (1979); Roger H. Gordon, Can Capital Income Taxes Survive in Open Economies?, 47 J. Fin. 1159 (1992); Hamada, note 10; David G. Hartman, Deferral of Taxes on Foreign Source Income, 30 Nat'l Tax J. 457 (1977); William H. Oakland & Yongsheng Xu, Double Taxation and Tax Deduction: A Comparison, 3 Int'l Tax & Pub. Fin. 45 (1996).

[FN67]. See Feldstein & Hartman, note 66, at 622.

[FN68]. Id. at 621.

[FN69]. See, e.g., Charles E. McLure, Jr. & George R. Zodrow, A Hybrid Consumption-Based Direct Tax Proposed for Bolivia, 3 Int'l Tax & Pub. Fin. 97, 97 (1996) (documenting the reluctance of the government of Bolivia to introduce a cash-flow style corporate income tax due to its potential noncreditability by U.S. investors in Bolivia). Case-specific tax provisions, such as individually-negotiated tax holidays, are more likely to be influenced by home country tax rules. See, e.g., Hines, note 19 (reporting evidence concerning the effect of “tax sparing” on local tax rates in developing countries).
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International

*Prof. Michael J. Graetz**

A Multilateral Solution for the Income Tax Treatment of Interest Expenses

The question of the proper treatment of interest expenses has generally been looked at from the perspective of either inbound or outbound investment and with the view that nations are either debtors or creditors, not both. As a result, the issues of residence countries' limitations on interest deductions on borrowing to finance tax-favoured foreign-source income, on the one hand, and of source countries' restrictions on interest deductions intended to limit companies' ability to strip income from a higher-tax to a lower-tax country, on the other, have generally been treated as separate issues, with no real effort to show how they relate. This article demonstrates their linkage and proposes a multilateral solution that would address both of these problems.

1. Introduction

Although there has been some discussion in recent years of the treatment of borrowing and its attendant interest expenses, the tax treatment of this expense has generally received less analysis than that of business income. Some recent developments, however – including greater taxpayer sophistication in structuring and locating international financing arrangements, increased government concerns with the role of debt in sophisticated tax avoidance techniques, and disruption by decisions of the European Court of Justice (ECJ) of a host of Member States' regimes for limiting interest deductions – have stimulated new laws and policy controversies concerning the international tax treatment of interest expenses. Recent developments make clear the complexity, the incoherence and the futility of countries acting independently to limit interest deductions.[1] They also raise fundamental questions about the proper treatment of interest expenses and whether other expenses, such as for headquarters costs or research and development (R&D), should raise similar concerns.

National rules are in flux regarding the financing of both inbound and outbound transactions. When outbound investments are financed by debt, the question arises whether the fact that the foreign-source income will be deferred or taxed at lower rates justifies the home country limiting the deductibility of interest expenses. In the United States and the United Kingdom, for example, attention has recently focused on whether to allocate and disallow interest deductions connected to foreign-source income under a dividend exemption system.[2] Also in the U.S., House Ways and Means Committee Chairman Charles Rangel (Democrat, New York) has introduced legislation under the U.S. foreign tax credit system that would allocate and postpone interest deductions on outbound investments until dividends are repatriated.[3]

The EU Member States have recently been revising their treatment of interest deductions with special concern for the taxation of inbound investments. As in the outbound context, the critical questions stem from government concerns about the potential for a disappearing corporate tax base. In Europe, the greatest attention has focused on the treatment of "fat" or "thin" capitalization rules (known in the U.S. as "earnings stripping rules"). Reconsideration of Member States' limitations on interest deductions in this context was required by the ECJ in its 2002 decision in the *Lankhorst-Hohorst* case (and subsequent decisions), which struck down Germany's thin capitalization rules as applied to interest paid to companies from other Member States as a violation of the freedom of establishment guarantee of the EC Treaty.[4] These ECJ decisions require equal treatment of

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1. For a useful summary of recent developments, see the excellent General Report authored by Pascal Hinny and the 34 Branch Reports on Subject 2: New tendencies in tax treatment of cross-border interest of corporations, in *Cahiers de droit fiscal international*, Vol. 93b (2008) (62nd Congress of the International Fiscal Association, Brussels, 2008). See also Arnold, Brian, General Report on Subject I: Deductibility of interest and other financing charges in computing income, in *Cahiers de droit fiscal international*, Vol. 79a (1994), at 491 (48th Congress of the International Fiscal Association, Toronto, 1994); and Shaviro, Daniel N., "Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of American Multinationals", 54 *Tax Law Review* 353 (2001).
2. The proposals by the U.S. Joint Committee on Taxation and the President's Advisory Panel on Federal Tax Reform for a dividend exemption system would require the allocation and disallowance of interest expenses incurred to earn foreign-source income. See U.S. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (27 January 2005); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposal to Fix America's Tax System* (Washington, D.C.: U.S. Government Printing Office, 2005). In contrast, the U.S. Department of the Treasury recently issued a report on the competitiveness of U.S. businesses that suggests a dividend exemption system with no allocation of interest. U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (20 December 2007). See also HM Treasury and HM Revenue & Customs, *Taxation of the Foreign Profits of Companies: A Discussion Document* (June 2007).
3. Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Congress, §§ 975-977 (2007). This is one of several proposals designed to help finance a lower corporate income tax rate in the United States. In addition, Congress passed legislation in 2004, effective in 2009, that would shift from water's edge interest allocation to worldwide allocation for purposes of determining the foreign tax credit limitation, but that change has now been postponed until 2011. Housing and Economic Recovery Act of 2008, Public Law 110-289, 122 Stat. 3039. See discussion at notes 19-21, infra.
4. *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, Case C-324/00, 2002 ECR I-11,779. In *Lankhorst-Hohorst*, the ECJ considered a law under which German subsidiaries of non-German parent companies were denied deductions for interest paid to the foreign parent company when the subsidiary had a high debt-to-equity ratio, although such deductions were allowed for

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borrowing by domestic and non-domestic companies that are from the EU Member States. In response, Germany now limits interest deductibility to a specified percentage (30%) of "earnings before interest, tax, depreciation and amortization" (EBITDA) without regard to whether the borrowing is from a foreign lender or a related company. Similar rules are being enacted or considered by certain other EU Member States.

In November 2007, the U.S. Treasury issued a report on earnings stripping in response to a congressional mandate requiring such a study as part of legislation dealing with corporate inversions from U.S.-headquartered to foreign-headquartered companies.[5] In Canada, questions about limitations on interest deductions have arisen in the context of a broad review of international tax policy.[6] And in Belgium, for example, a notional interest deduction based on a company's net assets was enacted in 2006 in an effort to reduce the advantages for debt over equity financing.[7] In addition to the foregoing specific rules, interest deductions may also be disallowed under general anti-abuse rules or transfer pricing regimes.

Some countries levy withholding taxes on cross-border payments of interest, although most do not. Where applicable, the withholding tax rates vary from about 12.5% (Italy) to nearly 42% (Mexico), but are often reduced or eliminated by bilateral tax treaties. (The OECD Model Tax Convention sets a maximum rate of 10%.) These treaty reductions are, in turn, restricted to residents of the treaty country by limitation on benefits clauses in the treaties. Obviously, a sufficiently high withholding tax on payments of interest can substitute for disallowing interest deductions.

As this very brief overview implies, the treatment of cross-border interest payments is now one of the most complex aspects of income tax law. Rules differ among countries and contexts. As a result of the decisions of the ECJ, some uncertainty remains in Europe about what rules are permissible. The subject is further complicated by different countries' varying approaches to distinguishing interest payments from dividends. Moreover, because money is fungible, it is difficult in both theory and practice to know the "purpose" of specific borrowing. Nevertheless, many countries attempt to "trace" borrowed funds to their use, creating opportunities for creative tax planning and inducing inevitable disputes between taxpayers and tax collectors.

These disparities in law and practice create opportunities for either double or zero taxation. Since taxpayers generally have great control over the location of their borrowing, there is considerably greater risk of the latter.

Heretofore, in both the literature and policymaking, the question of the proper treatment of interest expenses has generally been looked at from the perspective of either inbound or outbound investment and with the view that nations are either debtors or creditors, not both. As a result, the issues of residence countries' limitations on interest deductions on borrowing to finance low-taxed, exempt or deferred foreign-source income, on the one hand, and of source countries' restrictions on interest deductions intended to limit companies' ability to strip income from a higher-tax to a lower-tax country, on the other, have generally been treated as separate issues. Each of these issues has been discussed in the literature, but there has been no real effort to show how they relate. A fundamental contribution of this article is to demonstrate their linkage and to call for a multilateral solution that would address both of these problems.

I shall use the following simple and stylized example to illustrate the fundamental issues and to show how they are connected. At the outset, the example assumes that the purpose of the taxpayer's borrowing is known; I shall deal subsequently with this oversimplification.

2. A Simple Example to Illustrate the Issues

Assume three countries: *H* – with a corporate income tax rate of 35%, *M* – with a 25% rate, and *L* – with a 15% rate. *H* is a high corporate tax rate country, such as the U.S. or Japan; *M*, like most of western Europe, has a corporate tax rate a bit below the OECD average; and *L*, like China and Ireland for example, has a low corporate tax rate. For simplicity of exposition, *H* is assumed to want to tax only the domestic-source income of both its residents and non-residents, and it therefore exempts foreign-source dividends.[8] The policy choice for *H* is (1) allowing interest deductions in full whenever borrowing occurs in *H* without regard to where the investment it finances occurs, or (2) disallowing interest deductions when borrowing is determined to be used for investing abroad. Thus, to the policymakers of *H*, the question is whether to disallow interest deductions when interest is incurred to finance exempt (or low-taxed) income. For reasons that will be made clear subsequently, an interest disallowance regime should disallow interest deductions only when the company's borrowing is disproportionately greater in *H* than elsewhere based on an allocation of interest expenses that compares the ratio of the company's *H* borrowing to *H* assets with the ratio of its worldwide borrowing to worldwide assets.

payments by German subsidiaries to German parent companies. See also *Bosal Holding*, Case C-168/01 (13 October 2003); and *Test Claimants in the Thin Cap Group Litigation*, Case C-524/04 (13 March 2007).

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

6. The 19 March 2007 Canadian federal budget included a proposal to eliminate the deductibility of interest on debt incurred by Canadian corporations to finance foreign affiliates. In the face of significant criticism, on 14 May 2007 Minister of Finance Jim Flaherty announced significant changes to the interest deductibility proposals. The 14 May 2007 news release is available on the Department of Finance web site at www.fin.gc.ca/news07/07-041e.html. The 2007 Canadian federal budget is available at www.budget.gc.ca/2007/index_e.html.

7. See Martin, Stéphane and Patrick Smet, Branch Report for Belgium on Subject 2: New tendencies in tax treatment of cross-border interest of corporations, in *Cahiers de droit fiscal international*, Vol. 93b, supra note 1, at 127, 139.

8. I use an exemption system for illustrative purposes here both for clarity in the exposition of the issues and because it is the dominant method of relieving double taxation of income on outbound investment within the OECD. Only the Czech Republic, Ireland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom and the United States use foreign tax credits. U.S. Department of the Treasury, supra note 2, at 19, Table 1.5.

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Take a simple case where an *H* resident company borrows 100 in *H* to finance an investment of 100 in *L*. Assume that the interest expense is 10 and the income from the *L* investment is 15. If the interest expense were deducted against the *L* income, the net income from the *L* investment would be 5, which at the 15% *L* rate would yield an *L* income tax of 0.75 and after-tax income of 4.25 to the *H* company. There would be no domestic income or deduction in *H* and no *H* tax.

If borrowing could be traced to its use, this seems a plausible answer. But, because money is fungible, such tracing is not feasible in practice (despite the commonplace efforts to do so). So it seems reasonable to conclude that the company borrowed in order to keep all of its worldwide assets (rather than selling one or more assets to make the investment in *L*) and to avoid issuing new equity. This explains why *H* should treat borrowing as occurring proportionately to the *H* company's worldwide assets.[9]

If, however, *H* has no interest disallowance rule and allows the 10 of interest to be deducted in full against other income that would otherwise be taxed by *H* at its 35% rate, this would save the company 3.50 in *H* income taxes. The 15 of income in *L* would result in an *L* income tax of 2.25. The *H* company would have earned 6.25 after tax on an investment yielding just 5 before tax – implying not just zero taxation of the *L* income, but in fact a negative rate of taxation, a subsidy for this investment. From the point of view of *H*, this investment would have cost it 3.50 in foregone revenue, 1.25 of which would go to the *H* company and 2.25 of which would go to the treasury of *L*.[10] Perhaps some argument (presumably on competitiveness grounds) can be made for *H* subsidizing this investment by the *H* company, but what argument is there in a case such as this for transferring revenues from *H's* treasury to the treasury of *L* simply because the company chose to locate its borrowing for this investment in *H*? If *H* is revenue constrained, the 3.50 of revenue lost on this investment must be made up from somewhere else, and important economic and distributional consequences will turn on who and what is taxed.

Moreover, at its 15% tax rate, the government of *L* should get only 0.75 in income taxes on an investment yielding a pre-tax profit of 5, rather than the 2.25 it did receive – an amount equivalent to levying a 45% tax on the company's before-tax profits. Under current arrangements, however, *L* will allow no deduction for interest expenses when the borrowing takes place in *H*, so the government of *L* might get 2.25 in taxes whether *H* allows the interest deduction or not. But the consequences will be very different depending on whether that money comes from the *H* company or from other *H* taxpayers. If *H* disallows the entire interest deduction in this case and *L* does not allow any deduction because the borrowing occurred in *H*, *H* will collect its 35% tax on the company's domestic income and, as indicated above, *L's* income tax of 2.25 would produce a tax rate of 45% on this investment – a rate higher than that in either of these countries. In other words, there would be a significant element of double taxation.

The *H* company, of course, could avoid this double tax by, for example, locating the borrowing in *L* rather than *H*. And if each country is to tax the net domestic income earned there, the interest deduction should be allowed by *L*, not *H*.

Internation equity also supports this result. In this example, the source country is given not only the first bite at taxing the active business income earned there, but the sole claim on taxing such income. Given the priority of source countries on the asset side, why should the residence country also be required to lose revenue on the liability side? The source country, by not allowing deduction of the interest, is the cause of the double tax. Why should it be the residence country's responsibility to undo that result – especially when the residence country is not even making a residual claim to tax the foreign income?

For an important variation on this basic example, assume now that *M*, with its income tax rate of 25%, has no interest disallowance rule. If the *H* company also has income and assets located in *M*, it might choose to borrow in *M* instead of *H* or *L* and deduct the 10 of interest against income that *M* would otherwise tax. In that case, the *H* company would save 2.50 of tax in *M* and pay income tax to *L* of 2.25 for an after-tax return of 5.25 on an investment yielding 5 before tax – again earning a return that is higher after tax than before tax. In this case, however, the 0.25 subsidy to the *H* company and the 2.25 transfer to the treasury of *L* would come from the taxpayers of *M* rather than *H*.

The policymakers of the *M* government would view this transaction as a problem of earnings stripping (or thin capitalization) by the *H* company. Thus, economically similar transactions will fit into different traditional analytic boxes depending on which country is examining the transaction and where the borrowing takes place.

Here again, if the borrowing company were resident in *M*, it is perhaps conceivable that some argument or empirical claim could be advanced for this treatment (as before, no doubt grounded in the competitive advantages to *M's* residents of a resident company making this investment[11]), but it seems impossible to fashion an

9. I ignore here the theoretical difficulty and practical necessity of using the book value rather than the fair market value of assets. Relying on basis, rather than value, does have the advantage of resolving the difficult issue of intangible assets since the costs of self-created intangibles are typically deducted rather than capitalized.

10. In theory, the revenue lost to *H* through the interest deduction might be made up if *H* were to tax the lender on the interest income. While the precise dimensions of this possibility are difficult to get a handle on, as a practical matter, given the large holdings of U.S. corporate debt in tax-exempt retirement accounts, university endowments and other tax-exempt entities and by foreigners, this is quite unlikely – at least in the U.S.

11. See Samuels, John, Vice President & Senior Counsel of Tax Policy and Planning, General Electric, "True North: Charting a Course for U.S. International Tax Policy in the Global Economy", the David R. Tillinghast Lecture on International Taxation, 25 September 2007 (forthcoming in *Tax Law Review*); see also the discussion at notes 35-37, infra.

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argument that this transfer from the treasury of *M* to both the *H* company and *L's* treasury makes any sense at all as a deliberate policy choice of *M*. Of course, if *M* is an EU Member State, the decisions of the ECJ in *Lankhorst-Hohorst* and subsequent cases might not allow it to treat an *H* company any differently than an *M* company.[12] And it is also possible that the non-discrimination clause of *M's* bilateral tax treaties might foreclose it from making such a distinction.[13]

To complete the analysis, it is worth noting that an *M* company contemplating a debt-financed investment in *L* would have an incentive to do its borrowing in *H* (if it had assets and income there) so that its interest deduction would offset income that would otherwise be taxed at *H's* higher 35% rate. Thus, *H* will also have earnings stripping (or thin capitalization) problems to deal with.

3. How Interest Expenses Should Be Allocated

3.1. A word about source

It is fundamental that, except in the context of a system of current taxation of worldwide income with an unlimited foreign tax credit – a system that no country now has, ever has had, or is likely ever to have – it is essential for each nation to distinguish between domestic-source income and foreign-source income. The consequences of this distinction vary depending on a country's tax rate and its system for avoiding double taxation. In the U.S. foreign tax credit system, for example, the distinction between foreign-source and domestic-source income is important principally for determining the limitation on foreign tax credits; in an exemption system, it is important for measuring taxable versus exempt income.

But, as is well known, the "source" of income is not well grounded economically, nor is it conceptually straightforward.[14] In many instances (not discussed here), archaic rules and distinctions prevail.[15] Moreover, the current rules often stem from political decisions and compromises made scores of years ago when capital was far less mobile. The sourcing of interest, for example, was a contentious decision made in the 1920s during the initial formulation of international agreements for relieving double taxation.[16] Since both net foreign-source and domestic-source income must be measured, however, it is necessary to source both income and deductions, even if the current sourcing rules seem arbitrary and archaic.

3.2. The effect of different rules in different countries

As the foregoing example illustrates and the empirical economics literature amply demonstrates, different tax rates in different countries create incentives for companies both in choosing where to locate real investments and in shifting income and deductions around the world.[17] And, as the example above illustrates, when countries differ in their rules for determining the source of a particular kind of income, both double taxation and zero (or even negative) taxation can occur. U.S. multinationals frequently complain, for example, about the double taxation that occurs because the U.S. allocates and disallows interest (for foreign tax credit limitation purposes) while other countries do not allow deduction of the interest disallowed by the U.S. They stifle such complaints, however, when in other contexts the lack of harmonization allows them to avoid taxation in any country.[18] In the absence of multilateral agreement, these difficulties, opportunities and issues will persist.

As a result, it is treacherous to evaluate companies' claims of competitive disadvantage based on pairwise distinctions of specific rules. To know whether a company headquartered in one country is advantaged or disadvantaged compared to another company headquartered elsewhere, one would have to compare the totality of consequences of similar investments. In the literature, this typically occurs only through efforts to measure the overall effective tax rates. These exercises typically simply assume a certain proportion of debt and equity finance, and therefore do not address the issues I am addressing here, in particular, the location of borrowing. In any event, piecemeal policy-by-policy comparisons should be taken with a grain of salt; a disadvantage in one aspect of tax policy may be compensated for by an advantage elsewhere. Taxpayers obviously have incentives to highlight their disadvantages rather than their advantages.

3.3. The particular difficulty of tracing interest deductions to the income the borrowing finances

Given the fungibility of money, knowing the purpose of borrowing is an impossible quest. Nevertheless, even for purely domestic investments, the U.S. tax law, for example, distinguishes among categories of personal interest, investment interest and a wide variety of business interest costs. The U.S. has essentially been undaunted by the folly of attempting to trace borrowed money to its use. So have many other countries. This is one reason why the tax provisions governing interest deductions, which frequently condition the deductibility of interest on the

12. *Lankhorst-Hohorst*, supra note 4, and the cases cited there.
13. Such claims were made – but ignored by the United States – in connection with the enactment of the U.S. earnings stripping rules. Graetz, Michael J. and Alvin C. Warren, Jr., "Income Tax Discrimination and the Political and Economic Integration of Europe", 115 *Yale Law Journal* 1186 (2006); Warren, Jr., Alvin C., "Income Tax Discrimination Against International Commerce", 54 *Tax Law Review* 131 (2001).
14. Ault, Hugh J. and David Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises", in Razin, Assaf and Joel Slemrod (eds.), *Taxation in the Global Economy* (1990), at 11.
15. See e.g. Colón, Jeffery M., "Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads", 1999 *University of Illinois Law Review* 775.
16. See Graetz, Michael J. and Michael O'Hear, "The 'Original Intent' of International Taxation", 46 *Duke Law Journal* 1021 (1997).
17. Gordon, Roger H. and James R. Hines, *International Taxation*, National Bureau of Economics Research Working Paper No. 8854-4 (2002); European Commission, Commission Staff Working Paper, *Company Taxation in the International Market*, COM(2001) 582 (2001).
18. Kane, Mitchell, "Strategy and Cooperation in National Responses to International Tax Arbitrage", 53 *Emory Law Journal* 89 (2004); Ring, Diane, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage, 44 *Boston College Law Review* 79 (2002); Rosenbloom, H. David, "International Tax Arbitrage and the 'International Tax System'", 53 *Tax Law Review* 137 (2000).

purpose of the indebtedness, are now among the most complex in the income tax. These complexities, and the controversies about them, often occur, as in the instant context, because of the tax-favoured treatment of assets financed with borrowed funds.

In the context of cross-border investments, beginning with the regulations issued in 1977, the U.S. generally accepted the fact that money is fungible and apportioned the interest expense of U.S. corporate entities for foreign tax credit purposes according either to the (book) value of assets or to gross income.[19] The assets approach was most widely used; thus, interest deductions (for foreign tax credit limitation purposes only) were generally computed using the following (simplified) formula: allowable U.S. interest expense equals worldwide interest expense times the ratio of U.S. assets to worldwide assets. The Tax Reform Act of 1986 refined this concept by looking at interest expenses on a consolidated basis for affiliated corporations rather than on an entity-by-entity basis. The 1986 law, however, unfortunately and erroneously ignored foreign subsidiaries in this calculation,[20] which is why it became known as "water's edge allocation". But that defect was remedied by legislation in 2004, which will treat all members of a worldwide group as a single corporation.[21] (The 2004 corrective legislation, however, was not scheduled to take effect until 2009 and, in 2008, the legislation was delayed until 2011.[22])

A worldwide allocation system, based on the ratio of debt to assets, is the most appropriate method for measuring domestic-source and foreign-source income if interest expense is to be allocated.[23] *Importantly, worldwide allocation based on assets implies that interest deductions will not be treated as allocable to foreign-source income and disallowed except when borrowing in one country is disproportionate to borrowing elsewhere.*

4. What is at Stake in the Treatment of Interest Expenses?

4.1. Location of investment

Some argue that the failure to allocate interest deductions on a worldwide basis will create an inappropriate incentive for companies to invest abroad rather than at home. The example above demonstrates why this might be true. It is important to recognize, however, that the fundamental income tax incentive for a company to invest in a low-tax country, such as *L*, rather than in higher-tax countries, such as *H* (or *M*), is due to the lower tax rate in *L*. Extensive econometric evidence shows that, although business, not tax, considerations often dominate, the location of investments is significantly influenced by tax rate differences, and an important study by the European Commission has concluded that differences in tax rates are the principal income tax factor affecting decisions about the location of investments.[24] The essential point is this: the incentive to invest in *L* rather than in *H* exists even if the investments are financed solely by equity and no interest deductions are at issue. An investment in *H* yielding 5 before tax will produce only 3.25 after tax, compared to the 4.25 available after tax for an investment in *L*. Only by eliminating the tax rate differential – through harmonization of tax rates or a capital-export neutrality policy of current taxation by *H* of the income earned in *L* with a foreign tax credit for *M's* taxes, a policy no country has adopted – will that incentive be eliminated.

Careful analyses of situations where assets eligible for favourable tax treatment are acquired with debt, such as where borrowing occurs to finance domestic tax-exempt income or other tax-favoured domestic investments, for example in plant and equipment, have also concluded that it is the tax preference, not the borrowing, that is the fundamental stimulant to the investment.[25] In such instances, it may even be the case that disallowing interest deductions will inhibit the effectiveness of the underlying tax preference.[26] But these analyses focus on cases where both the income taxation on the asset side and the tax treatment of the interest expense are controlled by the same domestic policymaking process. Importantly, with the issue here, the tax preference on the asset side – the low tax rate in *L* – is outside the control of the *H* or *M* government. And, as the example demonstrates, allowing full deduction of the interest on the borrowing in *H* (or *M*) will tend to exacerbate the preference for investments in low-tax countries by producing an overall *negative* rate of income tax on the foreign investment.

19. For a history of interest allocation, see Hufbauer, Gary Clyde and Airel Assa, *U.S. Taxation of Foreign Income* (2007), at 236-240. For an analysis suggesting that worldwide allocation of interest is "more consistent [than water's edge allocation] with the basic objective of the foreign tax credit limit" and details about the formulas that have been used in the United States, see Gravelle, Jane G. and Donald J. Marples, "The Foreign Tax Credit's Allocation Rules", Congressional Research Service (16 May 2008).

20. To my knowledge, no respectable policy argument has been made in support of the U.S. system of water's edge allocation. It is an unprincipled revenue grab enacted in 1986 that has remained in the law far too long, but the U.S. Congress, seeking revenues to finance other tax reductions, seems determined to keep it in place at least for a while longer.

21. American Jobs Creation Act of 2004, Public Law 108-357, 118 Stat. 1418, § 401.

22. See note 3, supra.

23. The comparison, for example, is U.S. debt to U.S. assets versus worldwide debt to worldwide assets, with allocation to a foreign source required only when the former ratio is greater than the latter (or, alternatively, the ratio of U.S. borrowing to worldwide borrowing must be the same or less than the ratio of U.S. assets to worldwide assets). There may, however, be an argument for looking at interest on a net basis, i.e. looking only at the excess of interest expense over interest income, but I will put that issue aside here. It is probably most important for financial institutions.

24. European Commission, supra note 17. See Hines, Jr., James R., *Tax Policy and the Activities of Multinational Corporations*, National Bureau of Economics Research Working Paper No. W5589 (1996).

25. See e.g. Warren, Jr., Alvin C. and Alan J. Auerbach, "Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing", 95 *Harvard Law Review* 1752 (1982); see also Pearlman, Ronald A., "A Tax Reform Caveat: In the Real World, There is no Perfect Tax System", in Auerbach, Alan J. and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform* (2005).

26. There is controversy, for example, in the U.S. policy literature over the merits of § 265(a)(2) of the Internal Revenue Code, which disallows interest deductions on indebtedness used to purchase or carry state and local bonds the interest on which is exempt from income tax. 26 U.S.C. § 265(a)(2); see Chirelstein, Marvin A., *Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts* (10th ed., 2005), § 6.06(a).

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4.2. Creating incentives for bad investments

As the example above illustrates, allowing a deduction in a higher-tax country for borrowing to invest in lower-tax countries can produce after-tax returns greater than the investment's pre-tax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments will clearly decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.[27] Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy, as discussed below, would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place.

4.3. Choice of debt over equity finance

Allowing an interest deduction without allocation increases the advantage of debt over equity as a source of corporate finance. However, as with the decision about where to invest, the crux of this problem lies not with the failure to allocate interest, but more fundamentally with the general corporate income tax disparity between the treatment of debt and equity. Much has been written on behalf of a variety of corporate tax integration proposals to eliminate or reduce this disparity.[28] But no country has achieved parity between debt and equity finance by disallowing deductions for interest, nor does that seem likely to occur. Interest deductions will continue to be generally allowed, but whenever debt finance is permitted to produce interest deductions that will offset income otherwise taxed at a higher rate than that on the income resulting from the borrowing, this will exacerbate the advantage of debt finance. Such a regime also affects companies' decisions about the location of debt and equity finance so as to maximize the tax savings from the disparities in their treatment.

4.4. Location of borrowing

Allowing an interest deduction in *H*, even if the borrowing is disproportionately located in *H*, will encourage companies to locate their borrowing in *H* whenever the tax rate in *H* is higher than elsewhere. For example, both companies headquartered in the U.S. and companies headquartered elsewhere will prefer to deduct their interest expense against U.S. income (if they have any) that would be taxed at 35%, rather than to use the interest deduction in a country where it would offset income that would be taxed at a lower rate.[29] Indeed, given the mobile nature of corporations' ability to borrow, borrowing may disproportionately be located in *H* almost as easily for a foreign multinational as for a domestic-headquartered company.[30] *There seems to be no good policy reason for the U.S. to want to encourage borrowing that finances foreign investments to be located in the U.S.*

Interest is not the only expense that companies incur which produces foreign-source income taxed at a low rate. For example, expenditures for R&D may, over time, yield royalty income both domestically and abroad. Under the U.S. foreign tax credit system, the foreign-source royalties may bear little or no corporate income tax anywhere.[31] Likewise, headquarters expenses, often described as general and administrative or stewardship costs, tend to be concentrated in the country where a company locates its headquarters, even though these expenses support the company's production of income throughout the world. In both of these cases, some commentators have argued for a full deduction of these costs in the country where they occur without regard to where the income is earned or whether it is taxed anywhere.[32] These arguments, however, are grounded in the special benefits of these expenditures to the country where they occur – due, for example, to positive externalities from R&D and the high-quality jobs at stake in both R&D and headquarters activities. No similar arguments are available for the location of borrowing transactions.

4.5. Internation equity between source and residence countries

Under current international income tax arrangements, the source country is generally given not only the first bite at taxing the active business income earned there, but in many cases, through the domestic exemption of foreign-source dividends, the sole claim on taxing such income.[33] This source-country priority has been established either unilaterally, such as by the United States when it first enacted a foreign tax credit, or bilaterally through income tax treaties. Today, this priority is a fundamental element of more than 2,000 bilateral income tax treaties.[34] But these treaties do not require countries to allow interest deductions wherever the borrowing occurs.[35] Since source countries have the first claim to

27. The argument for repealing § 265 of the U.S. Internal Revenue Code is not applicable here; there is a great difference between transferring U.S. federal revenues to U.S. state and local governments to help them save interest costs and transferring such revenues to low-tax foreign countries. Moreover, although the advantages of repealing § 265 have long been known, this denial of interest deductions remains untouched.

28. See e.g. Graetz, Michael J. and Alvin C. Warren, Jr. (eds.), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (1998).

29. While corporations may have considerable control over where they locate their borrowing, that control may not be absolute: *L*, for example, may not have well-developed capital markets for corporate borrowing. And there may be economies of scale from concentrating borrowing in one or a few places. Moreover, a corporation will have to have assets in *L* to deduct interest there given *L's* likely earnings stripping rules. But the *government* of *H* should prefer *L* as the place for corporate borrowing to finance investments in *L*.

30. The foreign company would need to have adequate assets or income in *H* in order not to run afoul of *H's* earnings stripping rules.

31. This is because royalties are permitted to be deducted abroad, may bear little or no withholding tax, and can be sheltered from U.S. tax through cross-crediting.

32. See e.g. Hufbauer and Assa, supra note 19, at 133-143.

33. Graetz and O'Hear, supra note 16; Avi-Yonah, Reuven S., "The Structure of International Taxation: A Proposal for Simplification", 74 *Texas Law Review* 1301 (1996).

34. OECD Model Tax Convention on Income and on Capital, 15 July 2005, Arts. 23 A and 23 B.

35. They do, however, require countries not to discriminate against foreigners.

the tax revenues from income on business assets, it seems incongruous that the residence country should also be required to forego additional revenue due to the location of liabilities there. This is not required by tax treaties. Source countries contribute to causing the double tax by not allowing the deduction of interest expenses. Why should residence countries be responsible for eliminating that double tax by allowing interest deductions for borrowing used to finance assets abroad – especially when most residence countries do not even make a residual claim to tax the foreign-source income?

4.6. The potential for competitive disadvantage

The recent debate in the United States over the treatment of interest expenses has focused on outbound investments and the proper scope for the allocation (and disallowance) of interest expenses. In a turn away from its previous view, the U.S. Treasury Department, in its December 2007 report, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, called for the U.S. to allow interest deductions in full without regard to the location of the investments attributable to the borrowing.[36] The University of Michigan economist James Hines in a recent article[37] and General Electric's top tax officer John Samuels in his New York University Law School Tillinghast Lecture[38] have also recently advocated this policy. The Treasury report emphasizes the complexity of interest allocation. Prof. Hines focuses on its potential to result in advantages for foreign over domestic ownership of businesses. And Mr Samuels claims that the U.S. disallowance of interest expense will put U.S.-based multinationals at a competitive disadvantage compared to companies headquartered in nations that allow interest deductions without any such limitations.

I cannot address these views in any detail in this article. Nor is such discussion necessary here since my main purpose here is to point the way to a *multilateral* solution to this issue. But the breadth of the claims that the benefits to the U.S. from having U.S. multinationals make foreign investments justify full U.S. deduction of interest under all circumstances is troubling. There is an extraordinary "race to the bottom" quality to these arguments. In essence, they claim that the U.S. makes a mistake by disadvantaging U.S.-based companies in *any* aspect of the tax law where the consensus treatment among the U.S.'s trading partners reaches a more advantageous result. Such claims are particularly hard to credit in a context where U.S. multinationals have ready access to worldwide capital markets. They are likely to respond to a U.S. rule disallowing interest deductions when borrowing is disproportionately located in the U.S. simply by relocating their borrowing to a more favourable jurisdiction.

Moreover, such claims do not respond to any of the concerns expressed above. Nor have they been supported by any compelling empirical evidence that either worldwide economic efficiency would be improved by such a policy or, more narrowly, that the benefits to U.S. workers and investors from such a policy would exceed their costs. (Indeed, if the U.S. is worried about the international competitiveness of its workers and businesses, a far stronger argument exists for lowering the U.S. corporate tax rates, but that issue is well beyond the scope of this endeavour.) To be revenue neutral, allowing interest deductions without any limit or allocation requires higher tax rates than would a U.S. policy which requires worldwide allocation of interest expenses. And, for the reasons discussed above, it is difficult to see why allowing interest deductions without allocation should be a policy priority.

5. A Multilateral Solution

5.1. Worldwide allocation

The problems I have described here – the mismeasurement of income, potential distortions in the location of investment, an increased incentive for debt over equity finance, distortions in the location of borrowing, and unjustified revenue transfers among countries – would all disappear if all countries allocated interest deductions to assets on a uniform worldwide basis and allowed a proportionate amount of interest expense to be deducted against income earned domestically *without regard to where the borrowing occurs*.[39] Such a system would deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world.

For outbound investment, the advantages of such a regime should by now be apparent. Incentives to locate borrowing in high-tax countries would disappear, as would incentives to make debt-financed investments because their after-tax returns exceed their pre-tax returns. Debt would be located wherever it is most economical. The revenue transfer from countries where borrowing is located to those where investments are made would stop. And the advantages of debt over equity finance would be reduced somewhat.

In the case of inbound investment, where the problem is typically described as earnings stripping or thin capitalization, there is also much to commend worldwide allocation as a mechanism for determining allowable interest. No country would have to fear that it was bearing a disproportionate portion of a company's interest expense. Indeed, some EU Member States now allow worldwide allocation as a safe-harbour method to protect companies against interest expense disallowance.

The practical difficulty with such an allocation rule for inbound investments is that, without international

36. U.S. Department of the Treasury, supra note 2, at 60.
37. Hines, James R., "Reconsidering the Taxation of Foreign Income", paper delivered at New York University Law School on 14 November 2007 (forthcoming in *Tax Law Review*), available at taxprof.typepad.com/taxprof_blog/files/hines_reconsidering_nov_07.pdf.
38. Samuels, supra note 11.
39. Another possibility would be to allocate interest expense proportionately to income rather than assets. This would also be a major improvement over current laws and practices, but an allocation based on assets seems conceptually more sound and is probably easier to implement.

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cooperation, the information about a company's total amount of borrowing and assets necessary to calculate a worldwide allocation may not be readily available to the source country. This explains why source countries have separately devised thin capitalization rules, often relying on fixed allowable debt-to-equity ratios or fixed limits on interest expense deductions as a percentage of income (EBITDA) to limit interest deductions. However, as with interest allocation for outbound investments, disallowing interest deductions through earnings stripping or thin capitalization rules – when, as is generally the case, the interest disallowed by the source country will not be allowed by the residence country – may lead to double taxation of the inbound income. On the other hand, allowing the interest deductions in full may produce negative tax rates and threatens the domestic tax base. Thus, worldwide allocation is desirable for both source and residence countries.

5.2. The benefits of a multilateral response

Rarely does a difficult international income tax issue produce such a clear solution. Worldwide allocation of interest expense by both source and resident countries would eliminate a host of problems now bedevilling nations throughout the world – problems that have produced varying, complex and inconsistent responses among different countries, responses that frequently may result in zero or double taxation. Given the flexibility of multinational corporations to choose where to locate their borrowing and the difficulties nations have in maintaining their domestic income tax bases in the face of such flexibility, achieving a multilateral agreement for the treatment of interest expense based on a worldwide allocation should become a priority project for both source and residence countries. The OECD and the European Commission might lead the way. The European Commission should begin by incorporating such a rule into its common consolidated corporate tax base project.[40] For the OECD, making worldwide allocation a commonplace feature of bilateral income tax treaties throughout the world, along with attendant requirements for information sharing adequate for source countries to be confident about their ability to enforce such a rule, would be fair to all nations and substantially improve economic efficiency and internation equity throughout the world. As has so often been the case, a common multilateral solution may be accomplished piecemeal through bilateral income tax treaties.[41]

Solving the problem of interest expense deductions on a multilateral basis would offer great benefits to virtually all nations. Unlike some other areas of international income tax law where a nation may see substantial advantages from pursuing a beggar-thy-neighbour tax policy, there is no important national competitive advantage available in departing from the solution I have offered here. That alone does not make achieving a multinational solution easy, but it might make it possible.

40. For an overview, see Weiner, Joann M., "Approaching an EU Common Consolidated Tax Base", 46 *Tax Notes International* 647 (14 May 2007).
41. One cannot help but note the irony that the most promising path to a multilateral solution to an income tax issue is through revisions of bilateral treaties.

Foreign Income and Domestic Deductions

Abstract *- To what extent should taxpayers deduct expenses incurred domestically that contribute to foreign income production? It is widely believed that if the home country does not tax foreign income, then it also should not permit deductions for that portion of domestic expenses attributable to earning foreign income. This prescription is, however, inconsistent with the decision to exempt foreign income from taxation in the first place. The paper shows that, for any system of taxing foreign income, the consistent and efficient treatment is to permit domestic expense deductions for all expenses incurred domestically. This differs from the current U.S. regime, under which American firms were required to allocate more than $110 billion of domestic expenses against foreign income in 2004.*

INTRODUCTION

Income tax systems, such as that used by the United States, permit taxpayers to claim deductions for expenses incurred in the course of earning income. Thus, a taxpayer who spends $100 on labor and materials to produce output subsequently sold for $140 will be taxed on income of only $40, since the $100 expense is deductible for tax purposes. Any sensible income tax must permit expense deductions, since otherwise it becomes a form of turnover tax, taxing gross rather than net income, overstating the incomes of some taxpayers, and reducing the efficiency of the economy by prompting excessive vertical integration and discouraging other activities that add economic value.

In an open economy, a taxpayer may incur expenses in one jurisdiction that contribute to producing income in other jurisdictions. What is the appropriate tax treatment of such expenses?

It is natural to match expense deductions against revenue attributable to the expenses. As a practical matter, however, considerable challenges arise in matching deductions against income for certain types of expenses, such as interest expense or general and administrative expense, that are general to a firm and difficult to attribute to particular activities. If a large multinational firm headquartered in the United States and with operations in 20 other countries spends $80 million on headquarters activities in the United States, the foreign countries typically do not permit the firm to take local tax deductions for any portion of the $80 million headquarters expense. What then should be the policy of the home country—should

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the firm be permitted to deduct the $80 million against its U.S. income or should that deduction be limited by apportioning some fraction of the $80 million against its income in other countries?

The common answer to this question is that it depends on the nature of the home country tax regime. So this reasoning goes, the firm should be permitted to claim home country deductions only for that part of an expense that produces income taxed by the home country. Hence, if a firm is resident in a country that taxes domestic but not foreign income, it follows that the portion of domestic expenses incurred to produce foreign income should not be deductible in the home country.

The analysis in this paper takes issue with this answer, instead concluding that the only policy consistent with efficiency, given the refusal of foreign governments to allow taxpayers to take deductions for general expenses incurred outside their countries, is to permit full domestic deductibility of expenses incurred in the home country. Full domestic deductibility is a feature of any efficient tax regime, including residence based worldwide tax systems with and without provision of foreign tax credits, and a system in which the home country exempts active foreign business income from taxation. All that is necessary is that the home country tax regime be tailored to promote home country welfare efficiently, and if it is, then full domestic deductibility is an efficient policy.

The claim that full domestic deductibility of home country expenses promotes efficiency is perhaps unintuitive and is certainly inconsistent with current U.S. policy and most prior analysis of this subject. In order to appreciate why full domestic deductibility is efficient, it is necessary to understand why countries have the international tax systems they do. This is particularly important in the cases of countries that exempt foreign income from taxation. Such tax systems appear inefficient from the standpoint of single investment decisions in isolation, since from this perspective they seem to give excessive incentives to invest in low–tax foreign countries. Hence, if an exemption system is efficient, it must be that its efficiency stems from considerations omitted by considering just one investment at a time. Since new investments trigger reactions by investors and their competitors, it is important to incorporate these reactions in evaluating the welfare properties of exempting foreign income from home country taxation. It is from the standpoint of all of the induced reactions that permitting full domestic expense deductibility makes considerable sense, since the failure to permit deductibility would distort asset ownership patterns and thereby reduce the productivity of domestic business operations.

It should not be surprising that a fully efficient tax system permits complete deductibility of domestic expenses. It is an efficient, and virtually universal, practice to permit full deductibility of domestic expenses incurred by firms that earn only domestic income, since efficient taxation preserves incentives to spend $1 to create more than $1 of pretax economic return. But a tax system that maximizes the welfare of the residence country also taxes foreign income in a way that makes the residence country indifferent between a marginal dollar of activity undertaken by one of its firms at home or abroad. If this were not so—if, for example, the home government would prefer that its firms concentrate more of their activity at home at the expense of activities abroad—then the tax treatment of foreign income must not be optimal in the first place. Hence, with optimal tax systems the value of foreign activity at the margin is the same as the value of domestic activity, so if an expense is properly deductible when producing domestic income, efficiency requires that it also be deductible when producing foreign income.

The second section of the paper describes international practice in permitting expense deductions and reviews evidence of the impact of the U.S. system of allocating domestic expenses against foreign income. The third section of the paper summarizes the efficiency rationales underlying competing systems of taxing foreign income. The fourth section analyzes the deductibility of domestic expenses with worldwide and territorial (exemption) tax systems, finding in every case that the efficient treatment corresponds to full domestic deductibility. The fifth section is the conclusion.

DOMESTIC EXPENSE DEDUCTIONS IN PRACTICE

The tax treatment of domestic expenses incurred by multinational businesses varies between countries and over time within the same country. Most of the world exempts active foreign business income from taxation and also effectively permits taxpayers full domestic tax deductions for general domestic business expenses, such as interest expense and general and administrative expenses. The details of these policies differ among countries; some permit blanket domestic expense deductibility, whereas others use tracing rules that require taxpayers to identify the income streams that deductible expenses are incurred to produce.[1] As a practical matter, tracing rules are largely equivalent to blanket domestic deductibility (Shaviro, 2001), since the unwillingness of foreign governments to grant tax deductions for domestic expenses gives taxpayers incentives to arrange their tracing to maximize domestic deductions. Most countries limit the deductibility of domestic interest expenses with "thin capitalization" rules of one form or another (Buettner, Overesch, Schreiber, and Wamser 2008), and while these typically apply even to purely domestic firms, there may be additional restrictions on interest deductions taken by foreign–owned firms and firms whose foreign affiliates have capital structures that differ greatly from those of their parent companies. In addition, there are countries that exempt slightly less than 100 percent of active foreign business income (France exempts only 95 percent, for example) to compensate, in some very rough sense, for permitting full domestic deductibility of home country expenses.

U.S. Expense Allocation Rules and Their Impact

The United States currently allows full deductibility of domestic expenses, but also requires taxpayers to allocate domestic expenses against foreign income for purposes of calculating foreign tax credits, thereby effectively limiting the deductibility of these expenses in some cases. Different rules apply to research and development (R&D) expenses, interest expenses, and other expenses that are supportive in nature, including overhead, general and administrative expenses, supervisory expenses, advertising, marketing, and other sales expenses. In the case of supportive expenses, such as general and administrative expenses, firms are entitled to deduct expenses incurred in the United States, but must allocate a portion of these expenses against foreign income based on the fraction of total income from foreign sources or activity undertaken in foreign countries. The significance of allocating these expenses against foreign income is that doing so reduces the foreign tax credit limit, thereby reducing the taxpayer's ability to offset its U.S. tax liability on foreign income with credits for foreign income tax payments. This is consequential only for

[1] U.S. Congress, Joint Committee on Taxation (2008) describes the practices of other countries, and Slaats (2007) offers a review of recent international developments in the deductibility of interest and other expenses.

taxpayers with excess foreign tax credits, since for those without excess foreign tax credits the limit does not bind. American taxpayers have excess foreign tax credits if their average foreign tax rates exceed the U.S. rate, and in the absence of expense allocation these taxpayers would owe no U.S. tax on their foreign incomes. For these taxpayers, reducing by one dollar the net foreign income used to calculate the foreign tax credit limit increases their U.S. tax liability by an amount equal to the marginal U.S. tax rate. This exactly offsets the value of the original deduction, so the U.S. system effectively denies domestic expense deductions for the allocated portion of general and administrative expenses incurred by taxpayers with foreign income taxed so heavily by foreign governments that it winds up untaxed by the United States. Taxpayers whose foreign income is lightly taxed by foreign governments, and who, therefore, owe residual U.S. tax on that income, receive the benefit of full domestic deductibility of expenses incurred in the United States.

Different, and rather more strict, rules apply to the allocation of interest expenses and R&D expenses, though with similar effect. Interest expenses are allocated against foreign source income based on relative values of domestic and foreign assets as calculated using a method that is widely criticized (e.g., Shaviro (2001) on several grounds, including that it ignores foreign borrowing; this system is currently scheduled to change in 2009. Half of a multinational firm's U.S. R&D expense is allocated against U.S. income, with the remaining half apportioned between domestic and foreign source based on relative sales or income. For all of these expenses the allocation rules matter only if taxpayers have excess foreign tax credits, in which case they are tantamount to denying domestic deductions for that portion of expenses allocated against foreign income. Different rules prevailed prior to passage of the Tax Reform Act of 1986, and the evidence indicates that American firms with excess foreign tax credits responded to the tax reform by changing their domestic borrowing patterns and domestic R&D spending around the end of 1986 in reaction to the higher after–tax cost of domestic borrowing and domestic R&D activity.[2]

These rules significantly influence the tax positions of American firms. Table 1 presents data on the aggregate volume of corporate expense deductions allocated against foreign income between 1992 and 2004. In 2004, American corporations allocated $110.8 billion of domestic expenses against foreign income, of which interest expenses accounted for $42.0 billion and R&D expenses accounted for $13.5 billion. Total allocated domestic expense represents more than 45 percent of the $241.5 billion taxable foreign income of American firms in that year, and was even higher fractions of taxable foreign income in other years.[3]

Table 2 provides an industry breakdown of these allocated domestic expenses in 2004. Manufacturing corporations allocated $46.1 billion of total domestic expenses against foreign income of $154.6

[2] Collins and Shackelford (1992), Froot and Hines (1995) and Altshuler and Mintz (1995) analyze responses to the interest allocation rules introduced in 1986, and Hines (1993) analyzes the response of R&D activity to changes in the R&D expense allocation rules. These studies provide greater detail on the reforms and the incentives they created.

[3] Expense allocation matters only if a firm has excess foreign tax credits, which not all American firms do, so it would be inaccurate to conclude that allocating $110 billion of expenses to foreign income at a tax rate of 35 percent increases the U.S. tax liabilities of American firms by $38.5 billion. But since a taxpayer's foreign tax credit status is itself the product of many purposeful choices that are influenced by the expense allocation rules, it is not correct either to take the foreign tax credit status as given in evaluating the cost of expense allocation.

TABLE 1
DOMESTIC CORPORATE EXPENSES ALLOCATED AGAINST FOREIGN INCOME, 1992–2004

Year	Number of returns	Deductions not allocable to specific types of income: Total	Research and development	Interest	Other	Taxable foreign income (less loss) before adjustments	Foreign tax credit claimed
1992	5,147	46,074,597	3,322,556	22,125,537	17,546,722	86,924,737	21,532,736
1993	6,322	56,490,849	3,031,964	26,319,175	26,706,975	94,687,024	22,894,610
1994	7,199	60,002,879	4,937,048	26,629,892	26,872,347	101,521,278	25,418,684
1995	6,710	79,650,578	8,198,150	35,916,338	34,779,814	120,517,753	30,415,605
1996	6,100	88,355,742	9,232,584	35,536,186	41,326,284	150,826,345	40,254,937
1997	6,569	94,428,510	9,565,637	43,342,264	40,176,836	157,989,290	42,222,743
1998	5,927	94,247,133	9,876,318	49,478,293	32,808,117	147,116,869	37,338,380
1999	5,789	102,542,312	9,539,700	51,322,499	41,287,061	165,712,961	38,271,294
2000	5,917	125,377,761	11,364,335	63,781,017	49,133,088	196,675,289	48,355,433
2001	5,478	109,909,312	9,122,373	52,679,130	47,638,165	164,753,343	41,358,458
2002	4,767	79,729,471	9,118,649	32,748,184	36,911,292	160,855,609	42,419,115
2003	5,409	93,226,238	11,961,592	32,120,658	47,669,031	205,129,663	49,963,270
2004	5,502	110,817,387	13,485,504	42,001,568	54,391,211	241,493,136	56,593,276

Source: Statistics of Income Division, U.S. Internal Revenue Service.

Note: Entries are drawn from information reported by corporations claiming the foreign tax credit. Figures in the table are thousands of current dollars.

TABLE 2
INDUSTRY DETAIL OF FOREIGN EXPENSE ALLOCATION, 2004

Industries	Number of returns	Deductions not allocable to specific types of income: Total	Research and development	Interest	Other	Taxable foreign income (less loss) before adjustments	Foreign tax credit claimed
All industries	5,502	110,817,387	13,485,504	42,001,568	54,391,211	241,493,136	56,593,276
Agriculture, forestry, fishing, and hunting	210	*21,971	*673	*10,534	*10,633	107,736	11,559
Mining	112	1,022,125	*23,501	482,400	482,337	4,418,975	1,434,081
Utilities	7	*54,649	0	*29,501	*25,026	*89,888	*29,961
Construction	235	21,810	*101	*890	*20,493	108,170	21,821
Manufacturing	1,039	46,096,041	10,906,052	15,239,527	19,617,336	154,593,276	37,151,333
Wholesale and retail trade	658	2,686,030	70,576	1,019,125	1,445,641	11,669,584	2,985,951
Transportation and warehousing	68	1,335,443	*25,432	8,600	1,295,194	2,444,326	197,508
Information	607	6,660,160	2,145,207	704,809	3,753,108	14,580,764	2,764,509
FIRE	965	23,114,114	*15,804	11,017,958	11,823,907	29,584,426	5,745,227
Services	1,603	29,805,044	298,157	13,488,225	15,917,537	23,895,992	6,251,328

Source: Statistics of Income Division, U.S. Internal Revenue Service.

Note: Entries are drawn from information reported by corporations claiming the foreign tax credit in 2004. Figures in the table are thousands of 2004 dollars. Entries in cells marked by an asterisk (*) are based on such small numbers of significant reporting firms that the figures may be unreliable.

billion. Service industry corporations and those in the finance, insurance and real estate industries allocated a total of $49.9 billion of domestic expenses against total foreign income of just $53.5 billion, the allocated expenses representing a much larger fraction of foreign income than in manufacturing. Manufacturing firms accounted for $10.9 billion of the $13.5 billion total allocated R&D expense, but significantly smaller fractions of other expenses.

The U.S. expense allocation rules influence the demand for R&D, administrative, and other activities in the United States, since firms with highly taxed foreign income do not benefit from full tax deductibility even in cases in which they incur expenses in order to earn income in the United States. The reason is that the allocation method does not attempt to identify the location of income generated by each expense, but instead implicitly attributes location on the basis of total foreign and domestic income and activity. More importantly, the expense allocation rules discourage foreign activity and foreign income production by firms with excess foreign tax credits, since the scope of its foreign operations affects the ability of a firm to benefit from tax deductions for a given amount of domestic expense. This limit on the effective deductibility of domestic expenses acts as a type of tax on marginal foreign activity, one whose rate depends on the firm's excess foreign tax credit status and the magnitude of its allocable domestic expenses. This tax encourages firms to substitute domestic for foreign activity, with greater substitution incentives for firms with significant domestic expenses.

Reform Proposals

Numerous recent reform proposals would change U.S. taxation of foreign income by exempting active foreign business income from U.S. taxation. As proposed, schemes such as those analyzed by Graetz and Oosterhuis (2001), Grubert and Mutti (2001), and Altshuler and Grubert (2008) would exempt from U.S. taxation dividends received from foreign subsidiaries. At the same time, these reforms would limit the ability of American firms to deduct domestic expenses for interest and supportive activities such as general and administrative activities. These expenses would be allocated between domestic and foreign income based on measures of domestic and foreign assets or incomes, with the portion allocated to foreign income effectively nondeductible for domestic (or foreign) tax purposes. The same treatment of domestic expenses appears in the territorial tax reform proposals considered by the U.S. Congress, Joint Committee on Taxation (2005), the President's Advisory Panel on Federal Income Tax Reform (2005), and the U.S. Treasury (2007). Hence, from a U.S. tax reform proposal standpoint, exempting foreign income from taxation appears to be closely associated with limiting the deductibility of domestic expenses.

This is a curious association, since exempting foreign income from home country taxation while limiting the deductibility of domestic expenses based on levels of foreign and domestic activity essentially replaces one tax on foreign operations with another. An expense allocation method that permits taxpayers to claim domestic tax deductions for only a fraction of domestic expenses, with the fraction equal to the ratio of domestic to total income, penalizes earning foreign income and rewards earning domestic income. The implied tax rate on foreign income is the product of the statutory tax rate, the ratio of domestic expenses to worldwide income, and the ratio of domestic to worldwide income. The implied rate of subsidy for producing domestic income is the product of the statutory tax rate, the ratio of domestic expenses to worldwide income, and the ratio of foreign to worldwide income.[4] Replacing a tax on foreign income with

[4] This is apparent by writing the firm's cost of domestic expense allocation as $Rt(F/F + D)$, in which R is the level of allocable domestic expense, t is the domestic tax rate, F is foreign income, and D is domestic income. Differentiating this expression with respect to F produces: $[R/(F + D)]t[D/(F + D)]$. Similarly, differentiating the expression with respect to D yields: $-[R/(F + D)]t[F/(F + D)]$.

an exemption system that limits the deductibility of domestic expenses does not remove the tax burden on foreign business activity, but instead merely changes the form of the tax burden and makes it less transparent.

There is an understandable appeal to limiting the deductibility of domestic expenses when the foreign portion of a firm's income is exempt from domestic taxation, and indeed, tax systems commonly restrict expense deductibility if the underlying income is untaxed. A prominent example, frequently cited by international tax reform proposals, is the restriction preventing American taxpayers from deducting interest payments if the borrowed capital is devoted to tax–exempt investments such as state and local bonds. This restriction on interest deductibility is intended to prevent arbitrage, though it is widely believed that, in the case of state and local bonds, its net effect is actually to create arbitrage opportunities by restricting demand for tax–preferred assets to a limited clientele of high tax rate potential buyers. Critics (e.g., Shakow (1987)) have called for repealing the restriction on interest deductibility to eliminate this problem, which might serve as a cautionary tale for those who would limit domestic expense deductibility in a territorial tax system.

THE TAXATION OF FOREIGN INCOME[5]

The older wisdom in the international tax policy area is that worldwide taxation of business income with provision of foreign tax credits promotes world welfare, whereas worldwide taxation of business income without foreign tax credits (instead permitting taxpayers to deduct foreign tax payments in calculating taxable income) promotes domestic welfare. These claims about the underlying welfare economics, introduced by Peggy Musgrave (Richman, 1963; Musgrave, 1969) and subsequently quite influential, have come under considerable academic fire in recent years. Modern economic thinking parts company with Musgrave's analysis in incorporating the effects of world capital markets and, in particular, the impact of ownership on capital asset productivity.

Capital Export Neutrality and National Neutrality

The Musgrave notion of capital export neutrality is the doctrine that the return to capital should be taxed at the same total rate regardless of the location in which it is earned. If a home country tax system satisfies capital export neutrality, then investments that maximize after–tax returns also maximize pre–tax returns, and there are then circumstances in which decentralized profit–maximizing behavior is consistent with global economic efficiency. The capital export neutrality concept is frequently invoked as a normative justification for the design of tax systems similar to that used by the United States, since accrual taxation of worldwide income with provision of unlimited foreign tax credits satisfies capital export neutrality. This does not describe the U.S. tax system, however, since taxpayers are permitted to defer home country taxation of certain unrepatriated foreign income, and foreign tax credits are limited, but the capital export neutrality notion is nevertheless the basis of the argument that systems of taxing foreign income similar to that used by the United States enhance world welfare. The argument can then be extended to say that, due to international cooperative bargaining, countries that adopt tax policies advancing world welfare thereby

[5] This section draws on material in Desai and Hines (2003, 2004) and Hines (forthcoming).

may ultimately advance even their own welfares (Shaviro, 2007).

The Musgrave analysis implies that governments that seek to maximize national but not necessarily world welfare should tax the foreign incomes of their resident companies while permitting only deductions for foreign taxes paid. Such taxation satisfies what is known as national neutrality, discouraging foreign investment by imposing a form of double taxation, but doing so in the interest of the home country that disregards the value of tax revenue collected by foreign governments. From the standpoint of the home country, foreign taxes are simply costs of doing business abroad and, therefore, warrant the same treatment as other costs, for which it is appropriate to give deductions and not credits against home country taxes. In this analysis, the home country's desired allocation of capital is one in which its firms equate marginal after–tax foreign returns with marginal pretax domestic returns, a condition that is satisfied by full taxation of foreign income after deduction of foreign taxes. This line of thinking suggests that the American policy of taxing foreign income while granting foreign tax credits is far too generous from the standpoint of the United States. In this view there is a tension between tax policies that advance national welfare by taxing after–tax foreign income, and those that advance global welfare by taxing foreign income while permitting taxpayers to claim foreign tax credits. The practice of most of the world in effectively exempting most foreign income from taxation, is, by this reasoning, difficult to understand, since it is inconsistent with either national or global interests.

Ownership Neutrality

Investment by domestic firms at home and abroad is likely to influence investment by foreign firms, which is inconsistent with the logic underlying capital export neutrality and national neutrality. If greater investment abroad by home–country firms triggers greater investment by domestic or foreign firms in the home country, and there is considerable evidence that it does,[6] then it no longer follows that the home country maximizes its welfare by taxing foreign income while permitting only a deduction for foreign taxes paid. The reason is that, from the standpoint of the home country, greater foreign investment by domestic firms does not come at the cost of reduced domestic investment, so there is no longer a welfare loss associated with reducing investment that is already excessively discouraged by domestic taxes. From the standpoint of global welfare, if home and foreign firms compete for the ownership of capital around the world, and the productivity of an investment depends on its ownership, then it is no longer the case that the taxation of foreign income together with the provision of foreign tax credits necessarily contributes to global productive efficiency.

The importance of ownership to productivity is reflected in the modern theory of foreign direct investment, which is based on a transaction–cost approach whereby the market advantages of multinational firms stem from the benefits conferred by joint ownership of assets across locations. It is also consistent with the scale of operation of the large and extremely active worldwide market in mergers, acquisitions, and asset divesti-

[6] This includes aggregate time–series evidence of the behavior of U.S. multinational firms (Desai, Foley and Hines, 2005), aggregate evidence for Australia (Faeth, 2006), industry–level studies of Germany (Arndt, Buch, and Schnitzer, 2007) and Canada (Hejazi and Pauly, 2003), and firm–level evidence for the United States (Desai, Foley and Hines, forthcoming), the United Kingdom (Simpson, 2008) and Germany (Kleinert and Toubal, 2007).

tures, with participating firms willing to bear the costs of the associated ownership realignments in return for the advantages that are associated with them. The modern property rights approach to the theory of the firm, as developed in Grossman and Hart (1986) and Hart and Moore (1990), suggests that the prevalence of incomplete contracts justifies particular configurations of ownership arrangements. It is the ability to exercise power through residual rights when contracts cannot prespecify outcomes that makes ownership important, and such settings are particularly likely to characterize multinational firms investing abroad. Desai, Foley and Hines (2004) analyze the changing ownership decisions of multinational firms, finding that globalization has made firms reluctant to share ownership of foreign affiliates, given the higher returns to coordinated transactions inside firms.

Tax systems satisfy capital ownership neutrality if they do not distort ownership patterns (Desai and Hines, 2003, 2004). Capital ownership neutrality is important to efficiency only insofar as ownership is important to efficiency, a notion that is ruled out by assumption in the Musgrave framework that serves as the basis of capital export neutrality and national neutrality. If the productivity of a business asset depends on who owns it together with other assets, then tax systems promote efficiency if they encourage the most productive ownership of assets within the set of feasible investors.

Capital ownership neutrality is satisfied if all countries exempt foreign income from taxation, since taxation would then not favor one set of potential investors at the expense of another, but the exemption of foreign income from taxation is not necessary for capital ownership neutrality to be satisfied. If all countries tax foreign income (possibly at different rates), while permitting taxpayers to claim foreign tax credits, then ownership would be determined by productivity differences and not tax differences, thereby meeting the requirements for capital ownership neutrality. In this case the total tax burden on foreign and domestic investment varies between taxpayers with different home countries, but every investor has an incentive to allocate investments in a way that maximizes pretax returns.

The same circumstances that make capital ownership neutrality desirable from the standpoint of world welfare also imply that countries disregarding world welfare have incentives to exempt foreign income from taxation no matter what other countries do. The reason is that, from an ownership standpoint, additional outbound foreign investment does not reduce domestic tax revenue, since any net reduction in home–country investment by domestic firms is offset by greater investment by foreign firms. With unchanging domestic tax revenue, home–country welfare increases in the after–tax profitability of domestic companies, which is maximized if foreign profits are exempt from taxation. Tax systems that exempt foreign income from taxation are, therefore, said to satisfy national ownership neutrality. Hence, it is possible to understand why so many countries exempt foreign income from taxation, and it follows that, if every country did so, tax systems would conform, capital ownership would be allocated efficiently, and global output would thereby be maximized.

Implications for Domestic Expense Deductions

Competing efficiency concepts carry differing implications for efficient taxation of foreign income, which in turn influence the desirability of permitting taxpayers to take deductions for domestic expenses. If international investors do not compete for potential ownership of the same assets, and greater foreign investment comes at the cost of reduced domestic investment, then governments promote national

welfare by taxing foreign income on accrual while providing only deductions for foreign income tax payments. Under the same circumstances, governments promote global welfare by permitting taxpayers to claim tax credits for foreign tax payments, a policy that may also advance national welfare if nations cooperate to share the benefits of international economic policies. In both of these cases, full deductibility of domestic expenses is consistent with efficiency. Governments that tax foreign income while permitting only a deduction for foreign income tax payments subject after–foreign–tax returns to home country taxation, and expenses incurred to produce these returns are properly deductible. Governments that tax worldwide income while providing foreign tax credits do so to promote global efficiency; since domestic plus foreign returns are cumulatively taxed at the domestic tax rate, efficiency requires that the expenses incurred to produce these returns should be deductible at the domestic tax rate.

If greater foreign activity is accompanied by higher levels of domestic activity, and the ownership of active business assets influences their productivity, then countries benefit from exempting foreign income from taxation, and global efficiency requires that all nations tax foreign income in the same way. In this setting it follows that the exemption of foreign income should be accompanied by permitting full deductibility of domestic expenses, since doing so advances national welfare, and is consistent with global efficiency if it is also the practice of other countries. A policy that instead limits domestic expense deductions based on indicators of relative foreign and domestic activity or income would effectively tax foreign income, thereby introducing ownership distortions. For example, if a country permits only a portion of domestic expenses to be deducted by firms owning foreign assets, the affected firms have incentives both to shed some of their foreign assets and to acquire other firms that have significant domestic assets. Firms unable to claim full deductions for their domestic expenses would also become attractive targets for foreign takeovers structured so that the combined firm was not subject to the expense allocation rules. Indeed, a tax system inevitably influences business ownership decisions whenever the tax treatment of domestic expenses is contingent on the ownership of foreign assets or the receipt of foreign income.

Firms with foreign income that is exempt from home–country taxation have incentives to allocate capital, management attention, and other resources between foreign and domestic production so that the after–foreign–tax marginal productivity of resources devoted to foreign production just equals the after–home–tax marginal productivity of the same resources devoted to domestic production. This marginal productivity condition is efficient because it reflects the tradeoffs made by most of the world's investors and is, therefore, capitalized into market prices. It follows that efficiency also requires that firms choosing among domestic expenses that contribute to domestic and foreign profitability similarly equate after–foreign–tax marginal foreign profitability with after–home–tax domestic profitability, since otherwise productivity could be augmented by altering the mix of capital and current expenditures. This marginal productivity condition for expenses is satisfied only if domestic expenses are fully deductible and, therefore, not contingent on the locations in which the corresponding income is earned.

ANALYSIS OF DOMESTIC EXPENSE DEDUCTIONS

This section offers an analytic evaluation of the domestic expense deduction rule that promotes efficiency as captured

by each of the norms described in the third section. It is most straightforward first to consider the case in which a home government treats foreign taxes simply as costs of doing business and, therefore, permits only a deduction for foreign income tax payments, unmindful of the ownership distortions associated with such a policy. An individual firm spends R at home to produce both domestic and foreign income, the value of its domestic production (net of other expenses) being denoted $Q(R)$, and the value of its production through a wholly owned foreign affiliate being denoted $Q^*(R)$. In order to abstract from issues of discounting and the taxation of capital returns, it is helpful to think of R as a current expense, such as administrative cost, that contributes to income production this year only. The home country taxes business income at rate τ, and the foreign country taxes income at rate τ^*. The home country permits the firm to deduct a fraction α of its expenditures on R against home country taxable income, and the foreign country permits the firm to deduct a fraction γ of its expenditures on R against taxable income in the foreign country. Critically, γ is assumed to be unaffected by α (and in practice is typically zero).

The firm's after–tax profit is denoted π, which with this regime of taxing foreign income takes the value:

$$[1] \quad \pi = \left[Q(R) + Q^*(R)(1-\tau^*) + \tau^*\gamma R\right](1-\tau) - R + \tau\alpha R.$$

A profit–maximizing firm chooses R to maximize the value of π in equation [1], for which the first order condition is:

$$[2] \quad \left[Q'(R) + Q^{*\prime}(R)(1-\tau^*) + \tau^*\gamma\right](1-\tau) = 1 - \tau\alpha.$$

Taking foreign taxes to be costs, the home country's return is $Q(R) + Q^*(R)(1 - \tau^*) + \tau^*\gamma R - R$, the difference between domestic profits plus after–tax foreign profits and the cost of domestic inputs. The first–order condition for maximizing the home country's return is then:

$$[3] \quad Q'(R) + Q^{*\prime}(R)(1-\tau^*) + \tau^*\gamma = 1.$$

Together, equations [2] and [3] imply that $\alpha = 1$. Hence, the home country maximizes its total return by permitting taxpayers to deduct all of their domestic expenses, even though some of these expenses may contribute to productivity in the foreign country, and even though (although this is rarely the case) some of the expenses might be deductible in the foreign country.

This implication is consistent with the intuition that a home country that taxes foreign income should also permit full deductibility of domestic expenses associated with producing that income. Partial deductibility excessively discourages expenditures that create net value for the home country, so aligning taxpayer and national incentives therefore requires full deductibility. It is noteworthy that γ does not influence the implication that the home country maximizes value by permitting full deductibility, since a positive value of γ not only increases a firm's incentive to spend on R, but also increases the home country's return, which includes any foreign tax savings.[7]

It is very uncommon for countries to tax active foreign business income while providing only deductions for foreign income tax payments; instead, countries that tax foreign income typically provide foreign tax credits. The paradigmatic case of worldwide taxation with foreign tax credits is a system in which the home

[7] Recall that γ is assumed to be fixed; if international cost sharing agreements or other arrangements were to make the level of γ contingent on α, then it would no longer necessarily follow that full domestic deductibility maximizes home country returns.

country taxes foreign income without deferral and with unlimited provision of foreign tax credits (including the possibility of a rebate if foreign tax rates exceed the home country rate). From the standpoint of home country firms facing such a regime of taxing their foreign investments, the foreign tax system becomes irrelevant, since any reduction in foreign taxes is immediately offset by greater home country taxes. The firm's after–tax profit, therefore, can be represented as:

$$[4] \quad \pi = \left[Q(R) + Q^*(R)\right](1-\tau) - R + \tau\alpha R.$$

The first order condition corresponding to the profit–maximizing choice of R is:

$$[5] \quad \left[Q'(R) + Q^{*\prime}(R)\right](1-\tau) = 1 - \tau\alpha.$$

The standard rationale behind having a system of worldwide taxation and unlimited foreign tax credits is to maximize world welfare by promoting capital export neutrality, as discussed in the third section. In this framework, world economic welfare is given by the difference between world output and the cost of world inputs, without regard to tax considerations. Maximizing world welfare in this context therefore corresponds to maximizing $Q(R) + Q^*(R) - R$, for which the first order condition is:

$$[6] \quad Q'(R) + Q^{*\prime}(R) = 1.$$

It is clear from inspection of equations [5] and [6] that once more the welfare maximizing policy is $\alpha = 1$, full domestic deductibility of domestic expenses, and again this is unaffected by whether or not the foreign country permits partial deductibility with a positive value of γ.

The implication that domestic expenses should be fully deductible against domestic income may not conform exactly to the common intuition that expenses incurred to produce foreign income should be deductible against home country taxable income to the extent that foreign income is taxed by the home country. Certainly in the case of worldwide taxation with foreign tax credits, the home country taxes foreign income, but the tax rate is zero if the average foreign tax rate equals the home country tax rate, and the home country tax rate on foreign income is negative if the foreign tax rate exceeds the domestic tax rate. In all of these cases, the analysis of equations [5] and [6] implies that efficiency requires the home government to permit full deductibility of domestic expenses. The reason is that the policy of worldwide taxation is premised on the notion that a country benefits by enacting domestic tax rules that maximize the world allocation of resources. Since both domestic and foreign returns are effectively taxed at the domestic tax rate, efficient incentives to devote resources to R require that the expense be fully deductible at the domestic tax rate also. By taxing foreign income and providing foreign tax credits the home country tax system removes any incentives created by foreign deductibility of expenses incurred in the home country, so it is necessary to provide full domestic deductibility to get the incentives right.[8]

Perhaps the most telling case is that in which the home country maximizes national welfare by promoting efficient asset ownership through exempting foreign income from taxation. With foreign income exempt from home country taxes, the firm's after tax profits are:

[8] It is worth noting that, in the unlikely event that the foreign government permits deductibility of a portion of home country expenditures on R through a positive value of γ, the home government immediately recoups the value of the deductibility by granting the home country taxpayer fewer foreign tax credits. Hence, from a government budgetary perspective, the cost of full deductibility of home–country expenses is offset to whatever extent foreign governments permit partial deductions for these expenses.

$$[7] \quad \pi = Q(R)(1-\tau) + Q^*(R)(1-\tau^*) + \tau\alpha R + \tau^*\gamma R - R.$$

A profit maximizing firm chooses R to satisfy:

$$[8] \quad Q'(R)(1-\tau) + Q^{*\prime}(R)(1-\tau^*) + \tau^*\gamma = 1 - \tau\alpha.$$

It is important to identify the government's objective in this situation. Exempting foreign income from taxation makes sense from the standpoint of encouraging efficient asset ownership, given the importance of ownership to productivity. Exempting foreign income from taxation implies that the government values equally one dollar of after–tax domestic income earned by home–country firms and one dollar of after–foreign–tax foreign income, since home–country firms make this tradeoff at the margin. This relative valuation is sensible in a world of shifting ownership, since it is effectively imposed by the world capital market. Then the government chooses international tax policy to maximize:

$$[9] \quad Q(R) + \frac{Q^*(R)(1-\tau^*) + \tau^*\gamma R}{(1-\tau)} - R.$$

The term $(1 - \tau)$ appears in the denominator of the second term of [9] to reflect the fact that after–home–tax domestic income and after–foreign–tax foreign income are valued equally. Then maximizing the value of [9] implies:

$$[10] \quad Q'(R)(1-\tau) + Q^{*\prime}(R)(1-\tau^*) + \tau^*\gamma = 1 - \tau,$$

from which, together with equation [8], it is clear that yet again the welfare maximizing policy is $\alpha = 1$, or full domestic deductibility of home country expenses.

The conclusion that the home country maximizes welfare by permitting taxpayers to deduct all of their domestic expenses follows from the relative valuation of foreign and domestic pretax incomes. This relative valuation is driven by the world market, which values after–tax income equally in every country, and which allocates capital and other resources in a manner consistent with this valuation. Individual countries benefit from adopting policies that are consistent with world valuations of after–tax income, which is why it is attractive to exempt foreign income from taxation and also why it is attractive to permit full deductibility of domestic expenses.

CONCLUSION

Why should a country that exempts foreign income from taxation nevertheless permit full domestic deductions for expenditures that contribute to foreign profitability? The rationale for domestic expense deductibility is the same as the rationale for exempting foreign income from taxation: that tax systems with these features foster productivity associated with efficient ownership. The intuitive criticism that it is wrong to permit a deduction for an expense that generates untaxed income overlooks the important role of foreign investors and begs the question of why the home country exempts foreign income from taxation in the first place. The plain fact is that most countries in the world both exempt active foreign business income from taxation and permit full domestic deductibility of home–country expenses; and there are sound economic reasons why these policies go together and make sense in a world of shifting ownership.

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SOME PERSPECTIVES FROM THE UNITED STATES ON THE WORLDWIDE TAXATION VS. TERRITORIAL TAXATION DEBATE[*]

J. CLIFTON FLEMING, JR.,[**] ROBERT J. PERONI,[***] AND STEPHEN E. SHAY[****]

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[1] See Charles H. Gustafson, Robert J. Peroni and Richard Crawford Pugh, *Taxation of International Transactions* (3d ed, 2006) 19-21. See *also*, Brian J. Arnold and Michael J. McIntrye, *International Tax Primer* (2d ed, 2002) 15, 30-47.

[2] See United States Treasury Department, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (2007) 55 <http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf> (hereinafter U.S. Treas. Dep't, *Approaches)*; J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income' (2001) 5 *Florida Tax Review* 299, 339-340 <http://ssrn.com/abstract=1022099> (hereinafter Fleming, Peroni and Shay, Fairness*)*.

[3] See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation* (2d ed, 2004) 345; Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, 'The David R. Tillinghast Lecture: "What's Source Got to Do with It?" Source Rules and U.S. International Taxation' (2002) 56 *Tax Law Review* 81, 83-106.

[4] See Gustafson, Peroni and Pugh, above n 1, 19-20.

IV CONCLUDING OBSERVATIONS: WEIGHING THE FACTORS

Exemption system advocates are inclined to ask why, if some other countries directly confer the advantages of an exemption system on their residents, should the United States treat its residents less favorably by holding to a worldwide system?[257] The answer is that the United States might choose to do so because it gives higher priorities to locational neutrality and to fairness in the design of its income tax rules than is implied by the choice of an exemption system.

To be specific, the U.S. income tax is heavily grounded on the fairness notion that taxpayers should contribute to the cost of government in relationship to their comparative economic wellbeing or ability-to-pay.[258] Territorial taxation facially conflicts with this norm to the extent that it excludes foreign-source income from the ability-to-pay calculus. This point is not the end of the matter, of course, because the goals of simplicity, economic neutrality/efficiency and economic growth must also be taken into account and may require that fairness concerns be somewhat circumscribed.

With respect to simplification, exemption system proponents argue that an exemption regime would advance the goal of reducing complexity in the tax system.[259] After all, what could be simpler than not taxing foreign-source income at all? Adoption of an exemption regime might, indeed, simplify the U.S. system for taxing its residents' foreign-source income, but the amount of simplification to be gained by the switch from a worldwide approach is uncertain and may not be great. This is largely due to the fact that adoption of a regime that provides an explicit zero rate of tax for foreign-source income will heighten the importance of those elements of the system dealing with the distinction between U.S.-source and foreign-source net income. Thus, the sourcing rules, transfer pricing rules and expense-allocation rules will inevitably assume a greater role under an exemption regime than under the present worldwide system. We should expect that these rules would all be tightened in the exemption context, thereby becoming more complex and more productive of controversy between taxpayers and the IRS.[260]

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[256] Moreover, a destination principle VAT/GST avoids transfer pricing problems that are inherent in an origin principle VAT/GST. See Grubert and Newlon, above n 10, 620, 639.
[257] See generally, NFTC, *International Tax Policy,* above n 72, 126-27.
[258] See authorities cited in above n 148.
[259] See Chorvat, above n 68, 850-53.
[260] See generally Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 36-37, 40-41; U.S. Treas. Dep't, *Approaches,* above n 2, 60; Michael J. Mclntyre, 'Thoughts on the IRS's APA Report and More Territorial Taxation' (2000) 87 *Tax Notes* 445, 446; Peter R. Merrill, 'International Tax and Competitiveness Aspects of Fundamental Tax Reform' in James M. Poterba (ed), *Borderline Case* (1997) 87, 103; Peroni, Back to the Future, above n 68, 985; David R. Tillinghast, 'International Tax Simplification' (1990) 8 *American Journal of Tax Policy* 211-12.

Moreover, to mitigate fairness and economic efficiency/neutrality concerns, some countries exclude both passive income and low-taxed foreign-source business income from their exemption systems (indeed, most countries exclude passive income from their exemption systems) and employ a worldwide system (with a foreign tax credit) for this excluded income.[261] If the United States went down this road and preserved its worldwide system (with its complex foreign tax credit) for passive and low-taxed foreign-source income, the simplification gains from an exemption system could be slim indeed.[262]

In addition, some exemption countries have determined that although a resident's foreign-source income should be excluded from the tax base, it should, nevertheless, be taken into account for purposes of determining the progressive tax rate that applies to the resident's domestic-source income. This principle is generally referred to as exemption-with-progression.[263] If the United States were to adopt this approach, the issue of whether or not to recognize unrepatriated controlled foreign corporation income when implementing exemption-with-progression would be critically important and might well result in the preservation of complex antideferral regimes for this purpose. If so, the simplification gains from converting to an exemption system would be significantly reduced.

An exemption system is also a highly distortionary departure from the goal of economic neutrality. At its worst, an exemption system can cause an investment in a low-tax foreign country to be preferred to a U.S. investment even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.[264] It is difficult to see how the economic well- being of the United States is furthered by distorting taxpayer decisions in this manner.

With respect to economic growth, exemption advocates contend that exemption systems create greater worldwide economic well-being than do worldwide taxation systems.[265] The empirical and theoretical support for this proposition is, however, so mixed and debatable that the claimed economic growth virtues of the exemption approach must be regarded as speculative at best.[266]

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[261] See Ault and Arnold, above n 3, 372-75, 378-79; Chorvat, above n 68, 855-59; Graetz, Outdated Concepts, above n 47, 324, 329; See also H. David Rosenbloom, 'From the Bottom Up: Taxing the Income of Foreign Controlled Corporations' (2001) 26 *Brooklyn Journal of International Law* 1525, 1549-50; Tillinghast, above n 260, 209-10.

[262] See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 38-41; Charles I. Kingson, 'The Foreign Tax Credit and Its Critics' (1991) *American Journal of Tax Policy* 1, 52-55; Peroni, Back to the Future, above n 68, 986. Although Australia generally employs an exemption regime for foreign-source income, it taxes certain foreign-source income under a worldwide system that features an anti-deferral regime described as "very complex." Robin Woellner, Steven Barkoczy, Shirley Murphy and Chris Evans, *Australian Taxation Law* (17th ed. 2006) 1,465.

[263] See Ault and Arnold, above n 3, 372-73. The United States actually employs the exemption-with-progression principle in its limited exemption for foreign-source personal service income. See IRC § 911(f)(1986 as amended).

[264] See text accompanying notes 68-71 *supra*; Avi-Yonah, Globalization, above n 101, 1604 n. 132; See also Jane G. Gravelle, 'Foreign Tax Provisions of the American Jobs Act of 1996' (1996) 72 *Tax Notes* 1165,1166; Mitchell, above n 164, 804; Peroni, Back to the Future, above n 68, 983; Peroni, End It, above n 68, 1613-14.

[265] See, eg, Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (1992) 57-59.

[266] See, eg, Staff of Joint Committee on Taxation, *Overview of Present-Law Rules and Economic Issues in International Taxation*, JCX-13-99 (1999) §IV.D <http://www.house.gov/jct/x-13-99.htm>; U.S. Treas. Dep't, *Deferral*, above n 47, 25-54; Altshuler, above n 80, 1585; James R. Hines, Jr., 'The Case Against Deferral: A Deferential Reconsideration' (1999) 52 *National Tax Journal* 385, 401-02; Rousslang, above n 68, 595-97.

Likewise, the claims that adoption of an exemption system by the United States is necessary to keep U.S. businesses on a competitive footing in foreign markets are rendered dubious, at best, by the extensive overseas success of those businesses.[267] Advocates of the competitiveness view have failed to provide convincing empirical evidence for their claims that worldwide taxation undermines the ability of U.S. individuals and corporations to compete in the global marketplace.[268]

In addition to the preceding points, Part III.E.7 has discussed ways to overcome objections to worldwide taxation that are based on a desire to accommodate the tax competition strategies of poor countries.[269]

Thus, it is quite rational for the United States to conclude that when the significance of the ability-to-pay fairness principle is weighed against an exemption system's distortionary effects, uncertain simplification benefits[270] and speculative economic growth consequences, and against the generally strong competitive performance of U.S. businesses abroad, worldwide taxation is the preferred option. This holds true regardless of the fact that other countries, with other ideas regarding the relative importance of fairness and efficiency, countenance generous deferral of foreign-source income or employ exemption systems.[271]

Although the application of the ability-to-pay fairness principle to international income taxation is complicated by the presence of foreign taxpayers, by income earned through C corporations and by the claims of other governments to tax cross-border income, it is nonetheless possible, and indeed important, to analyze international tax policy in terms of fairness in addition to efficiency. As the foregoing discussion demonstrates, we believe that both fairness and efficiency considerations support the conclusion that a properly designed worldwide income tax regime is superior to either the current U.S. hybrid worldwide system[272] or an exemption system.

[267] See U.S. Treas. Dep't, *Deferral,* above n 47, 56.
[268] See U.S. Treas. Dep't, *Deferral,* above n 47, 56-57, 61.
[269] See text accompanying above n 238-44.
[270] See text accompanying above n 259-63.
[271] See Reuven S. Avi-Yonah, 'Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy' (2000) 21 *Tax Notes International* 2841, 2843 (arguing that an exemption system, as typically constructed, is a prohibited export subsidy under the General Agreement on Tariffs and Trade). For a more cautious view on this point, see Richard Westin and Stephen Vasek, 'The Extraterritorial Income Exclusion: Where Do Matters Stand Following the WTO Panel Report?' (2001) 23 *Tax Notes International* 337, 341-44.
[272] See Summers, above n 83, 39 ("[W]hen given the choice between the continuation of the status quo—which seems to me to permit very large amounts of abuse in which income is caused to be located in jurisdictions that do not seek to maintain serious tax systems and to remain there for very long periods of time—and the end of deferral, it is not clear to me that the status quo is to be preferred.").

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tax analysts special report

Throw Territorial Taxation From the Train

By Edward D. Kleinbard

Edward D. Kleinbard is a partner with Cleary Gottlieb Steen & Hamilton LLP. The author thanks his colleagues Lilian Faulhaber and Richard Sultman for their assistance in preparing this article for publication.

This report reviews the case for replacing the Internal Revenue Code's complex rules for taxing foreign direct investment with a territorial tax system. The report acknowledges that a territorial system offers one unambiguous advantage over current law, which is that it removes U.S. tax frictions on repatriating foreign profits. The report argues, however, that a territorial tax system would vastly exacerbate cross-border transfer pricing problems by rewarding successful transfer pricing gamers as "instant winners" of the tax lottery. In light of the overwhelming evidence of pervasive transfer pricing problems today, Kleinbard argues that this alone is sufficient reason not to move to a territorial tax system. Kleinbard also argues that other purported advantages of territorial systems, including simplicity and a more competitive tax environment for U.S. multinationals, are overstated.

Kleinbard believes a "full-inclusion" tax system also would eliminate the tax frictions on repatriating foreign earnings, and would genuinely be simpler than current law (in contrast to a territorial tax system). Importantly, he further argues, U.S.-based multinationals would have little reason to pursue aggressive transfer pricing tax strategies in a full-inclusion environment (again in contrast to a territorial tax system). Without more, however, a full-inclusion solution would be profoundly anti-competitive. Kleinbard shows how his business enterprise income tax proposal (first discussed in *Tax Notes*, Jan. 3, 2005, p. 97) addresses the competitiveness problems of a full-inclusion system, in large measure by enabling the tax rate imposed on U.S. firms to be substantially reduced and the foreign tax credit rules to be simplified.

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I. Introduction

Territorial income tax systems are designed to exempt the "active" income of a U.S. firm's foreign branches or foreign subsidiaries from U.S. income tax when that income is repatriated to the United States. Territorial tax proposals are the current darling of many international tax reform recommendations, including those made in late 2005 by the President's Advisory Panel on Federal Tax Reform.[1]

This report advances three related arguments regarding the taxation of foreign direct investments by U.S. firms. The first is that territorial income tax proposals are a terrible idea. Once the actual implementing rules of a realistic territorial tax system are understood, territoriality cannot be recommended, even on the grounds advanced by that idea's proponents.

The report's second argument is that a *properly constructed* implementation of a "full-inclusion" income tax system for outbound investments (that is, an income tax that imposes current U.S. residual tax on income earned by a U.S. firm's foreign branches or subsidiaries, regardless of whether that income is "active" or "passive") can be pro-competitive, economically neutral in application, and infinitely more administrable than a territorial tax system. A properly constructed income tax satisfies four conditions: Its statutory tax rates are close to the low end of the range of rates employed by the major trading partners of the United States; it permits firms to claim

[1]President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/ (hereinafter Tax Reform Panel Report).

foreign tax credits to the greatest extent compatible with protecting the fisc from the erosion of the domestic tax base; it permits the deductibility of foreign losses with no more restrictions than are imposed on the use of domestic losses; and it does not prefer outbound portfolio investment to outbound direct investment (or vice versa) by effectively imposing (for example) a ''deferral regime'' on one and a ''full-inclusion system'' on the other.

The third argument advanced by this report is that just such a properly constructed full-inclusion tax system has already been proposed. It is the business enterprise income tax, or BEIT — a comprehensive business income tax reform proposal that I first presented in an article published in January 2005 and have continuously refined since then.[2]

To this author's infinite dismay, many readers of this report will not yet be familiar with the BEIT. Part II therefore takes matters out of order by quickly summarizing the BEIT's basic features. Part III then returns to the logical flow of the presentation by describing why the United States should not adopt a territorial tax system. Finally, Part IV demonstrates how the BEIT (in particular), or a more modestly overhauled version of the current income tax (as a second best), advances competitiveness, economic neutrality, and sound tax administration regarding foreign direct investment.

Two other introductory matters need to be addressed. First, for the avoidance of doubt, the arguments that follow are not a disguised attack on big business, multinational enterprises, or the pursuit of money. To the contrary, the BEIT is intended to advance the competitiveness of American businesses and the economic neutrality of the tax system, thereby eliminating many distortions that the current income tax system introduces into commercial and financial decisionmaking.[3]

Second, this report advocates a full-inclusion tax system for foreign direct investment by *all* U.S. firms, as part of the larger overall restructuring of the U.S. system for taxing business enterprises and business capital outlined below. In the absence of that sensible development, all active income of U.S. firms should be treated consistently, which is to say that income should be eligible for deferral. In particular, there is no justification for singling out the active international income of U.S.-based financial service firms for a more punitive tax regime than that enjoyed by the rest of the U.S. economy. Accordingly, while it is to be hoped that the BEIT becomes law, if fundamental business tax reform were not to occur, the case for making the ''active financing exception'' of section 954(h) and 954(c)(2)(ii) permanent would be persuasive, both as a matter of fairness and to prevent distortions in cross-industry investment over time.

II. The BEIT in a Nutshell

The business enterprise income tax's individual proposals comprise an integrated package of reforms that rely on traditional income tax concepts but produce a more efficient and neutral system for taxing the returns to capital invested in private businesses. This part summarizes the BEIT's principal operating rules. The papers cited in note 2 describe the reasoning behind the rules and compare the BEIT with other income tax reform packages, particularly Treasury's 1992 ''comprehensive business income tax'' (CBIT) proposal.

A. Overview

The BEIT superficially resembles the current corporate income tax, but the underlying architecture has been completely overhauled. The result is a tax system that is economically neutral (returns to capital are burdened consistently) and that has much lower corporate (now ''business enterprise'') tax rates than current law's 35 percent corporate rate. The working hypothesis is that the new business enterprise tax rate can be in the range of 25 percent to 28 percent and that the system can remain revenue neutral compared with current law.

The BEIT abandons current law's multiple and frequently elective tax regimes (each turning on largely formal differences from the others) with a single set of tax rules for each stage of a business enterprise's life cycle:

1. Choosing the form of business enterprise.
2. Capitalizing the enterprise.
3. Selling or acquiring business assets or business enterprises.

As a result, under the BEIT, every form of business enterprise — sole proprietorship, partnership, or corporation — is taxed identically and every investor in a business enterprise is taxed identically on his investments, regardless of the label placed on an instrument as debt, or equity, or anything else. The BEIT thus moves the income taxation of business enterprises closer to the ideal of a *featureless tax topography* — an environment in which

[2] I presented the bare-bones outline of the BEIT in ''The Business Enterprise Income Tax: A Prospectus,'' *Tax Notes*, Jan. 3, 2005, p. 97 (hereinafter BEIT Prospectus). That outline was expanded in some respects in a presentation made to the President's Advisory Panel on Federal Tax Reform, *available online at* http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml (hereinafter BEIT Presentation). Finally, an explanation of the conceptual underpinnings of the BEIT, titled ''Designing an Income Tax on Capital,'' was presented at the Brookings Institution in Sept. 2005 and is scheduled to appear in a volume to be published in 2007 containing the papers from that conference.

[3] The BEIT is an income tax, and therefore by definition accepts one distortion that consumption taxes are designed to eliminate, which is the distortion attendant on taxing future consumption financed through savings more heavily than current consumption. In practice, that distortion will have no effect on the lives or savings of most Americans because the BEIT is intended to coexist with tax-deferred savings plans of the sort embodied in current law or in the recommendations of the President's Advisory Panel on Federal Tax Reform. As a result, under the BEIT the only savings that will be materially burdened by current taxation will be those of the wealthiest Americans because they are the only taxpayers with significant savings that exceed those sheltered by tax-deferred savings plans. The author, at least, believes that the resulting additional progressivity to the individual income tax is consistent with political ideals and practical revenue constraints.

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there are as few special tax rules, exceptions to those rules, and antiavoidance glosses on the exceptions to the rules as is practical.

The centerpiece of the BEIT is a *comprehensive* and *coordinated* system for taxing time value of money returns, through the BEIT's cost of capital allowance (COCA) system. Under the COCA regime, a business enterprise deducts a time value of money return on all capital invested in its business (whether denominated as debt or equity) and investors include in income every year a time value of money return on their investments in financial capital (regardless of cash receipts). Investor-level calculations are based on an investor's cost basis in an instrument and thus do not require mark-to-market valuations or other financial information beyond simple arithmetic. The COCA system relies on the BEIT's other operating rules as a platform from which to apply the COCA calculations.

The fundamental theme of the COCA system (in conjunction with the BEIT's other rules) is to tax "economic rents" (the supersized returns attributable to unique commercial ideas or market positions) and risky returns entirely (or nearly so) at the business enterprise level and to tax time value of money returns once (and only once) at the investor level. The COCA system thus achieves both *integration* (that is, the elimination of double tax on corporate profits) and a consistent and accurate measure of income.

B. Specific Rules

The following bullets describe the principal components of the BEIT as applied to large business enterprises. (There are special rules for small businesses not summarized here.)[4]

- Taxation of all business enterprises, regardless of form (for example, sole proprietorships, partnerships, or corporations), as separate taxable entities. Entrepreneurs thus are free to choose whatever form of business organization they wish, but that choice has no collateral tax consequences. The basic tax system looks much like today's corporate income tax, in that the entity tax roughly follows current rules for taxing corporations, subject to the major modifications described below. Also, investors are taxed under the new COCA system on their investment returns. The BEIT thus preserves a two-level tax system, which minimizes transition revaluations of financial assets. The two levels of tax, however, are for the first time coordinated and integrated.
- Substantially lower enterprise-level tax rates (working hypothesis: 25 percent to 28 percent) than the current corporate income tax rate (35 percent).
- Broadening of the business tax base by reforming some important but technical business tax accounting rules and industry-specific preferences (for example: last-in, first-out inventory accounting; like-kind exchanges; or percentage depletion). The largest base-broadening component, however, is the COCA system for taxing returns on investment, as described below.
- Adoption of the COCA system for taxing time value of money returns to investors and deducting the cost of capital by issuers. The basic theme of the COCA system (in conjunction with all the other rules described below) is to tax economic rents and risky returns at the business enterprise level and to tax time value of money returns on a current basis at the investor level. The critical difference between COCA and current law is that COCA taxes investors on a current basis on an expected time value of money return on *all* forms of financial capital invested in businesses, whether called debt or equity, without regard to cash receipts. That current income inclusion is determined by straightforward arithmetic, not observed market valuations for assets. The COCA system is described in a bit more detail a few paragraphs below.
- Mandatory "super tax consolidation" for affiliated enterprises. (All subsidiaries are treated as part of the parent company, as in financial accounting, rather than the hodgepodge consolidated return tax rules we have today.) Consolidation in general would be measured at the 50 percent level and would be measured by reference to all of a company's long-term financial instruments (with tie-breaker rules to prevent multiple consolidations). The rule both eliminates substantial complexity and serves as a foundation for the COCA system.
- As described in more detail in Part IV, the extension of the "super-consolidation" rules to international income. As a result, the BEIT eliminates the "deferral" of active foreign income from current U.S. tax.[5]

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[4]There are also special rules for financial services firms, under which those institutions basically are taxed on a mark-to-market basis (for liabilities as well as assets). *See* BEIT Prospectus, *supra* note 2, at 103-105.

[5]Repeal of the current deferral regime has been recommended before, for example, by Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay. *See* Peroni, Fleming, and Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 *SMU L. Rev*. 455, 507-519 (1999). They proposed a "passthrough" approach, under which each U.S. person owning stock in a foreign corporation would be required to include currently a pro rata share of the corporation's gross income and expenses in computing its own U.S. tax liability. A U.S. investor also would be permitted to deduct a pro rata share of the foreign corporation's losses, up to the amount of the shareholder's basis of its investment in the stock of the foreign corporation.

When applied to a wholly owned foreign subsidiary, the results reached under the Peroni-Fleming-Shay model would be roughly similar to those obtained under the BEIT. Even in this circumstance, however, there are important differences between the two recommendations. For example, the Peroni-Fleming-Shay approach limits loss use to a U.S. person's tax basis in its investment. Similarly, the Peroni-Fleming-Shay model does not contemplate revising the U.S. interest expense allocation rules for FTC purposes (as does the BEIT in respect of its replacement for interest expense deductions, the cost of capital allowance or COCA).

As applied to minority investments in a foreign corporation, the Peroni-Fleming-Shay model and the BEIT diverge more

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(The BEIT in this respect is the perfect mirror image of a territorial system.) At the same time, the BEIT contemplates (1) eliminating the allocation of U.S. interest expense (now COCA deductions) against foreign income — the principal source of ''excess FTC'' problems for U.S. multinationals — and (2) lowering the tax rate on global income. Finally, global super-consolidation also means that foreign losses will become currently deductible in the United States, thereby restoring neutrality to the U.S. tax analysis of foreign direct investments.

- Repeal of all tax-free organization/reorganization rules, and their replacement with a much simpler ''tax-neutral'' acquisition system in which *all* acquisitions of business assets or business enterprises —- basically, all incorporation transactions, or all entries to or exits from a super-consolidated group —- are treated as taxable asset acquisitions. The seller's tax rate, however, differs across the different asset classes that it transfers, depending on the present value to a taxpaying buyer of the step-up in the tax basis of the various assets acquired. The result, from the point of view of the tax system as a whole, is close to that of entirely tax-free transfers (at least at the business enterprise level), but with important technical and administrative advantages.

The COCA system is the centerpiece of the BEIT's ability to measure and tax returns to capital, but the COCA cannot be implemented in a logical fashion without the other reforms summarized above. Nonetheless, because of the COCA's central role, it is useful to outline how it would be implemented.

An investor's COCA income calculation for a year is simply the relevant rate of return for the year (as published by the IRS) multiplied by the taxpayer's tax basis in his financial investments.[6] That amount — termed the minimum inclusion — is includable in income regardless of whether it is paid currently by the issuer to the investor. Cash received from the issuer is tax-free to the extent of current or prior minimum inclusion accruals. The COCA rate will be published regularly by the IRS (just as the applicable federal rate is today) and will be set by reference to the one-year Treasury note rate (for example, one-year Treasuries plus 1 percent).

In the COCA environment, issuers deduct each year, in lieu of current law's interest deductions, a uniform cost of capital allowance equal to the same COCA rate multiplied by the aggregate tax basis of their assets. Thus, an equity-funded issuer obtains exactly the same COCA deduction as does a debt-funded issuer, regardless of the coupons paid on its financial capital.

Under the COCA system, losses from sales of financial assets are currently deductible against ordinary income (to the extent of prior time value of money inclusions on those assets). The result is a more economically neutral investment environment than that provided by current law's capital loss limitation rules.

As currently contemplated, the COCA system would impose a *small* (10 percent to 15 percent) additional tax on an investor's gains beyond time value of money returns. That incremental tax is not compelled by the logic of the system, but rather is suggested in response to traditional fairness and ability-to-pay concerns.

Depreciation methods are unaffected by the COCA system, but the interaction of the COCA rules and depreciation at the business enterprise level has the effect of neutralizing the present value to the government of a firm's tax obligations regarding the capitalization/depreciation methods that it might employ: Faster depreciation means less remaining tax basis in business assets and smaller COCA deductions for the future.

While the COCA system does require some record keeping and arithmetic, it is feasible, in ways that ''accruals'' (universal mark-to-market) taxation and other ideal systems are not. The COCA's allocation of the incidence of tax between investors and issuers is technically superior to Treasury's 1992 CBIT proposal to tax all time value of money returns solely at the business enterprise level.[7]

The COCA system is intended to coexist with broad savings incentives similar to current law and the President's Advisory Panel on Federal Tax Reform's proposals. As a result, the COCA system adds progressivity to the tax code because its burden falls on only the wealthiest taxpayers (as the only taxpayers with significant financial investments not sheltered by tax-deferred savings plans).

III. Why U.S. Should Reject Territorial Tax Solutions

A. Practical Implementations of Territoriality

Territorial tax systems seek to exempt from U.S. income tax the active foreign income of branches or subsidiaries of U.S. firms when that income is repatriated to the United States. Three principal reasons usually are advanced for preferring a territorial tax system as the basis for taxing the international income of U.S.-based multinationals. First, by exempting foreign income from any incremental U.S. taxation, territorial solutions are said to improve the international competitiveness of U.S.

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sharply, because the former applies its passthrough model to all U.S. investors, while the BEIT taxes noncontrolling U.S. shareholders in a foreign company in the same manner that they would be taxed regarding a noncontrolling domestic investment. The BEIT thus attempts to achieve neutrality in result across domestic and foreign minority investments. The BEIT also is more straightforward to apply for minority investors because it does not require a minority investor to have any knowledge concerning its pro rata share of the foreign company's results.

[6]Special rules not described here ensure that COCA works seamlessly with financial derivatives. *See* BEIT Prospectus, *supra* note 2, at 105-106.

[7]A potential political weakness of the BEIT system is that, at least in its idealized form, the BEIT would explicitly tax current tax-exempt investors on their time value of money returns, but not on excess returns. CBIT also would have currently taxed tax-exempt investors, but would have done so indirectly. A practical implementation of the BEIT is expected to modulate this ideal result.

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firms.[8] Second, territorial systems are said to promote goals of economic neutrality, in particular by eliminating current law's bias in favor of keeping low-taxed foreign income offshore, rather than repatriating it, simply to avoid incremental U.S. repatriation tax costs.[9] Third, territorial tax solutions are thought to be simpler than current law because, in particular, they do away with the FTC in respect of active foreign income.[10]

A practical territorial tax system requires several design elements that critically affect the validity of those claims. First, there appears to be a consensus among tax theorists that a territorial solution in practice would apply only to active foreign income; as the price for exemption from U.S. tax, that active income of course would not bring with it an FTC for any non-U.S. taxes that burdened that income.[11] Active foreign losses would not offset domestic taxable income; that is, in effect, the mirror image of domestic exemption for active foreign income.[12] Interest, royalties, or other deductible flows paid by a foreign affiliate to its U.S. parent would be fully taxable in the United States because that income would not have been subject to foreign tax. Further, current law's subpart F regime generally would be retained for passive/mobile income.[13] The FTC system in turn would apply as it does today for any such nonexempt income.

One important implementation issue that is not explicitly discussed in most of the literature is what the treatment should be for ''stripping'' payments (deductible interest or royalties, for example) paid by one foreign affiliate of a U.S. firm to another foreign affiliate.[14] Thus, if a German subsidiary pays royalties to an Irish sister company for the use of intangible assets owned by the Irish company, and those payments reduce German (high-tax) active foreign income, should the receipt of that deductible flow in (low-tax) Ireland be treated as active income or instead as passive/mobile income that is ineligible for the territorial regime? Until the adoption of section 954(c)(6) a few months ago, the answer under current law would have been that the Irish affiliate's income was subpart F income.[15] Today, section 954(c)(6)

[8]*See* Testimony of Dean R. Glenn Hubbard, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006) (hereinafter Hubbard Testimony) (encouraging policymakers to review ''fundamental reforms like a territorial system, with a view to removing biases [in the U.S. international tax system] against the ability of U.S. multinationals to compete globally'').

Interestingly, however, the most sophisticated analyses have argued that, by virtue of (1) eliminating the FTC blending strategies described later in this report and (2) disallowing U.S. interest expense allocable to exempt income, a territorial tax system might actually *raise* total taxes on income derived from very-low-taxed jurisdictions. Rosanne Altshuler and Harry Grubert, ''Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations,'' 54 *Nat'l Tax J.* 787 (2001). *See also* Part III.E.

[9]*See generally* Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., ''Repatriation Taxes and Dividend Distributions,'' 54 *Nat'l Tax J.* 829 (2001) (finding that repatriation taxes generate annual efficiency losses equal to 2.5 percent of dividends).

For an economic analysis of the changed incentives created through the elimination of a repatriation tax, see generally Rosanne Altshuler and Harry Grubert, ''Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy,'' 87 *J. Pub. Econ.* 73 (2003) (working with a model of a parent and its low-tax affiliate).

[10]*See* staff of the Joint Committee on Taxation, ''The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses,'' JCX-22-06, *Doc 2006-12053*, *2006 TNT 120-17*, at 5 (June 21, 2006). *See also* American Bar Association, ''Report of the Task Force on International Tax Reform,'' 59 *Tax Law.* 649, 786 (2006) (hereinafter ABA Report) (''Irrespective of one's views regarding the broader issues relating to deferral, there is a consensus regarding both the high cost of compliance with, and the ineffectiveness of many parts of, the subpart F rules. As such, the current rules may be viewed as the worst of all worlds: avoidable, but only with significant transaction costs.'').

[11]Michael J. Graetz and Paul W. Oosterhuis, ''Structuring an Exemption System for Foreign Income of U.S. Corporations,'' 54 *Nat'l Tax J.* 771, 774 (2001).

[12]Harry Grubert, ''Enacting Dividend Exemption and Tax Revenue,'' 54 *Nat'l Tax J.* 811, 814 (2001).

[13]Graetz and Oosterhuis, *supra* note 11, at 776-778. *See also* ABA Report, *supra* note 10, at 673 (advocating the modernization of subpart F ''if the exemption proposals of either the Joint Committee Staff or the President's Advisory Panel were adopted, since each would retain the subpart F regime'').

[14]For example, Harry Grubert and John Mutti contemplate that ''the current anti-abuse regime that applies to controlled foreign corporations [that is, subpart F] . . . would also continue in force.'' Grubert and Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* 9 (2001), The AEI Press *available at* http://www.aei.org/docLib/20021130_71546.pdf. This thought could be read as implicitly incorporating all of current law's treatment of related-party interest and royalties (ex-section 954(c)(6)), or it could be read as signaling that the authors simply did not expressly consider the issue.

[15]The IRC contains rules that exempt from the reach of subpart F some ''active'' royalty income. Those rules require that the foreign affiliate that owns the intangibles in question have developed or added significant value to the intangible, or, in the case of marketing intangibles, have provided substantial services in connection with marketing the product in question. Section 954(c)(2)(A); reg. section 1.954-2(d).

Those exceptions from subpart F do not apply to royalties received from corporate affiliates, other than affiliates that employ the intangibles in question in the country in which the licensor is incorporated. However, royalties paid by a foreign affiliate that itself is treated as a disregarded entity owned by the licensor under the check-the-box rules of reg. section 301.7701-3 do not give rise to income in the United States sense at all, even though those payments are treated as real for foreign tax purposes.

Moreover, in some cases profits from high-value intangibles can readily be converted from royalty streams into operating income beyond the reach of subpart F. Thus, at the cost of building a highly automated manufacturing facility or CD-ROM pressing plant, a foreign subsidiary located in Ireland (for example) could exploit intangibles owned by it in respect of pharmaceuticals or computer software as sales of physical goods, which sales in turn would fall outside of subpart F.

Grubert, *supra* note 12, at 816, attempts to model the revenue impact of the expected migration of royalty streams paid to a U.S. parent as a result of a switch to a territorial system. He does

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would treat the income as retaining the active income character that it had in the hands of the German payor — at least for the three years that section 954(c)(6) is scheduled to apply. So one could say that recent tax policy points in every possible direction on this critically important question that goes to the heart of the utility and fairness of a territorial tax system.

Finally, most territorial tax systems that have been seriously studied in the United States to date have included a provision to allocate interest expense incurred in the United States, and in some cases other classes of domestic expenses, against foreign ''exempt'' income (which, of course, is not necessarily exempt in a global sense and which may in fact have borne foreign tax at rates as high as or higher than the U.S. rate).[16] Most commentators agree that some sort of sensible interest expense allocation rule, or some comparable provision (for example, an efficacious ''thin capitalization rule'' that would prevent the overleveraging of U.S. operations), unquestionably is required in the context of a territorial foreign tax system to protect the *domestic* tax base. In the absence of such a rule, analysts fear that U.S. firms would overleverage their U.S. operations to the point where they ''zeroed out'' their U.S. tax liability on their domestic operations and would service that debt with tax-exempt (from the perspective of the United States) foreign-source income.[17]

That last concern demonstrates in turn the critical importance of the treatment of interaffiliate stripping transactions, as described above. If one is confident that foreign income will bear a tax burden comparable to that of the United States, the case for domestic interest expense allocation rules becomes more attenuated. Conversely, if one believes that foreign-to-foreign income stripping to reduce foreign tax burdens is appropriate, the need to protect the domestic tax base becomes more urgent. (Of course, if one believes that foreign tax rates are highly likely to be comparable to those of the United States, one can fairly question the need to adopt a territorial tax system at all, as doing so would not reduce tax burdens or in practice significantly change repatriation policies.)

The remainder of this part demonstrates that practical implementations of territorial tax systems are anything but simple. For example, as described above, territorial tax systems in practice inescapably require two parallel tax regimes, one comprising current law (for passive/mobile income) and the other the territorial scheme. With those two parallel regimes come difficult coordination and line-drawing issues. Similarly, territorial tax systems are usually scored as revenue generators once ancillary expense allocation or comparable rules are considered. And while it is true that a territorial tax system removes current law's distorting effects on firm repatriation policies, the irony is that so too does a full-inclusion system. At the same time, territorial tax schemes introduce important new distortions, of which the most important by far is the pressure those schemes put on our transfer pricing systems. The next sections therefore turn to transfer pricing and its relationship to the choice of a foreign direct investment tax regime.

B. The Critical Importance of Transfer Pricing

Transfer pricing issues (that is, efforts by firms, whether U.S. or foreign-based, to reduce their U.S. tax liabilities by shifting U.S. profits to low-taxed non-U.S. affiliates) are the most important challenge today to the administration of the international tax provisions of the code. That observation is consistent as an anecdotal matter with the issues that many practitioners see in their practices.[18] More usefully, that observation also is consistent with objective data.

The IRS now confronts transfer pricing cases involving staggering sums of money. For example, the IRS recently announced the settlement of a tax case against GlaxoSmithKline in which the pharmaceutical company agreed to pay the IRS $3.4 billion (including interest) for tax deficiencies relating to a 12-year period (and concurrently agreed to abandon a $1.8 billion tax refund claim), all as a result of its transfer pricing practices.[19] Similarly, Merck & Co. recently revealed that it is contesting similar transfer pricing (and other) cases, in which the tax claims against it by the IRS and the Canadian tax administration total some $5.6 billion.

In a recent and sophisticated paper, Dr. Harry Grubert of the Treasury Department and Prof. Rosanne Altshuler of Rutgers University (and formerly on the staff of the President's Advisory Panel on Federal Tax Reform) considered in detail the role of intangibles in cross-border transfer pricing.[20] Paraphrasing the work of this academic study (hopefully without excessive violence to the authors' intent), Grubert and Altshuler concluded that:

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not appear explicitly to break out the separate effect of a change in systems on the behavior of foreign subsidiaries holding high-value intangibles.

[16]Grubert, *supra* note 12, at 814. The interest expense allocation proposals in particular typically apply ''worldwide'' fungibility principles (as developed in the American Jobs Creation Act of 2004), thereby avoiding the logical errors of prior law's ''water's-edge approach,'' Daniel N. Shaviro, ''Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals,'' 54 *Tax L. Rev.* 353 (2001), but even worldwide fungibility can be criticized as significantly imperfect because it does not treat foreign currency translation losses as, in effect, a component of worldwide interest expense.

[17]Similar arguments have been made regarding other U.S. domestic expenses (for example, ''head office'' general and administrative expenses, or domestic research and development expenditures), but there is less of a consensus on how those expenses should be treated.

[18]*See* ABA Report, *supra* note 10, at 716 (saying that the current U.S. tax rules encourage ''using transfer pricing to shift additional income to foreign corporations subject to low effective tax rates'').

[19]IRS News Release IR-2006-142, *Doc 2006-19012*, *2006 TNT 176-6* (Sept. 11, 2006).

[20]Harry Grubert and Rosanne Altshuler, ''Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,'' presented at the Baker Institute for Public Policy on

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- The exportation of intangible assets has been a "significant source" of foreign direct investment income; royalties and license fee income received by U.S. companies *tripled* from 1990 to 2004.[21]
- At the same time, royalties paid by foreign subsidiaries to U.S. parent companies "represent *less than half* of the contribution that parent R&D makes to subsidiary income."[22]
- The data suggest that low-tax countries "are becoming much more important destinations for U.S.-produced intangible assets"; in this connection, "the share of total affiliate royalties accounted for by Ireland and Singapore doubled between 1994 and 1999."[23]
- "Pre-tax profits in relation to sales are almost three times higher in Ireland on average than the group mean. These 'excess' profits presumably reflect the fact that very valuable intellectual property is located in Ireland and the royalties paid back to the United States, while significant, do not fully reflect its contribution."[24]

A recent economic analysis by Martin Sullivan reaches similar conclusions.[25] Sullivan concludes, for example, that while foreign affiliates of U.S. multinationals in the aggregate earned a 7.2 percent return on sales in 2004, Irish subsidiaries had more than twice that profitability — 14.8 percent. By contrast, the unweighted average of the returns on sales realized by subsidiaries in Europe's larger economies was much lower than the all-countries aggregate figure — roughly 4.2 percent.[26]

An important *Wall Street Journal* article from November 2005 gives life to those dry statistics by describing in detail Microsoft's use of "cost-sharing agreements" with an Irish subsidiary to develop and exploit Microsoft's core intellectual property.[27] According to that article, Round Island One, Microsoft's intellectual property holding company in Ireland, earned nearly $9 billion in gross profits in 2004, and roughly $2.4 billion in taxable income, by exploiting intangible assets to which it acquired ownership by virtue of its cost-sharing agreements with its U.S. parent.[28]

To be clear, I do not mean to suggest that Microsoft's arrangements with its Irish subsidiary violate the requirements of the extensive arm's-length transfer pricing regulations governing cost-sharing agreements. That is the purpose of the IRS examination process, to which I am a complete outsider. I do think it fair, however, to point to *The Wall Street Journal* article and the academic paper discussed above to illustrate the magnitude of the intangible property transfer pricing issue and its importance to tax administration.

I also believe it fair to draw from all of the above the inference that the IRS is shouldering a near-impossible burden in that area, for two reasons. First, the accurate valuation by outsiders of intangible assets like Microsoft's proprietary "crown jewel" software is nearly impossible, because the assets themselves are incredibly complex and because in practice genuinely comparable third-party transactions almost never exist. (That is, major software companies rarely enter into cost-sharing agreements with third parties to develop new versions of their crown jewel intangible assets.) Yet the arm's-length transfer pricing cost-sharing regulations require just such an inquiry, to measure "buy-in" payments for the existing intangible assets that form the basis for a cost-sharing agreement.[29]

Second, the entire premise of our transfer pricing rules — that related parties should deal with each other for tax purposes at the prices and on the terms at which third parties would engage in comparable transactions — is unachievable, particularly when applied to high-value intangible assets held by multinational enterprises. There is abundant literature to support the proposition that multinational enterprises thrive in the world economy precisely because the economy is increasingly global and because multinational enterprises can muster *tightly integrated* global resources to take advantage of that fact.[30]

Apr. 27, 2006, *available at* http://bakerinstitute.org/Pubs/conferences/2006_tax_007.pdf (hereinafter Grubert and Altshuler).

[21]*Id.* at 9.

[22]*Id.* at 10 (emphasis added).

[23]*Id.* at 18.

[24]*Id.* at 26.

[25]Martin A. Sullivan, "A Challenge to Conventional International Tax Wisdom," *Tax Notes*, Dec. 11, 2006, p. 951, *Doc 2006-24455*, *2006 TNT 238-6*.

[26]*Id.* The percentage figure in the text is the unweighted average of the returns on sales for subsidiaries located in France, Germany, Italy, the Netherlands, Spain, and the United Kingdom.

[27]Glenn R. Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," *The Wall Street Journal*, Nov. 7, 2005, at A1.

[28]I derived the latter figure by grossing up Round Island's reported tax liability to Ireland of $300 million at the Irish tax rate of 12.5 percent. I ignored in this calculation the $17 million that *The Wall Street Journal* reported that Round Island paid in tax to other European countries (presumably through withholding taxes). If, as I believe to be the case, those payments were creditable in Ireland, Round Island's taxable income actually would have slightly exceeded $2.5 billion in 2004.

[29]*See* reg. section 1.482-7(g)(1)-(7) (establishing rules for "buy-in" payments for preexisting intangible property). It is unusual for a cost-sharing agreement to be an entirely "greenfields" arrangement in which neither party contributes existing intangibles to the project.

Cost-sharing agreements can also be criticized as based on a false premise, which is that each party to the agreement bears the financial risk of the costs it has agreed to shoulder. That premise might be valid in the case of third-party arrangements, but is fundamentally not credible when applied to a U.S. parent and its foreign subsidiary: The subsidiary's "risk" is the parent's risk, and the former's capital comes from (or at the sufferance of) the latter. The combination of such an intragroup cost-sharing agreement and territorial tax systems in practice thus reduces to the U.S. parent's agreement to forgo U.S. tax deductions for a specified fraction of its global development costs, in exchange for obtaining an exemption from U.S. tax for the same percentage of its worldwide income derived from the intangibles covered by the agreement.

[30]*See*, in this regard, Hubbard Testimony, *supra* note 8 ("Multinationals are an intrinsic part of global integration because they represent an alternative means by which nations

(Footnote continued on next page.)

The paradigmatic example of the integrated global strategies of modern multinational enterprises, of course, is the worldwide exploitation of a common pool of high-value intangible assets.

Arm's-length transfer pricing tends to deny (or perhaps misallocate) the synergies that flow directly from the globally integrated activities that explain the success of multinational enterprises in the first place. As applied to intangible assets, arm's-length transfer pricing requires us to pretend that a multinational group does not in practice control a single common pool of intangible assets with worldwide application, but rather comprises essentially independent enterprises negotiating with each other as if trade barriers to the direct global exploitation of those intangible assets still existed.[31]

As a result, the arm's-length transfer pricing principle at its core presupposes a business model that is fundamentally inconsistent with the business strategies of multinational enterprises that possess high-value and globally relevant intangible assets. When the tax model that we have created is so fundamentally agonistic to business realities, the administration of the tax system can never be wholly successful.

C. Territoriality and Transfer Pricing

Changing to a territorial tax system would greatly exacerbate the importance of transfer pricing issues. The reason is simple. Under current law, the principal "reward" for successfully gaming our transfer pricing rules is the accumulation of profits in a foreign subsidiary, presumably located in a low-tax jurisdiction.[32] To collect that reward, however, a U.S. firm must keep those earnings offshore indefinitely. *Territorial tax systems, by contrast, reward successful transfer pricing gamers as "instant winners"* by enabling the successful U.S. firm to recycle immediately its offshore profits as tax-exempt dividends paid to the U.S. parent.[33]

That concern is widely shared, and has been identified as a topic of concern by the staff of the Joint Committee on Taxation and other authors who have described or proposed possible territorial tax systems.[34] The principal difference between my views and the views of these other observers is that they typically conclude that the

conduct cross-border transactions. That is, the economic costs of production, transportation, distribution, and final sale may be lower [if] conducted within a single firm than via a series of market transactions. Accordingly, the rise in global integration carries along with [it] an increased volume of transactions for which multinationals have a particular advantage.").

[31]*See* reg. section 1.482-1(b)(1) (stating that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)"). It is true, of course, that, whether under existing Treasury regulations or by virtue of multilateral advance pricing agreements, intercompany tax transfer pricing arrangements for intangibles or services often rely on various "profit split" methods. Those methods may have the indirect effect of allocating (or misallocating) the benefits of groupwide synergies, but do not do so explicitly, and in any event are not universally required under the "best method" approach. *See* reg. section 1.482-1(c)(1) ("The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others.").

[32]Also, a U.S. parent company can employ a related strategy, under which it shelters from U.S. tax the zero-taxed royalty income from foreign subsidiaries paid to the U.S. parent company (and thereby not subject to deferral) with FTCs arising from repatriating very-high-taxed operating income from other foreign subsidiaries. Grubert and Altshuler describe that strategy in detail; their paper estimates that in 2000, royalties

(Footnote continued in next column.)

received by U.S. parent companies amounted to roughly $45 billion, but that roughly $30 billion of the amount was sheltered from tax by those FTC blending strategies. Grubert and Altshuler, *supra* note 20, at 9-10.

[33]It is true, as Grubert and Altshuler point out, that territorial tax systems disable the popular current strategy of blending zero-taxed foreign-source royalties paid to the U.S. parent by foreign subsidiaries with high-taxed dividend income to shelter those royalties from tax. Grubert and Altshuler, *supra* note 20, at 28-30. Without considering any possible dynamic responses by U.S. multinational firms, the effect of a territorial tax system thus would be to *raise* the effective rate on the exploitation of intangible assets from low-taxed jurisdictions. *Id.* at 29.

One probable dynamic response by taxpayers to a territorial system would be to attempt to understate royalty payments owed to the U.S. parent by foreign subsidiaries. *Id.* at 30. In addition, cost-sharing agreements, in particular, do not ordinarily generate royalty payments to the U.S. parent company beyond any "buy-in" payments required from the foreign subsidiary. That means that, for companies that employ cost-sharing agreements, royalty payments to the United States should decline relative to the value of the intangible assets that the foreign subsidiary owns outright with the passage of time. As royalties paid to the United States decline (in absolute or relative terms), a foreign subsidiary will be able to capture more profits over time as exempt active foreign income.

[34]Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, *Doc 2005-1714*, *2005 TNT 18-18*, at 195 n.431 (Jan. 7, 2005) (hereinafter JCT Staff I) (noting that an "exemption system may place somewhat more pressure on [transfer pricing rules], thus making it somewhat more important to remedy existing defects in the design and administration of those rules."); Tax Reform Panel Report *supra* note 1, at 242 (stating that "because pressures" to use transfer pricing to minimize taxable income "are more pronounced in a territorial system, it would be necessary to continue to devote resources to transfer pricing enforcement."); Peter Merrill et al., "Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience," *Tax Notes*, May 15, 2006, p. 799, *Doc 2006-7791*, *2006 TNT 94-33* (arguing that the incentive for transfer pricing gaming will become greater under territoriality); Graetz and Oosterhuis, *supra* note 11, at 772, 775 ("A simpler system would no doubt result if the transfer pricing rules . . . rather than an exclusion from income, could be relied on to constrain tax avoidance [on passive/highly mobile income]"); Sullivan, *supra* note 25 ("The United States should beef up transfer pricing rules to prevent increasing the incentive effect of already favorable tax rates in production tax havens."); ABA Report, *supra* note 10, at 723 ("Transfer pricing would have higher stakes for the taxpayer and the Government and enforcement of the rules would have to be strengthened and, possibly, the rules reviewed.").

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administration of our existing arm's-length transfer pricing rules simply will require greater vigilance in a territorial tax system.[35] By contrast, I believe that it is unrealistic to expect that enhanced administration can ever adequately address the transfer pricing challenge that modern tightly integrated multinational enterprises possessing high-value intangible assets would pose to a territorial tax system.

D. Competitiveness and Economic Neutrality

In recent years, many observers have described how the rapid evolution of the global economy has compelled U.S. tax policymakers to become increasingly sensitive to issues of international competitiveness. For example, Glenn Hubbard, the dean of the Columbia Business School and former chair of the president's Council of Economic Advisers, recently testified before the House Ways and Means Committee on precisely that topic. Hubbard identified several important themes relating to the changing competitive landscape in his testimony, including the increasingly integrated nature of the global economy, the enormous rise in international capital flows (which include cross-border portfolio investments), and the shift over the last several decades from the United States' role as the world's largest exporter of capital to its current status as the world's largest capital importer.[36]

Hubbard rightly draws from these facts the conclusion that U.S. international tax policy norms from, say, 1962, do not necessarily serve the interests of the United States in 2006. The same underlying questions remain relevant, however: What principles should we in fact adopt as our international tax policy norms in the new world economy? And how can we measure different tax proposals against those norms?

It is the traditional practice in discussions of international tax policy choices to begin to address those questions by laying out the principle of ''capital export neutrality'' — that a U.S. multinational firm should face the same tax burden on a new investment wherever in the world that investment might be made — and the principle of ''capital import neutrality'' — that a U.S. multinational firm should bear the same tax when competing in a foreign market as its local competitors face.[37] To those can be added at least two other widely discussed ''neutralities'' — ''national neutrality'' and ''capital ownership neutrality.''[38]

The traditional discussion then goes on to demonstrate that it is not fully possible to satisfy both capital export neutrality and capital import neutrality simultaneously in the real world.[39] At the same time, most analysts acknowledge that, all other things being equal, maintaining capital export neutrality would be desirable, and, by the same token, so would maintaining capital import neutrality. Finally, every traditional discussion concludes by asserting that whatever policy is being proposed represents a fair balancing between those two irreconcilable objectives, in every case based largely on the author's preexisting intentions. No wonder our international tax policy is muddled!

In a refreshing break from that familiar presentation, Grubert and Altshuler implicitly conclude that the traditional ''Battle of the Neutralities'' (as I term the process) is an essentially sterile exercise that by itself cannot usefully guide tax policymakers in shaping the international tax policy norms of the United States.[40] Instead, they urge policymakers to focus on the *behavioral distortions* among taxpayers (and, to a lesser extent, governments) that flow from current law and to evaluate reform proposals by reference to their success in mitigating the distortions:

> What reform within an income tax can hope to accomplish is to eliminate unnecessary waste and the possibility of extremely high or low tax burdens that are not justified under any standard. Then we can at least be sure that we are moving toward the optimum without overshooting it and running the risk of making things worse.
>
> International tax systems can act on many behavioral margins in addition to the choice of location. The current tax system induces a number of behavioral responses that both waste resources and lead to inappropriate incentives to invest tangible and intangible capital in various locations. These include strategies to avoid the U.S. repatriation tax on dividends, to shift debt from high-tax to low-tax locations, and to shift income to low-tax locations by distorting transfer prices or paying inadequate royalties. Besides directly wasting resources, these strategies can lead to inefficient choices between related party and arms' length transaction and a

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[35]*Id.*

[36]Hubbard Testimony, *supra* note 8. *See also* Testimony of Prof. Michael J. Graetz, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006) (hereinafter Graetz Testimony) (recognizing ''integration of the world economy'').

[37]Staff of the JCT, *supra* note 10, at 3, 5, 57-61.

[38]*See, e.g.*, Mihir A. Desai and James R. Hines Jr., ''Old Rules and New Realities: Corporate Tax Policy in a Global Setting,'' 57 *Nat'l Tax J.* 937 (2004).

[39]*See, e.g.*, Michael J. Graetz, ''Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies,'' 54 *Tax L. Rev.* 261, 272 (2001).

[40]The ABA's Task Force on International Tax Reform reaches a similar conclusion in its final report. In its discussion on the different forms of neutrality, the task force states:

> The Task Force has not based its analysis on strict application of any one of [the neutrality] principles. None of the principles can be fully achieved by a country unilaterally, and no country applies any of the principles in a pure form. There is not sufficient evidence for the Task Force to conclude that any one of the principles should be determinative in the design of U.S. tax rules. Instead, the Task Force has taken a more pragmatic approach and attempted to evaluate how taxpayers would apply rules in practice and what the incentive effects of rules would be when analyzed in the context of the overall U.S. tax regime.

ABA Report, *supra* note 10, at 681.

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> distribution of tangible and intangible assets that cannot be justified on any conceptual basis.
>
> In our evaluation of the distortions that may be eliminated by some of the reform proposals, we focus on how the proposals affect (1) the location of tangible capital, (2) the location of intangible capital, (3) the repatriation decision, (4) financing decisions, (5) income shifting, (6) incentives to lower foreign tax burdens, (7) export decisions and (8) host government decisions regarding the taxation of U.S. companies.[41]

I submit that reviewing the effect of current law or any tax reform proposal on the eight criteria listed immediately above is a far more productive exercise than continuing the sterile ''Battle of the Neutralities'' that has dominated much of the policy discussion to date.

It also unfortunately follows from the above that it is absolutely necessary in evaluating any international tax reform proposal to wade into the technical details of how that proposal will be implemented. That is, it turns out that an international tax reform proposal must be *specified* and *analyzed* in detail, if one is to predict with any degree of accuracy how the behaviors of differently situated taxpayers will be affected by the proposal, and, therefore, what distortions in economic activity might follow.[42]

E. Consequences of Territorial Systems

This section considers the economic and competitiveness consequences of adopting a practical territorial tax system for taxing foreign direct investment. It turns out that when one applies the metrics proposed in the previous section to realistic implementations of territorial systems, the analysis becomes surprisingly complex and the answers not at all intuitive.

A territorial tax system unquestionably would reduce distortions inherent in the current code in one important respect, which is that it would eliminate the barriers to repatriation that current law imposes. As observed earlier, a U.S. firm today must ''earn'' the tax benefit of deferral through patiently deploying its active foreign profits outside the United States, even if the highest and best use of those funds would be in a domestic application.[43] As a result, current law encourages the wasteful accumulation of profits abroad, and in some cases the wasteful investment of those profits in the expansion or acquisition of ''active'' businesses, solely to preserve the continuing benefits of deferral. A territorial tax system eliminates tax considerations from the repatriation decision and therefore removes this significant economic distortion of current law.

Many advocates of territorial tax systems also believe it to be self-evident that territoriality will enhance the competitiveness of U.S. firms by eliminating residual U.S. income tax. Those proponents view territorial tax systems as the paradigmatic implementation of capital import neutrality themes. The revenue implications of practical territorial tax systems, however, are more ambiguous than those advocates might expect.

In January 2005 the JCT staff proposed a comprehensive territorial tax system, described as a ''dividend exemption system.''[44] The JCT staff estimated that its territorial system would *raise* $55 billion in tax revenue over 10 years. It is difficult to describe that proposal as self-evidently enhancing the competitiveness of U.S.-based multinational firms if by that phrase one means a *reduction* in total tax burden imposed on the income of U.S. multinationals.

Later in 2005, the President's Advisory Panel on Federal Tax Reform proposed a system similar in broad outline to the JCT staff proposal, although with some differences in detail (particularly regarding expense allocation rules).[45] No official revenue estimate accompanied that proposal. Most recently, Grubert and Altshuler concluded that switching to a territorial system would generate a small revenue gain, but that the revenue estimate was critically sensitive to possible behavioral responses that are difficult to model.[46] Their paper also summarizes earlier work that concluded that a territorial tax system would significantly *increase* the tax burden on investments in low-taxed foreign subsidiaries.[47]

There are two principal factors at work behind those surprisingly effective tax rate results. The first factor is the conclusion reached by the JCT staff and others that a territorial tax system must be accompanied by interest expense allocation rules modeled on current law, as described in Part III.A, with the result that interest expense allocated to tax-exempt income would not be deductible.

The second principal reason why a territorial tax system can raise effective tax rates in some cases is that it eliminates a taxpayer's ability under current law to average down high-taxed foreign income with zero-taxed foreign royalty income (or low-taxed affiliate income). I liken the process to a master distiller blending a perfect tax liqueur, in which the blended product bears tax at precisely 35 percent, so that no residual U.S. tax is due and no excess credits are generated.

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[41]Grubert and Altshuler, *supra* note 20, at 16 (enumeration in the last paragraph supplied by this author).

[42]This, in effect, is one major theme of Grubert and Altshuler, *supra* note 20.

[43]The 2005 experience with the one-year 5.25 percent repatriation tax afforded by section 965 illustrates the magnitude of the issue: One estimate put the size of the one-year repatriation flows triggered by that section as in the neighborhood of $200 billion. Grubert and Altshuler, *supra* note 20, at 19. Another $100 billion was expected to be repatriated by the end of 2006. American Shareholders Association, ''ASA Repatriation Scorecard'' (Mar. 20, 2006), *available at* http://www.americanshareholders.com/news/asa-repats-03-20-06.pdf.

[44]JCT Staff I, *supra* note 34, at 189. The JCT staff proposal in turn was said to be modeled on that of Grubert and Mutti, *supra* note 14.

[45]For a comparison of the two proposals, and a rough revenue estimate for the advisory panel's package, see Merrill, *supra* note 34, at 808-809.

[46]Grubert and Altshuler, *supra* note 20, at 12.

[47]*Id.* at 29. That observation leads to the conclusion, to paraphrase the dry humor of academic articles, that when applied to the lowest-taxed foreign affiliates, a territorial system actually is a step toward capital *export* neutrality.

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More specifically, every territorial tax system that has been seriously studied in the United States would *not* exempt from tax royalty or interest income paid by a foreign subsidiary to its U.S. parent, on the theory that those amounts were deductible abroad and that exempting them from U.S. tax thus would result in those amounts bearing tax nowhere in the world. Under current law, a U.S. parent company's stream of royalty or interest receipts from its foreign subsidiaries nominally constitutes taxable income, but in fact the actual tax liability on those amounts is largely sheltered by the tax ''master blender'' at each company, who brings up sufficient high-taxed income from other foreign operations to shelter those income streams.

In a territorial system, by contrast, the royalty and interest income would be fully includable in income without offset for any tax credits attributable to exempt income. As a result, a firm's cask of exempt high-taxed income could not be blended with liqueur from a low-taxed cask in a way that would reduce the effective tax rate on the former.

It is for those sorts of reasons, I believe, that Stephen Shay, in his 2006 testimony before the Ways and Means Committee on the theme of international competitiveness, suggested that U.S. multinationals today actually enjoy the best of all worlds.[48] In a similar vein, the National Foreign Trade Council in 2002 undertook a comprehensive review of territorial tax proposals on behalf of a wide range of U.S. multinational firms. That study concluded that the evidence did *not* unambiguously support the claim that a territorial tax system would enhance competitiveness:

> While it is true that a territorial system could improve competitiveness and simplicity for some U.S.-based companies with substantial operations abroad, the accompanying reduction in foreign tax credits attributable to exempt income could more than offset that benefit for other such companies. Moreover, the benefit for any significant group of companies would be dependent on the adoption of a broad exemption, a cut back on the existing subpart F rules, and reform of the current expense allocation rules.[49]

It is ironic that some proponents of territoriality may be unaware that the current system often can be used to optimize a U.S. firm's global tax liabilities in ways that a territorial system cannot.[50] Similarly, those proponents might not appreciate the complex and ambiguous effects of a well-designed territorial tax system (that is, one with proper expense allocations or other mechanisms to safeguard the domestic tax base) on a U.S. multinational firm's worldwide effective tax burden.

The previous paragraphs acknowledged that a territorial tax system would eliminate the behavioral distortions attendant on current law's repatriation tax burdens. The probable effect of a well-designed territorial tax system on effective tax rates, however, is not unambiguously pro-competitive, as that term ordinarily is employed. At the same time, a territorial tax system can exacerbate (or create novel) economic distortions, compared with those that exist under current law. Most importantly, a territorial tax system will encourage multinational firms to express increased enthusiasm for aggressive transfer pricing strategies (particularly relating to high-value intangibles), for the reasons described in Part II.C.[51] Because that topic already has been addressed, the remainder of this section considers some other, less obvious, economic distortions that accompany practical territorial tax systems.

First, a territorial system can be expected to impose radically different tax burdens on the international income of different U.S. industries, largely as a result of different industry norms for debt-to-equity ratios,[52] different levels of reliance on separately identifiable intangible assets (as opposed to goodwill and the like), and different rates of adopting tax-preferred methods of developing global intangibles. For example, if a territorial tax system includes an interest expense disallowance rule modeled on current law's FTC rules allocating domestic interest expense against foreign-source income, U.S. financial services firms (with their high debt-to-equity ratios) will be disadvantaged compared with other industries that are primarily equity funded. Similarly, territorial systems will reward those firms or industries that were early and aggressive adopters of cost-sharing agreements with their foreign subsidiaries, because they will be able to capture the returns of those non-U.S. intangibles as exempt income.

Second, an important potential source of economic distortion is that tax policy can distort investment by

[48]Testimony of Stephen E. Shay, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong (2006). The JCT staff made a similar point in 2005: ''In many cases, the present-law 'worldwide' system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the 'territorial' exemption systems used by many U.S. trading parties.'' JCT Staff I, *supra* note 34, at 189.

[49]National Foreign Trade Council, ''NFTC Territorial Tax Study Report,'' at 24 (2002), *available at* http://www.nftc.org/default/tax/Territorial%20Report.pdf (hereinafter NFTC Territorial Report).

[50]For more on the effect of the current system, see ABA Report, *supra* note 10, at 689 (''The current U.S. international rules allow U.S. multinationals to achieve outcomes that are superior to exemption and therefore cannot be justified by reference to [neutrality principles.] These opportunities are a consequence of structural and technical rules that operate together to afford tax reduction opportunities that almost certainly are unintended.'').

[51]*See supra* note 34. *See also* ABA Report, *supra* note 10, at 730 (''The Joint Committee Staff and President's Advisory Panel exemption proposals are deficient on several grounds. The failure to include any requirement that the exempt income be subject to a foreign tax will invite substantial tax avoidance planning and place great pressure on transfer pricing rules.'').

[52]Traditional industrial firms, for example, might have debt-to-equity ratios of 1:1, while the financial services industries' debt-to-equity ratios might be on the order of 30:1.

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portfolio investors as well as direct investors. One example of that phenomenon is the tax-driven differences in the relative attractiveness for a U.S. investor of making a portfolio investment in a U.S. multinational firm (which in turn makes foreign direct investments), compared with making such investments in a foreign-domiciled multinational. The same issue can also arise from the perspective of a foreign portfolio investor considering the same two investments, or a U.S. multinational corporation considering a foreign portfolio as opposed to a foreign direct investment, or even a U.S. portfolio investor considering investing in U.S. multinational firms as opposed to U.S. domestically oriented businesses. In light of the enormous surge in global capital flows, the increased transparency and liquidity of many foreign capital markets, and the ease of global research through online tools, it is absolutely imperative that U.S. international tax policy consider any tax reform proposal's potential for distorting those portfolio investment decisions.[53]

As envisioned by the JCT staff, a territorial tax system would not directly distort portfolio investment decisions between U.S. and foreign portfolio investment opportunities, although of course the ultimate effective tax rates imposed on different firms or different industries in a particular implementation of territoriality might do so. Territoriality would, however, distort the decision to make a portfolio investment rather than a direct investment, because the former (at least in many proposed implementations) would be subject to full double taxation, while a direct investment would not.[54]

The territorial proposal made by the President's Advisory Panel on Federal Tax Reform would introduce still another particularly dramatic economic distortion for portfolio investors, because of the peculiar way in which the panel chose to combine its territorial tax proposal with domestic relief from the double taxation of dividends. Essentially, when viewed from the perspective of the ultimate owners of a business enterprise, the panel's proposal would have dramatically preferred portfolio investment in domestically oriented U.S. firms over portfolio investment in U.S.-based multinational enterprises that bore precisely the same effective global tax rate.

More specifically, the panel's ''simplified income tax'' (SIT) proposal, apparently following the (erroneous) logic of Treasury's 1992 CBIT proposal, would have imposed a sort of compensatory tax when a U.S. company paid dividends to its U.S. shareholders out of exempt foreign earnings.[55] The result would have been a significantly anticompetitive step backwards for U.S. multinationals in respect of their cost of equity capital.[56] In that respect, then, the panel's SIT proposal would have introduced a distortive double tax on foreign income.

For example, imagine two U.S. corporations, Domestico and Globalco. Domestico earns $100 pretax, entirely from U.S. operations; Globalco also earns $100 pretax, but entirely from operations in Freedonia. Both companies are entirely equity funded.

Under the panel's SIT, Domestico pays $31.50 in tax on its $100 income. Domestico then can distribute the remaining $69.50 to its shareholders as an exempt dividend.

Globalco, by serendipity, also pays $31.50 in income tax on its $100 income, but Globalco makes out the check for its tax payment to the Freedonia IRS. Globalco can repatriate its $69.50 of after-Freedonian-tax profits to the United States, but when it distributes that amount to its U.S. shareholders they will be subject to full ordinary income tax on the distribution, while their brethren who invested in Domestico keep the same $69.50 distribution free of any tax.

A third potential new distortion again relates to the role of income stripping transactions, in their broadest sense. At least some proponents of a territorial tax system use ''competitiveness'' as a code word for ''the lowest possible tax on foreign income that can legally be devised.'' One can fairly ask, however, whether competitiveness in that sense is truly nondistortive or whether instead a less distorting goal might be to design a tax system that would enable a U.S. firm to compete against local firms in their domestic markets at an effective tax burden that is directly comparable to that faced by those local firms.

Those two thoughts are not identical. We all understand the importance of ''check the box'' disregarded

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[53]*Cf.* National Foreign Trade Council, *NFTC Foreign Income Project: International Tax Policy for the 21st Century*, at 98-99 (2001), *available at* http://www.nftc.org/default.asp?Mode=DirectoryDisplay&id=162 (hereinafter NFTC Foreign Income Project); Grubert and Altshuler, *supra* note 20, at 6.

[54]Grubert, *supra* note 12, at 813. Michael J. Graetz and Paul W. Oosterhuis observe that many OECD countries that employ exemption systems impose a 10 percent stock ownership threshold for qualification for that regime. Graetz and Oosterhuis, *supra* note 11, at 779. Those authors argue, to the contrary, that portfolio investments by U.S. corporations should be exempt from U.S. tax, without regard to active/passive distinctions. *Id.* They would not extend that result to portfolio investments by households. *Id.* at 780.

[55]*See* Tax Reform Panel Report, *supra* note 1, at 243-244 (stating that under its proposal, ''shareholders of U.S. corporations could exclude from income 100 percent of the dividends paid from income of the corporation reported as taxable in the United States,'' implying that the exclusion would be limited in the case of a corporation that is not taxable in the United States).

[56]CBIT's designers apparently believed that a compensatory tax was appropriate in this case because the code as then drafted (and, indeed, today) did not grant an indirect FTC to individuals. The code does, however, grant the indirect credit to our principal vehicle for conducting business (the corporation). Because the whole purpose of CBIT and other integration proposals is to treat individual stakeholders as if they directly earned their share of business enterprise income, it is far more logical to assume in designing an integrated tax system that a tax credit that has always been available to prevent double taxation of business income should remain available when that business income is taxed only once, rather than twice. Otherwise, one simply substitutes one form of distortive double taxation for another.

The President's Advisory Panel on Federal Tax Reform followed the logic of CBIT in this respect in fashioning the international tax provisions of the panel's ''simplified income tax.'' As a result, that proposal, like CBIT, would introduce a distortive double tax on foreign income.

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entities, hybrid instruments, and hybrid entities in U.S. international tax planning today. The difficult question that deserves more debate is whether, if a U.S. firm can employ those arrangements to drive its effective tax rate on its Freedonian operations *below* the rate imposed in law and in practice by Freedonia on its domestic companies, we should applaud that result as enhancing competitiveness or instead decry the result as distorting investment decisions.

That point can be generalized by observing that territorial tax systems in practice inevitably bring with them the prospect of ''stateless income'' — income that is taxed nowhere in the world (or, at least, taxed at extremely low rates in a country where the income is not earned). Stateless income is not simply an artifact of transfer pricing abuses, but also arises from decisions as to where to place financial capital within a multinational group (so as to generate interest expense in a high-tax country and offsetting income in a very-low-tax jurisdiction), differences in implementation of different tax systems, hybrid instruments, and hybrid entities. All territorial tax systems struggle with the issue of stateless income.[57]

For example, if a territorial system permits a deductible payment paid by one foreign affiliate out of its exempt income to retain its exempt character when paid to another foreign affiliate, that system will encourage — indeed, impel — taxpayers to use affiliate interest, rents, and royalties to strip out earnings from the countries in which that income economically is earned. That leads directly to the phenomenon of stateless income. Conversely, treating all such income as ''passive'' (and therefore as immediately taxable in the United States) will be criticized as undercutting the purpose of a territorial system. The conflict inevitably will lead both to difficult technical issues (for example, layering rules for determining from which income a deductible interaffiliate expense is paid) and to a political tug of war identical to that which has bedeviled subpart F of the code, as reflected in its various ''same country'' exceptions, the recent adoption of the temporary provisions of section 954(c)(6), and the even more recent passage by the House of Representatives of a bill to scale back some of the provisions of section 954(c)(6).[58]

The problem of stateless income is not an abstract academic concern. Recent European Court of Justice jurisprudence, for example, suggests that it is becoming difficult for one European Union member state to tax (through subpart F analogies or the like) the income of a subsidiary in another member state, or to protect its tax base from widespread income stripping within the EU (by imposing withholding tax on outbound deductible payments or imposing thin capitalization rules on foreign investments only).[59] The effect of those developments, if combined with a U.S. territorial tax system that treats

[57]OECD, *Harmful Tax Competition: an Emerging Global Issue*, at 43 (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf. One popular solution, rejected by most, but not all, U.S. proposals, is to limit the benefits of exempt income status in a territorial system to income earned in jurisdictions with specified minimum tax rates, or jurisdictions on a ''good'' list, or jurisdictions not on a blacklist. *Id.*

[58]In light of the central importance of deductible interaffiliate payments in determining the consequences and scope of a territorial tax system, one would expect extensive discussion of the issue in the literature. Oddly, that does not appear to be the case.

[59]*See, e.g., Cadbury Schweppes PLC & Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* (Case C-196/04), *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie* (Case C-170/05), and *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (Case C-324/00).

In *Cadbury Schweppes* (decided in Sept. 2006) the court held that differential treatment under ''controlled foreign companies'' legislation of companies resident in one member state on the basis of the level of taxation imposed on their subsidiaries in other member states is prohibited under European Community law, except to the extent the applicable legislation specifically counteracts wholly artificial arrangements aimed solely at escaping national tax normally due, when the legislation does not go beyond what is necessary to achieve that purpose.

Denkavit (decided in Dec. 2006) held that the imposition by a member state of withholding tax on dividends paid to a parent company in another member state is contrary to EC law when a dividend paid to a parent in the same country would not be subject to the tax. The court also held that the existence of a double tax convention that authorizes the withholding tax, and provides for an FTC for the withheld tax, does not alter that conclusion if the parent company is unable to take advantage of the credit.

In *Lankhorst-Hohorst* (decided in Dec. 2002), the court ruled that thin capitalization rules that apply only to cross-border loan finance without applying to comparable domestic loan finance are contrary to EC law. A new case on cross-border thin capitalization rules is now before the court (*Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* (C-524/04)). The court has not yet issued its ruling but, interestingly, the advocate general's opinion (issued in June 2006) suggested that such rules may in fact be in conformity with EC law in circumstances in which they can be justified on antiabuse grounds and they do not go beyond what is necessary to attain that objective.

Partly in recognition of the increasing number of infringement proceedings being brought, the European Commission has recently announced a series of initiatives to promote coordination between member states in parallel with litigation. The stated objectives of the initiatives are to provide short- to medium-term targeted measures to remove discrimination and double taxation within the Community, to prevent unintended nontaxation and abuse, and to reduce compliance costs associated with taxpayers being subject to more than one tax system. The first two targeted areas identified for coordination are cross-border loss relief and exit taxation. In the long term, the commission believes that a common consolidated corporate tax base is the solution to removing underlying tax obstacles for corporate taxpayers operating in more than one member state. In his announcement of those initiatives, EU Taxation Commissioner Laszlo Kovacs emphasized the problems currently facing member states when he said, ''There is an urgent need to improve coordination of national tax rules to allow them to interact more coherently . . . I am convinced that coordination would help member states to prevent unintended non-taxation or abuse and hence avoid undue erosion of their tax base.'' ''Europe Outlines Coordination Plans for Exit Taxes, Cross-Border Relief,'' *BNA Daily Tax Report* No. 244 at G-4 (Dec. 20, 2006). For more on this recent commission proposal, see http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)825_en.pdf.

(Footnote continued on next page.)

interaffiliate deductible payments made out of exempt income as retaining its exempt character, would be to ensure that a large fraction of the income earned by many U.S. multinational groups in the EU would be taxed at no greater rate than that imposed by whichever member state had the lowest rates.[60]

Finally, territorial tax systems are distortive in one unassailable respect, which is that they would bring with them substantial deadweight losses in the form of compliance and similar costs. *A territorial tax system is simpler than current law only in the imaginations of those who have never immersed themselves in the detailed implementation of either.*

More specifically, as described in Part III.A, every territorial tax system that has been seriously proposed in the United States would retain a subpart F construct for passive and mobile income.[61] That subpart F income in turn would be entitled to FTCs, so that all the complexities of current law would be replicated, except that the new system would stimulate new taxpayer impulses, which in turn would require new antiabuse rules.[62] In particular, because FTCs would be useless when attributable to exempt active income, but would remain valuable if allocated against subpart F income, elaborate policing mechanisms (which admittedly exist in more rudimentary form today) would be required to ensure that advanced tax planning tactics could not be used to cause tax credits to migrate (from a U.S. perspective) from active (exempt) income to subpart F income.

Today, subpart F income means the unavailability of deferral; tomorrow, categorizing revenue as subpart F income would mean that the revenue would move from wholly exempt to immediately taxable status. The result would be even greater stress on the divide between active (exempt) income and subpart F income than exists under current law.[63] Similarly, the U.S. law on the ''source'' of income (and many losses or expenses) is relatively undeveloped, compared with other areas of the code. Those concepts would become critical, however, in defining and policing the scope of a territorial tax system.

IV. 'Full-Inclusion' but Pro-Competitive

A. Transfer Pricing and Repatriation Neutrality

In direct contrast to current law, or to a territorial tax system, a ''full-inclusion'' U.S. international tax system would greatly attenuate the role of transfer pricing strategies by U.S. multinationals as an affirmative taxpayer device to minimize global tax liability, because all income earned by a U.S. multinational group would be taxed by the United States on a current basis.[64] As a result, any remaining transfer pricing issues for U.S. multinationals would relate primarily to conflicting positions that might be taken by different taxing jurisdictions. A U.S. multinational corporation ordinarily would be a disinterested bystander to any such disputes, except in the limited case in which the foreign jurisdiction's tax rates greatly exceed those of the United States.[65]

In practice, a full-inclusion U.S. international tax system will not eliminate transfer pricing cases involving U.S. multinationals, but it will elevate (or at least relocate) those cases to direct negotiations between affected tax administrations, rather then serial negotiations between a taxpayer and those tax administrations. It is my hypothesis that, with little or no money of its own at risk, a U.S.-based multinational will be both less ingenious in its internal transfer pricing strategies and more forthcoming in dealing with the IRS. By elevating the debate to one between tax administrations, a full-inclusion system also will increase the likelihood that all affected tax administrations will work from a common understanding of the facts and that 100 percent of the taxpayer's income — neither more nor less — will be accounted for.

Because a full-inclusion system would materially dampen current law's incentives for multinational corporations to embrace transfer pricing strategies with excessive enthusiasm, such a system would remove significant tax-induced distortions in corporate behavior attributable to transfer pricing gamesmanship. The data marshaled by Grubert and Altshuler and in other academic papers are just too powerful to ignore: It cannot simply

See also Harry Huizinga and Luc Laeven, *International Profit Shifting Within Multinationals: A Multi-Country Perspective*, presented at the European Commission General Directorate Economic and Financial Affairs Workshop on Corporate Tax Competition and Coordination in Europe (Sept. 25, 2006), *available at* http://ec.europa.eu/economy_finance/events/2006/events_workshop_250906_en.htm (modeling income stripping within the EU).

[60]*See, e.g.*, Harry Huizinga, Luc Laevan, and Gaëtan Nicodème, ''Capital Structure and International Debt Shifting,'' presented at the European Commission General Directorate Economic and Financial Affairs Workshop on Corporate Tax Competition and Coordination in Europe (Sept. 25, 2006), *available at* http://ec.europa.eu/economy_finance/events/2006/workshop250906/tax_conf_nicodeme_en.pdf (EU-based multinational groups' capitalizations of subsidiaries reflect international differences in corporate tax rates).

[61]*See, e.g.*, JCT Staff I, *supra* note 34, at 191.

[62]For example, under a territorial tax system a U.S. parent company might try to convert high-taxed *exempt* income into subpart F income, so that those high FTCs could be used to shelter low-taxed subpart F income elsewhere in the system.

[63]*See* NFTC Territorial Report, *supra* note 49, at 19 (''in light of the higher stakes presented by a territorial exemption . . . even greater pressure would be placed on the issues of whether and to what extent types of active business income now subject to subpart F (*e.g.*, foreign base company sales and services income) would be eligible for exemption.'').

(Footnote continued in next column.)

[64]*Cf.* Peroni, Fleming, and Shay, *supra* note 5, at 514 (under the authors' proposal, ''the number of outbound pricing disputes under section 482 should be significantly reduced, thereby lowering taxpayer compliance costs and IRS administration costs. The deferral subsidy encourages U.S. multinational corporations to use intercompany pricing to shift profits to their CFCs operating in tax haven jurisdictions. This passthrough proposal would make such shifts an ineffective tax planning strategy since the profits would be subject to a current U.S. tax in the hands of the U.S. multinational owning stock in the foreign corporation.'').

[65]The U.S. firm might hope to either maximize low-taxed foreign-source income, or minimize high-taxed foreign income, but only for the purpose of averaging down that very-high-taxed income to the U.S. rate, to be able to use all of its FTCs.

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be the luck of the Irish, for example, that explains the extraordinary and systematic profitability of Irish subsidiaries of U.S. firms. A full-inclusion tax model is the only approach that directly addresses this critical problem.

Of course, a full-inclusion U.S. tax system does not eliminate the incentives of *foreign*-owned multinationals to engage in U.S. tax transfer pricing planning, as the recent example of GlaxoSmithKline, described in Part III, illustrates. But, by enabling the IRS to concentrate nearly all of its transfer pricing resources on inbound investments by foreign multinationals, the full-inclusion system would indirectly improve compliance in that direction as well.

''Repealing deferral'' also would enhance competitiveness directly in the same important respect that adopting a territorial tax system would, which is that without deferral, U.S. firms' repatriation policies would reflect the highest and best use of their cash surpluses, rather than tax rate arbitrage. Ironically, the most unambiguous economic argument for adopting a territorial tax system — the elimination of tax considerations in firms' decisions whether to repatriate offshore profits — is a feature that territoriality shares with its mirror image, a full-inclusion system.

A full-inclusion system also would eliminate the distortions attendant on policing the boundaries of a territorial tax policy. As described in Part III, the serious proposals for territorial tax systems for the United States suspend the availability of the FTC for exempt (active) income, but preserve the FTC, and all its attendant limitations, exceptions, and qualifications, for subpart F (passive) income. That requires drawing clear lines between the two categories of income, as well as even more elaborate mechanisms than exist under current law to ensure that uncreditable foreign taxes associated with active (exempt) income do not, through advanced tax planning, migrate over to a taxpayer's subpart F income (where those taxes would become valuable as credits). By dispensing with the sharp demarcation between exempt (active) and subpart F (passive) income, full-inclusion systems eliminate the need to police the border between uncreditable foreign taxes associated with exempt income and creditable foreign taxes associated with subpart F income.

Notwithstanding these attractive features of any full-inclusion system, simply ''repealing deferral'' by itself is likely to be profoundly noncompetitive. First, current U.S. corporate income tax rates are much too high, relative to those of our important trading partners.[66] Second, without modification, our current FTC system, and in particular its interest expense allocation rules, would leave too many companies with ''excess'' FTCs, which in this context means that their global effective tax burden would be even higher than the (too high) nominal U.S. corporate tax rate. Third, most proposals to repeal deferral have been inconsistent with the economic neutrality that the proposal purports to espouse, in that the repeal of deferral is not accompanied by an ability on the part of the U.S. parent to deduct losses incurred by foreign operations.[67] Fourth, proposals to end deferral for direct investments ordinarily drive a wedge between the tax burden imposed on direct investments and the burdens imposed on portfolio investment, because the latter means of employing capital in a foreign business would still enjoy the benefits of deferral.

While it follows from the above that simply repealing deferral would be anticompetitive, it remains the case that a full-inclusion system, like a territorial system, would eliminate current law's important distorting effects on firms' repatriation decisions. Full-inclusion systems also dampen the incentives found in current law (which would be *exacerbated* by territorial tax systems) for multinational corporations to engage in overenthusiastic transfer pricing strategies. And finally, the adoption of a full-inclusion system would eliminate current law's incentives for U.S. multinationals to game the boundary between exempt and subpart F income and to cause the migration of high effective foreign tax rates to subpart F income, all for the purpose of minimizing global tax liabilities.

In light of those attractive elements of a full-inclusion system, the intriguing question is, can a full-inclusion system be designed that retains those desirable features, but is pro-competitive as well? I believe that a review of how the BEIT would apply to outbound investments demonstrates that the question can be answered in the affirmative.

B. Application of BEIT to Outbound Investment

From an internationalist's perspective, the BEIT can be seen in large measure as the perfect mirror image of a territorial system. The international aspects of the BEIT begin with the ''super tax'' consolidation described in Part II, above. That idea is intended to apply globally. As a result, the BEIT treats foreign subsidiaries as if they were branches. The most obvious consequence of that, of course, is the end of deferral (and with it, the need to maintain rules to distinguish between active income and subpart F income). Another immediate consequence is to vastly attenuate the relevance to the United States of transfer pricing issues for outbound investments, for the reasons already described. Global consolidation also means that foreign losses will be deductible in the United States as those losses are incurred, thereby restoring true neutrality in application when compared to current law, and to many proposals over the years to ''end deferral.''

The BEIT divides all investments in business enterprises into two categories: controlling interests (which trigger the super-consolidation rules referenced earlier) and other interests (which give rise to current taxable income, through the minimum inclusion mechanism). As a result, current law's concept of a controlled foreign corporation that is controlled by, say, three unrelated U.S. investors in equal proportions would no longer exist. Similarly, the hope is that current law's passive foreign

[66]*See* Sullivan, ''On Corporate Tax Reform, Europe Surpasses the U.S.,'' *Tax Notes*, May 29, 2006, p. 992, *Doc 2006-10099, 2006 TNT 103-5*.

[67]*See* Peroni, Fleming, and Shay, *supra* note 5, at 501-507 (critiquing two such proposals for curtailing deferral).

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investment company rules also would no longer be required. In each case, investors will include annually their minimum inclusion amounts (without regard to cash distributions), just as they would with investments in U.S. firms.

Without more, the BEIT's international aspects could fairly be described as economically neutral regarding transfer pricing, repatriation decisions, and the location of risky investments, but probably on balance still anti-competitive. The BEIT contains two other critical design elements, however, that revise that calculus to yield a system that fair-minded business people should agree is pro-competitive. The first, and most important, is *lower tax rates* — as mentioned above, 28 percent is the goal, but 25 percent (if affordable) would be even better — financed through systematic base broadening.[68] The second design element is the repeal of the allocation of domestic interest expense (now COCA) expense deductions against foreign income for purposes of calculating a U.S. business enterprise's allowable FTC for its international operations, for the reasons described below.

As previously described, sensible territorial tax proposals must incorporate an interest expense allocation system (or some equally painful alternative, such as an efficacious thin capitalization regime). The reason, of course, is that the failure to do so would mean that territoriality would quickly lead to a zeroing out of the U.S. *domestic* business tax base, by borrowing money (and deducting the resulting interest expense) domestically and supporting the attendant interest deductions with exempt cash flows from equity-financed foreign investments.

The BEIT abandons interest expense (now COCA expense) allocations for two reasons. First, by virtue of the "true" consolidation of foreign income, there is no income that is exempt or indefinitely deferred anywhere in the BEIT system. As a result, there is no urgent need to protect the U.S. tax base by ensuring that domestic interest expense is not ultimately serviced from deferred or exempt income.

The second, and ultimately more powerful, reason why domestic COCA expense need not be allocated against foreign income under the BEIT is that the purpose of the COCA deduction in the BEIT is different from today's interest expense deduction. In the BEIT, the COCA deduction exists to achieve a form of business enterprise-investor *integration* and applies across the board to all forms of financial capital invested in a business. As such, the COCA deduction is not an "expense"; it is an income allocation device.

If we were to imagine that all business enterprises were 100 percent equity funded, we would not spend much time worrying about allocating the (nonexistent) cost of capital deductions. The COCA result is the same in theory (but superior in many practical respects) to a world in which all interest expense is disallowed or in which (to put things in today's perspective) all firms are 100 percent equity funded. Accordingly, given that under the BEIT we have neither exempt nor deferred income and that we also have implemented an integrated tax system, there is no convincing reason to treat the device by which we achieve that integration as if it were an old-fashioned interest expense deduction.[69]

I previously observed that portfolio investments have taken on a larger role in cross-border financial flows in recent years. A tax system that produces radically different results for portfolio investments by U.S. households in foreign companies as compared with portfolio investments in U.S. business enterprises (which in turn make foreign direct investments) will prove not to be stable. One important question in that calculus is how to deal with foreign income when distributed by a U.S. business enterprise to its domestic investors.[70]

The BEIT addresses those issues differently than do other proposals. As described in Part II, full consolidation combined with the COCA deduction/inclusion system basically works to tax economic rents and risky returns at the business enterprise level, and time value returns at the investor level. The COCA component of the BEIT

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[68]The COCA system, in particular, is carefully designed, based on 30 years of practice in the area, to be a robust system to capture the time value of money component of financial investments — the hallmark of an income tax — on a current basis. As quickly summarized in Part II, the BEIT includes other significant base-broadening components as well. In some cases, that base-broadening flows from the imposition of the "super" consolidation and acquisition rules described earlier. In other cases, it is attributable to the reform of tax accounting rules (for example, the repeal of LIFO inventory accounting and percentage depletion).

[69]The absence of a COCA expense allocation deduction can create the misimpression that FTCs are sheltering U.S. domestic business income, but that result is one of cosmetics, not substance. For example, assume that a company has $100 of invested capital (that is, tax basis in its assets), and that the COCA rate (the company's deduction for its cost of capital) is 5 percent. Further assume that the company earns $12 before its COCA deduction, that half of that amount ($6) is treated by both the United States and Freedonia as income arising in Freedonia, and that this $6 accordingly is taxed in Freedonia. Finally, assume that both the Freedonian and the U.S. tax rate is 30 percent.

The company will pay $1.80 in Freedonian income tax. All of that foreign tax will be creditable in the United States, because the company's pre-COCA foreign income is equal to $6, and the Freedonian tax is no greater than the U.S. tax on that income. The net result will be that the company will have $7 of taxable income and a tentative tax liability of $2.10, but will pay only $0.30 to the U.S. government — or will it? The "missing" U.S. tax liability has not disappeared at all, but rather has migrated to investors, who will have minimum inclusions equals the COCA rate multiplied by their aggregate tax bases in their investment. Assuming for convenience that their bases also equal $100 (in fact of course, this will not be true, but it is a useful simplifying assumption), they will include $5 of income in respect of their investments, and pay $1.50 in tax. So in total the U.S. fisc collects $1.80, and Freedonia collects $1.80, on the company's pre-COCA income of $12, which reflects a tax split that precisely mirrors the relative domestic and foreign pre-COCA taxable incomes of the company.

[70]For example, Treasury's 1992 CBIT proposal contemplated imposing a compensatory tax on foreign-source income earned by a U.S. firm when that income was distributed as a dividend to its domestic portfolio investors. *See supra* note 56.

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achieves neutrality between U.S. portfolio investors investing in either U.S.-based multinational firms or foreign-based firms — between, say, investing in Exxon or investing in British Petroleum — by the simple expedient of applying its investor minimum inclusion rules (current inclusion of time value of money returns, regardless of cash distributions) to portfolio investments in foreign companies, just as those new rules apply to domestic portfolio investments. Finally, the BEIT achieves source neutrality at the level of U.S. portfolio investors in U.S. firms with foreign income by not discriminating (through compensatory taxes or otherwise) against different source of enterprise-level earnings when ultimately received by investors.

This report does not generally address the BEIT's approach to taxing inbound investment into the United States, but the above discussion points to an advantage that the BEIT offers in dealing with inversion transactions, or more generally with the phenomenon of new business enterprises being organized as offshore companies for the purpose of shielding foreign direct investments from the reach of U.S. net income tax. Under the BEIT, U.S. portfolio investors will be taxed currently on time value of money returns on their investments through the minimum inclusion mechanism. As a result, organizing a new business enterprise outside the United States will not reduce the immediate U.S. tax burden on U.S. portfolio investors in that enterprise. Of course, the minimum inclusion device does not address the tax savings that might follow (and ultimately be enjoyed by U.S. investors) at the business enterprise level regarding the new enterprise's non-U.S. income if the average tax rate on that income is lower than the U.S. business enterprise rate. (By the same token, the BEIT does not create the problem either. It exists today in an even more dramatic form.) The answer here lies in rethinking the definition of a business enterprise's residence[71] and in the withholding tax burdens that might be imposed under the BEIT for distributions from a U.S. subsidiary to a tax-haven parent company.

The BEIT also attempts to introduce some rough tax neutrality between majority and minority investments by U.S. multinationals in foreign joint ventures. The BEIT's super-consolidation rules are meant to apply to majority-owned affiliates, which would mean, for example, that the income derived by a 51 percent-owned foreign joint venture would be taxed in its entirety by the United States.[72] By contrast, the income earned by a minority-owned foreign joint venture that did not conduct business in the United States would not be subject to U.S. net income tax. Under the BEIT, however, the U.S. multinational investor would be required to include in income each year its minimum inclusion (time value of money) amounts, regardless of cash distributions, as well as any excess distributions it might receive. That rule erodes, at least to some modest extent, current law's cliff effect, in which majority-owned joint ventures are subject to subpart F, and minority-owned ones are not.

Grubert and Altshuler review the economic theory and revenue effect of the international aspects of the BEIT (which their paper — no doubt sensibly — renames the ''burden neutral'' international proposal). They conclude that the BEIT's super-consolidation approach to taxing international investment (along with retention of the FTC system but abandonment of interest expense allocation) ''seems to dominate'' both current law and territorial tax proposals as a matter of theory.[73] Moreover, they provide some encouraging news about tax rates. To be clear, Grubert and Altshuler do not offer a revenue estimate for the BEIT as a whole. But they do estimate that, if the super-consolidation/FTC provisions described above were grafted onto current law, the tax rate imposed on the international income of U.S. corporations could come down to 28 percent and the BEIT's international provisions would still be revenue neutral compared with current law.[74]

The principal criticism that can be leveled against the international provisions of the BEIT — or, indeed, of any full-inclusion system — is that the system can distort at the margin international investments by U.S. business enterprises. If foreign tax rates are materially lower than those of the United States, it is argued that U.S. firms would have no great incentive to minimize their foreign tax burden. Conversely, if tax rates are very high in a foreign jurisdiction, a U.S. firm at the margin would have an incentive to ''average down'' its effective foreign tax rate by making its next investment in a low-taxed jurisdiction.[75]

The first objection to a full-inclusion system — the indifference to actual foreign tax liabilities, if the aggregate effective foreign tax rate is materially lower than that of the United States — is substantially undercut in a world where the U.S. corporate tax rate has been repositioned at the low end of the rates imposed by the major world economies. That, of course, is a key component of the implementation of the BEIT. Moreover, we have today regulations in our FTC systems that prohibit the crediting of ''voluntary'' taxes, and, more importantly, so-called soak-up taxes.[76] Those rules in fact work reasonably well. As a result, the United States is largely the beneficiary of a ''free rider'' phenomenon, in which local

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[71]*See* JCT Staff I, *supra* note 34, at 178-181 (proposing changes to the current law for determining corporate residency because the law as it now stands ''is artificial, and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations'').

[72]One can imagine special rules to deal with this case if the results reached under the general rule were thought inappropriate. For example, one could have a special rule that raised the affiliation test for foreign entities to 60 percent or 65 percent, provided that the minority interests were themselves not publicly traded and were foreign-owned.

[73]Grubert and Altshuler, *supra* note 20, at 31.

[74]*Id.* at 33 (''the burden neutral rate based on 'static' calculations is about 28%'').

[75]*See, e.g.*, Testimony of Prof. James R. Hines Jr., Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006).

[76]Reg. section 1.901-2(e)(5) (''noncompulsory'' taxes); reg. section 1.901-2(c) (''soak up'' taxes).

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firms can be expected to lobby for lower local tax rates, which local subsidiaries of U.S. firms also will enjoy.

The BEIT responds to the second objection to any full-inclusion system — that, at the margin, a U.S. firm might have an incentive to invest in a very low-tax jurisdiction to average down its overall foreign tax rate to the amount allowable as a credit in the United States — by eliminating the allocation of U.S. interest expense (now COCA) deductions against foreign income for FTC purposes, for the reasons described above. Current law's interest expense allocation rules are necessary in our deferral system, but they also are the principal source of ''excess'' FTC problems, and, with them, the incentive for U.S. firms to average down their FTC systems.

Despite the above rebuttals, I acknowledge that even a well-implemented full-inclusion system brings with it the theoretical possibility of some distortions to investment behavior, particularly if U.S. tax rates are so low as to leave many U.S. firms in excess credit positions, even in a world without interest (COCA) expense allocation for FTC purposes.[77] Ultimately, policymakers will not be able to choose a perfect international tax system — that cannot exist in a world of many sovereign nations with different rates — but they can endeavor to adopt the least distortive practical design. A territorial tax system brings with it two problems that, for all the reasons described above, are insuperable at a practical level: the policing of transfer pricing and the policing of the divide between active (exempt) and passive (currently taxable) income.[78] Against those overwhelming problems, the objection to a well-designed full-inclusion system — that it might encourage a firm to invest real capital in a location that makes little business sense, to average down its aggregate foreign tax rate to the U.S. rate — seems, to this practitioner at least, a remote and speculative concern.

A further potential objection to a full-inclusion system is that it could raise complicated transition issues.[79] That objection, however, could be leveled at any serious modification to the current regime, and many commentators have emphasized the need for altering the international tax rules.[80] My proposal is thus premised on the growing consensus that change is necessary, and with change comes the cost of transition.[81]

Finally, the problem of stateless income (described above in Part III.E), which has become both more urgent and more obvious in recent years, explains my response to another criticism that might be leveled against the particular implementation of a full-inclusion system that I advocate, which is that it is different from the tax systems employed in the other major capital exporting countries. The major European capital exporting countries, in particular, can fairly be said to be in a state of crisis regarding their own territorial tax systems, as a result of the ECJ's approach to the intersection of EU member state cross-border investment rules and EU constitutional concerns.[82] That is an area in which I believe the United States could lead by example. The result would be both conformity to a new norm and a sharp reduction in stateless income, which is another way to get to a playing field that is fair as well as level.

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[77]In practice, U.S.-based multinationals are likely to deal with the incentive to ''average down'' in a much more straightforward manner than by locating *physical* capital in a low-tax jurisdiction. Instead, U.S. firms will average down by financing high-taxed operations with deductible *financial* capital (in the form of loans paying deductible interest) provided by low-taxed affiliates. Complex ''solutions'' to that sort of taxpayer behavior can be devised — for example, by imposing special FTC limitations on interaffiliate interest payments, to discourage such cross-crediting. The text, however, points in a different direction, by arguing that the problem is too remote to require a ''solution.''

[78]To this can be added the practical and political problems in designing a satisfactory interest expense allocation system (or an alternative, like an efficacious thin capitalization solution) to protect the domestic tax base — and the associated problems of protecting that solution from erosion through years of taxpayer lobbying.

[79]*Cf.* Peroni, Fleming, and Shay, *supra* note 5, at 519-523 (outlining potential transition relief for the authors' proposal for changing the current deferral rules).

[80]*See, e.g.*, JCT Staff I, *supra* note 34, at 189 (''The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.'').

[81]For more on transition to the BEIT, see BEIT Presentation, *supra* note 2, at 15.

[82]*See supra* note 59.

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taxanalysts special report

RESTRUCTURING FOREIGN-SOURCE-INCOME TAXATION: U.S. TERRITORIAL TAX PROPOSALS AND THE INTERNATIONAL EXPERIENCE

By Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn van Kessel

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The President's Advisory Panel on Federal Tax Reform has recommended two tax reform options. One option, the simplified income tax plan, would adopt a so-called territorial income tax system with an exemption for active foreign-source business income. That plan is similar to a proposal described in a January 2005 report of the Joint Committee on Taxation staff.

This article summarizes the principal features of the panel's proposal, compares it with the Canadian, German, and Dutch systems, and discusses tax and economic issues presented by the proposal. The article identifies important issues raised by the panel's territorial proposal that should be given careful consideration by tax policymakers.

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On November 1, 2005, the President's Advisory Panel on Federal Tax Reform recommended two tax reform options for the Treasury Department's consideration.[1] One option, the simplified income tax (SIT) plan, would adopt a so-called territorial income tax system with an exemption for active foreign-source business income. That plan is similar to a proposal described in a January 2005 report of the Joint Committee on Taxation staff that was estimated to increase federal government revenues by $54.8 billion over the fiscal 2005-2014 period.[2]

This article summarizes the principal features of the panel's territorial proposal, compares it with the Canadian, German, and Dutch systems, and discusses tax and economic issues presented in the proposal. The article is intended to identify important issues raised by the panel's territorial proposal that should be given careful consideration by tax policymakers.

Part I of this article summarizes the panel's territorial proposal. Part II summarizes the main features of the

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[1]President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform*, November 2005, *Doc 2005-22112, 2005 TNT 211-14.*

[2]Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, Jan. 27, 2005, *Doc 2005-1714, 2005 TNT 18-18* (hereinafter JCT options pamphlet).

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Canadian, German, and Dutch dividend exemption systems. Part III discusses tax issues presented in the panel's proposal. Part IV reviews the main economic issues associated with the proposal. Part V concludes.

I. Principal Features of Panel's Territorial Proposal

The principal features of the panel's territorial proposal are described below, with separate consideration of the taxation of corporate and individual shareholders.

A. Taxation of Corporate Shareholders

1. Controlled foreign corporations. Under the panel's proposal, all income of controlled foreign corporations[3] would be divided into two categories: (1) some passive, portfolio, and movable income (mobile income); and (2) all other income (active business income). Mobile income generally would include passive income plus other business income that typically is not taxed abroad (for example, ocean and space income).[4] Mobile income would not include dividends from investment by one CFC in another CFC, active financial services income, or investment in U.S. property (section 956). Mobile income below a de minimis percentage of gross income or assets would be treated as active income. Gain or loss on the sale of CFC assets that generate active income would be treated as active income (that is, excluded from the U.S. tax base). While gain on the sale of CFC assets that generate mobile income presumably would be treated as mobile income (that is, taxable), the panel does not address the treatment of losses on the sale of those assets.

Under the panel's proposal, dividends paid by a CFC out of active business income to a 10 percent U.S. corporate shareholder would be exempt from U.S. income tax with no credit for direct or indirect foreign taxes. The exemption would not be limited to dividends paid out of post-effective-date earnings; dividends paid after the effective date of the proposal out of pre-effective-date earnings would also be eligible for exemption. The exemption would not apply to dividends that are treated as interest expense by foreign jurisdictions (that is, hybrid dividends).

Capital gains from the sale of stock of a CFC by a U.S. corporate shareholder would be exempt from U.S. income tax to the extent that the amount is treated as a dividend under section 1248. It is unclear whether gain from the sale of CFC stock that exceeds the section 1248 amount would be categorized as exempt active business income, taxable mobile income, or bifurcated in proportion to the assets that produce each type of income. It is also unclear how a loss on the sale of CFC stock would be treated. The JCT option would tax the excess, whether attributable to assets that generate active or mobile income, and would disallow a deduction for losses on the sale of CFC stock.

Nondividend payments by a CFC to a U.S. person — for example, interest, rents, royalties, fees for services, and so on — would be subject to U.S. income tax as under current law, with a credit for applicable withholding taxes. For many U.S. multinationals, the panel's proposal would increase the tax burden on foreign-source royalties, which could not be sheltered by excess foreign tax credits attributable to high-tax dividends.

Similar to the current-law treatment of subpart F income, mobile income of a CFC would be subject to U.S. shareholder-level tax when earned, with a credit for indirect taxes imposed on that income. Distributions out of mobile income would be treated as previously taxed income and thus would not be subject to tax as under current law.

The computation of the FTC would be modified. A single FTC limitation would apply to all creditable foreign taxes.

It is unclear whether the panel's proposal would modify the current rules for sourcing income. For example, under current law, a portion of the income from the export of inventory property when title passes abroad is treated as foreign-source income. The panel does not specify whether that income would be treated as active foreign business income, mobile income, or U.S.-source income. The JCT option would treat that income as mobile income, so that it would be included in calculating the FTC limitation.[5]

Some expenses allocable to exempt income would be disallowed. In general, expenses would be allocated as under current law; however, expenses allocated against foreign-source income would be apportioned among exempt and taxable foreign-source income. Expenses apportioned to exempt foreign-source income would be nondeductible, while expenses apportioned to foreign-source taxable income would reduce the FTC limitation.

Interest expense would be allocated against foreign-source income using the worldwide fungibility approach adopted in the American Jobs Creation Act of 2004 (P.L. 108-357).[6] The JCT option would apportion foreign allocated interest expense between taxable and exempt income in proportion to the assets that generate each type of income.

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[3]The term "controlled foreign corporation" is not defined in the proposal.

[4]Under the proposal, mobile income generally would include foreign personal holding company income (for example, interest, dividends, rents, and royalties arising from passive assets), some types of foreign active business income that is not likely to be taxed in any foreign jurisdiction (for example, some income from personal services and income from international waters and space), and income from the sale of property purchased from or sold to a related person by a foreign corporation located in a country that is neither the origin nor the destination of that property.

[5]Because the proposal would disallow credits for foreign taxes allocable to exempt income, few taxpayers would be expected to have excess foreign tax credits. Consequently, there would be little if any tax benefit from increasing the FCT limitation.

[6]Under Jobs Act section 401 and revised code section 864, taxpayers may make a one-time election to allocate and apportion third-party interest expense of U.S. members of a worldwide affiliated group to foreign-source income for FTC limitation purposes in an amount equal to the excess, if any, of: (1) the worldwide affiliated group's interest expense multiplied by its worldwide assets, over (2) third-party interest expense incurred by foreign members of the group that would otherwise be

(Footnote continued on next page.)

General and administrative (G&A) expenses of the U.S. shareholder that are not recovered through intercompany fees or charges would be allocated based on gross income of all members of the worldwide affiliated group (that is, members of the U.S. affiliated group and CFCs). Presumably, foreign allocated G&A expenses would be apportioned between taxable and exempt income in proportion to the amount of gross income of each type. It is unclear whether the proposed allocation for G&A expenses would require the allocation of stewardship expenses that, under current transfer pricing rules, cannot be charged to subsidiaries of the U.S. shareholder.

No research and development expenses would be allocated or apportioned to exempt foreign-source income; thus, there would be no disallowance of R&D expense deductions. That is a significant departure from the JCT proposal, which would have used current rules (section 846(f)) to allocate R&D expenses between U.S.- and foreign-source income and disallowed a deduction for the excess of those expenses over taxable royalties and similar foreign-source payments (for example, cost-sharing payments) to the extent apportionable (on a pro rata basis) to exempt CFC income. The JCT proposal would have discouraged R&D activities in the United States because other countries generally do not disallow deductions for domestic R&D expense.

2. Noncontrolled foreign corporations (10/50 companies). The panel's report does not address the treatment of dividends received by 10 percent U.S. corporate shareholders of noncontrolled foreign companies (10/50 companies). The JCT staff proposal would have allowed 10 percent U.S. corporate shareholders to elect CFC treatment for all purposes (including subpart F); nonelecting shareholders would have been treated as portfolio investors with no entitlement to indirect FTCs.

3. Foreign partnerships and branches. Foreign branches of a U.S. company would be taxed under rules designed to achieve parity with CFCs. Thus, active business income of branches would be exempt. Nondividend payments, such as royalties, would be imputed as if the branch were a separate legal entity. Branch losses would not flow through to the corporate shareholder. However, all branches in the same country would be treated as one CFC, which may have important implications for limiting mobile income on interbranch transactions.

The panel's report does not specifically address the treatment of foreign entities that are treated as branches under U.S. law (that is, disregarded) as a result of check-the-box elections. Because the panel proposal would tax hybrid dividends in accordance with their classification under foreign law, parallel treatment would imply classification of hybrid branches as CFCs. If hybrid branches are treated as CFCs, disregarded payments from those branches to U.S. shareholders (for example, interest) would become taxable.

The panel report also does not address the treatment of income earned through foreign partnerships.

B. Taxation of Individual Shareholders

The panel's proposal provides that the exemption for some foreign-source income would apply only to businesses and not to individual shareholders. However, other aspects of the panel's SIT plan affect the taxation of foreign-source income at the individual shareholder level.

1. Domestic corporations. Under the SIT plan, qualifying dividends paid by U.S. corporations out of U.S. taxable income would be excluded from shareholder taxation. Also, 75 percent of capital gains on U.S. corporate stock would be excluded from taxation. In determining the portion of a total dividend to be treated as a qualifying dividend paid, the panel's proposal would look to the proportion of U.S. taxable income included in worldwide book income in the preceding year, with U.S. taxable income adjusted for the excess of book-over-tax-depreciation, and excluding section 78 gross-ups. Because there are numerous other adjustments between book and taxable income, that simplistic approach could result in significant distortions of the ratio of U.S. to worldwide income. Also, basing calculations only on the preceding year's income can result in a mismatch of the domestic share of a corporation's income and the qualifying portion of a dividend paid out of income earned in earlier years.

2. Foreign corporations. Dividends paid by foreign corporations out of U.S. taxable income would be taxable even if attributable to U.S.-source income. Thus, dividends paid by a company that earns all of its income in the United States would be fully taxable if incorporated abroad and fully excluded if incorporated in the United States, despite equal U.S. corporate tax payments in each case.

Capital gains on stock issued by companies incorporated abroad would remain fully taxable. Thus, capital gains on stock issued by a foreign corporation would be fully taxable to U.S. shareholders even if all of its income was earned and taxed in the United States, while gains on stock issued by a U.S. corporation would be permitted a 75 percent exclusion from U.S. tax even if all of its income was earned abroad (and excluded from U.S. tax under the proposed territorial tax system).

II. International Experience

Below are brief summaries of the dividend exemption systems used by Canada, Germany, and the Netherlands. A chart comparing those systems with the panel's proposal is included at the end of this section.

A. Canada

The Canadian regime for taxing income earned by a foreign affiliate of a corporation resident in Canada has characteristics of both an exemption and an FTC system. Also, passive-type income earned by a controlled foreign affiliate, referred to as foreign accrual property income (FAPI), is subject to Canadian tax on an accrual basis.

1. Taxation of corporate shareholders.

a. Foreign corporations. The Canadian tax treatment of dividends paid by a foreign affiliate to a corporate

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allocated to foreign sources. The worldwide affiliated group for this purpose generally includes 80-percent-or-greater-owned U.S. corporations and CFCs. Revised section 864 also provides elections to apply those rules separately to a financial institution and financial services group of a taxpayer.

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shareholder resident in Canada depends on the type of income earned by the affiliate and the country in which the foreign affiliate is resident and carries on its business. The affiliate's earnings are tracked through exempt and taxable surplus balances maintained by the taxpayer regarding each of its affiliates.

Exempt surplus includes income from an active business earned by a foreign affiliate that is resident and carries on the business in a designated treaty country (DTC); 100 percent of capital gains arising from the sale of property generating income from an active business in a DTC (50 percent if the property is located in a non-DTC or if the property earned income that was included in taxable surplus); 50 percent of capital gains arising from the disposition of shares of another foreign affiliate; and dividends from another foreign affiliate of the taxpayer that are paid from the paying affiliate's exempt surplus. Taxable surplus includes income from an active business carried on in a non-DTC; FAPI; 50 percent of capital gains from the sale of assets producing income included in taxable surplus; 50 percent of capital gains arising from the disposition of shares of another affiliate; and dividends received from another affiliate that are paid from the paying affiliate's taxable surplus.

Ordering rules provide that dividends are considered to be paid first from exempt surplus, next out of taxable surplus, and finally out of preacquisition surplus of the affiliate. A dividend from preacquisition surplus reduces the tax cost of the affiliate's shares owned by the shareholder receiving the dividend. If the tax cost of the shares becomes negative, a capital gain will arise.

A dividend received by a corporate taxpayer resident in Canada from a foreign affiliate is included in income for Canadian purposes, but the taxpayer is entitled to a deduction equal to the portion of the dividend prescribed to be paid out of exempt or preacquisition surplus. For any portion of the dividend prescribed to be paid out of taxable surplus, the taxpayer is entitled to a grossed-up deduction for any underlying foreign income and withholding tax applicable to the dividend.

Capital gains arising on the sale of shares of a foreign corporation by any taxpayer resident in Canada are subject to tax in Canada. Under the panel's proposal, a capital gain from the sale of the stock of a CFC would be exempt to the extent that the gain would be treated as a dividend under section 1248. There is a similar concept in Canada under the foreign affiliate rules whereby a taxpayer may elect under subsection 93(1) of the Income Tax Act (Canada) (the act) to treat a portion of the proceeds of disposition as a dividend received from the affiliate.

i. FAPI. The FAPI rules prevent taxpayers resident in Canada from avoiding or deferring Canadian tax on passive income and some other income deemed to be passive income earned by a controlled foreign affiliate. The FAPI rules are analogous to subpart F of the code, and income earned by a controlled foreign affiliate is imputed to its Canadian shareholders in proportion to their shareholdings. The amount imputed for Canadian tax purposes is reduced proportionately to the extent such income is subject to foreign income tax. FAPI of a controlled foreign affiliate in a particular year not exceeding CDN $5,000 is not taxable in Canada.

FAPI includes income from property — such as interest, dividends, rents, and royalties — except to the extent it was paid and deducted by another affiliate of the taxpayer in computing the other affiliate's earnings from an active business. Such payments are subject to Canadian tax if paid directly to a Canadian shareholder.

FAPI also includes income that is deemed to be income from a business other than an active business, such as income derived by an affiliate from: (1) selling property to Canadian residents; (2) insuring Canadian risks; (3) Canadian debt and lease obligations; and (4) services rendered to related Canadian corporations. From a tax policy perspective, it was considered that to otherwise treat that income as from an active business of an affiliate would inappropriately reduce the Canadian tax base. Finally, 50 percent of the capital gain derived by a foreign affiliate from the sale of the shares of another affiliate is included in FAPI unless all or substantially all (generally, 90 percent or more) of the assets on a fair market value basis of the affiliate are used in or generate income from an active business. Even if no FAPI arises on the disposition of shares of another foreign affiliate, because 50 percent of the gain is included in the taxable surplus of the disposing affiliate, that amount eventually will be taxable in Canada.

ii. Expenses. Unlike existing U.S. legislation and the panel's proposal, there are no specific provisions in the act that limit or prevent the deduction of expenses incurred by the taxpayer that may be considered as incurred directly or indirectly regarding an investment in a foreign affiliate. In particular, interest on funds borrowed to invest in a foreign affiliate are generally deductible even though dividends earned from the affiliate may not give rise to Canadian income tax.

b. Foreign partnerships and branches. Corporations resident in Canada are taxed on their worldwide income, which includes income of a foreign branch or partnership. Similarly, losses incurred by a foreign branch or partnership are generally deductible for Canadian tax purposes. FTCs are available for any foreign income tax paid on branch or partnership profits.

2. Taxation of individual shareholders.

a. Domestic corporations. The Canadian tax rules employ several concepts designed to achieve tax parity between investment income earned directly by an individual and investment income earned indirectly through a Canadian controlled private corporation (CCPC). Some of the concepts include: (1) the ability of a CCPC to pay a tax-free capital dividend out of the untaxed portion of a capital gain; (2) a partial refund of corporate tax that is triggered by the payment of a dividend out of a CCPC's previously taxed investment income; and (3) a dividend tax credit at the individual shareholder level. Perfect integration may not be achieved in some instances when the CCPC's investment income includes foreign-source income.

In the context of a corporation that is not a CCPC, or active business income of a CCPC not subject to the reduced small-business tax rate, double taxation is partially mitigated through the dividend tax credit mechanism at the individual shareholder level. The federal government had just implemented an enhanced dividend tax credit in the case of dividends paid by Canadian

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public corporations or out of the active business income not subject to a reduced corporate tax rate. The purpose of the amendment is to reduce the combined corporate and personal tax burden associated with the earnings of Canadian corporations relative to income trusts that are treated as transparent entities for tax purposes.

b. Foreign corporations. Individual shareholders are required to include in taxable income all dividends received from a foreign corporation including a foreign affiliate, subject to an FTC for any foreign withholding, but not income tax payable on the dividend. Similar to corporations, an individual shareholder is generally entitled to deduct interest expense related to any borrowing incurred to invest in shares of a foreign corporation. The FAPI rules are applicable to individuals resident in Canada and require them to report as income their share of any FAPI earned by controlled foreign affiliates of the individual.

B. Germany

German residents are generally subject to taxation on their worldwide income if no tax treaty is applicable. Double taxation of foreign-source income is mitigated by a tax credit system. Under that system, a German resident receives a credit for income taxes paid on foreign income in the year in which the income is taxed in Germany. In loss situations, paid foreign income taxes may be deducted. German tax law provides neither a carryforward period for FTCs nor an indirect tax credit.

Germany has concluded income tax treaties with about 90 countries. Compared with the tax credit system provided by German domestic tax law, tax treaties usually exempt some types of foreign-source income from German taxation and therefore partially follow a territoriality approach. The most important exemptions apply to dividend income of corporate shareholders if the shareholding reaches a threshold (usually 10 percent or 25 percent depending on the treaty); income attributable to foreign permanent establishments (that is, branches); and income from immovable (real) property. Income attributable to a foreign PE generally covers income derived through a participation in a foreign partnership.

1. Taxation of corporate shareholders.

a. Foreign corporations. The Tax Reform Act of 2001 introduced a classical corporate tax system under which income received by German corporations is subject to a flat corporate income tax rate of 25 percent (plus a solidarity surcharge of 5.5 percent on the amount of the corporate tax liability). Also, trade tax is levied (effectively about 15 percent). To prevent double taxation of corporate earnings, corporate shareholders receive a 100 percent dividends received deduction for corporate income tax purposes independent of the amount and the duration of the shareholding. The deduction applies to domestic as well as to foreign dividends. For trade tax purposes, dividends are generally tax-exempt if the distributee holds at least 10 percent of the shares in the distributing company. For dividends from foreign corporations to be exempt for trade tax purposes, however, the distributee must be engaged in an active business. Trade tax will be levied on those dividends for shareholdings of less than 10 percent. Foreign withholding taxes on exempt dividends cannot be credited or deducted by the recipient corporation.

Capital gains from the disposition of shares in domestic and foreign corporations are exempt from corporate income tax as well as the trade tax. The exemption applies regardless of the size and duration of the shareholding. Accordingly, capital losses from the sale of shareholdings as well as writedowns in value may not be taken into account for tax purposes.

The dividend exemption and the gain/loss exemption do not apply to shares held by banks, financial institutions, and financial services companies for deriving short-term trading income. The rules also do not apply to shareholdings held as investments by life insurance and medical insurance companies.

Five percent of the gross amount of a German parent company's tax-exempt domestic and foreign dividends/capital gains are deemed to be nondeductible expenses, which effectively creates a 95 percent dividend exemption. The 5 percent rule does not apply to banks, financial institutions, financial service companies, and the above-mentioned insurance providers, for which expenses are fully deductible.

Those rules apply to direct shareholdings as well as shareholdings held indirectly via partnerships.

The German CFC rules attempt to ensure that the distributed foreign income has been taxed on a basis comparable to a German-source dividend. The general CFC regime applies when German residents own more than 50 percent of the common stock or voting rights in a foreign corporation and the foreign corporation earns passive, low-taxed income. Income is considered low-taxed if it has been subject to an income tax of less than 25 percent. Income subject to the general CFC regime comprises trade or service income when a foreign entity is used to shelter income from German taxation without appropriate economic activity of its own. Dividend income is not treated as passive income. Capital gains are treated as passive to the extent they relate to portfolio investment income. The CFC rules apply to multitier structures.

For CFCs that receive investment-type income, the participation of a German resident of at least 1 percent is sufficient to trigger the CFC rules. The law provides a de minimis exemption for CFCs with little investment income. If the CFC receives exclusively investment-type income, a participation of less than 1 percent triggers the CFC rules if the CFC's shares are not listed on a recognized stock exchange.

A CFC is deemed to have distributed its CFC income to its German shareholders on the first day of its tax year following the fiscal year in which the income was earned. German shareholders are not entitled to exempt income from CFCs from taxation. Rather, CFC income is subject to general taxation at the shareholder level, with CFC income calculated in accordance with the German income tax principles. A carryforward is allowed for losses of a CFC, and losses may be credited against income that a CFC receives in later years. Any income or wealth tax paid at the CFC level may be deducted for income tax purposes. Alternatively, domestic taxpayers may credit

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foreign taxes paid against their domestic tax. A gross-up is required for creditable foreign taxes paid on CFC income.

Distributions of income that were subject to the CFC rules in the distribution years or the seven preceding years are tax-exempt at the level of individual shareholders. The same applies to capital gains from the sale of CFCs — 50 percent of related expenses are deductible. For corporate shareholders, the general exemption rule applies — 95 percent of related expenses are fully deductible.

b. Foreign partnerships and branches. Germany regularly exempts income that is attributable to a foreign PE of a German taxpayer from domestic taxation based on the provisions of the tax treaties. That income is, however, taken into account for the calculation of the tax rate applicable to the income of the taxpayer that is subject to taxation in Germany (the so-called progression clause). The CFC rules apply also to foreign PEs (that is, branches) of German residents. To the extent the CFC rules apply, the CFC income is fully taxable and an FTC is granted instead of the foreign income being exempt from German taxation.

2. Taxation of individual shareholders. To reduce the effects of double taxation, individual shareholders are subject to taxation on only 50 percent of dividends received from domestic and foreign corporations as well as 50 percent of capital gains from the sale of domestic and foreign shareholdings. Domestic and foreign withholding taxes on the dividends received are generally fully creditable against the income tax on the taxable portion of the dividends received. Half of the expenses related to dividend income/capital gains are deductible. The remainder is disallowed.

The rules apply to direct shareholdings as well as to those held indirectly via partnerships. The CFC rules described above also apply in the same way to individuals who are German residents.

C. The Netherlands

The Netherlands has a relatively small and open economy. Its tax system has always been recognized as one that does little to hinder the international expansion of business. Consequently, the Dutch tax system has many features that make the Netherlands an attractive location for businesses with international operations. Features of the Dutch tax system include the tax treatment of business profits, the participation exemption, the absence of withholding taxes (except for dividends), and the large number of tax conventions to which the Netherlands is a signatory.

1. Taxation of corporate shareholders.

a. Foreign corporations. The Dutch Corporation Tax Act provides for a participation exemption that is applicable to both domestic and foreign shareholdings. That exemption is one of the main pillars of the Netherlands Corporation Tax Act. It is motivated by the desire to prevent double taxation when the profits of a subsidiary are distributed to its parent company, which is also liable for corporation tax. The main features of the exemption system are that all dividends, including disguised dividends and capital gains from eligible participations, are exempted and losses arising from liquidation of the company are deductible only under limited conditions. There is no withholding tax on dividend distributions from a domestic company to its domestic corporate shareholder if the participation exemption applies to that shareholding. Further, Dutch withholding tax on dividend distributions to foreign shareholders may be reduced significantly or mitigated if a tax treaty is applicable.

The participation exemption is applicable to both domestic and foreign participations. A shareholding should qualify for the participation exemption if the Dutch shareholder:

- holds at least 5 percent of the nominal paid-up capital; or
- holds less than 5 percent, but ownership of the shares is part of the normal business conducted by the taxpayer, or the acquisition of the shares served a general business interest of the taxpayer.

The participation exemption is not applicable if the taxpayer or the subsidiary is a so-called fiscal investment institution. A fiscal investment institution is a Dutch company with the sole purpose of investing funds. Subject to several conditions regarding its shareholders, distribution of its profits, the guarantees on its debt, and the composition of its board, profits of a fiscal investment institution are subject to zero percent Dutch corporate income tax.

The participation exemption is also not available when the shares are held as inventory (for example, shares held by a dealer in securities).

Further, the participation exemption is not applicable when shares in a foreign company are held as a portfolio (passive) investment. A further requirement for granting exemption is that a foreign company in which the shares are held be subject to a tax on profits levied by the central government in the country in which it is established. Moreover, the participation exemption is not applicable for participations in foreign passive finance companies.

In general, a Dutch company cannot claim a credit for any foreign withholding tax on dividends received from foreign subsidiaries to which the participation exemption is applicable. However, the dividend tax payable by a Dutch parent company (if any) out of foreign dividends received can be reduced partly for those foreign taxes, subject to conditions. The reduction amounts to a maximum of 3 percent of the foreign dividends received.

Expenses other than acquisition costs relating to eligible participations are generally deductible in full, subject to general interest limitation provisions.

Generally, losses from participations may not be deducted by the Dutch corporate shareholder. An exception is provided for losses resulting from subsidiary liquidations, for which, under specified conditions, a loss may be deducted in the year in which the liquidation of the subsidiary is completed. The loss resulting from liquidation is, with some exceptions, the difference between the liquidating distributions and the original cost of the participation (the sacrificed amount).

To deduct a loss from the liquidation of a foreign subsidiary, the parent company must have had at least a 25 percent participation, and the subsidiary must have

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been held during the five years preceding the discontinuation of the subsidiary's business, the year of discontinuation itself, and during subsequent years in which liquidating distributions are made. Also, if the participation was acquired from a related company, the sacrificed amount at the level of the Dutch shareholder is deemed to equal the sacrificed amount at the level of the former shareholder (that is, the related company).

b. Foreign partnerships and branches. Income and losses of foreign partnerships and branches (that is, foreign PEs) are included in the Dutch parent company's taxable income; foreign partnership and branch income, however, is excluded from the computation of the Dutch parent company's tax liability. To prevent partnership or branch losses from being deducted against a Dutch parent company's profits in the Netherlands and later converting a former lossmaking partnership or branch into a subsidiary eligible for the participation exemption (thus avoiding recognition of profits in the Netherlands), the profits of the new subsidiary are not exempt from taxation to the extent that losses have previously been deducted at the level of the Dutch company.

Because foreign partnership and branch profits are excluded from the computation of the Dutch parent company's tax liability, profits of foreign partnerships or branches are generally not taxable in the Netherlands, and, consequently, no FTCs are available. However, when the branch or the partnership is considered passive (for example, passive financing), the profits are fully taxable in the Netherlands, whereby a credit is given for any foreign taxes.

2. Taxation of individual shareholders.

Income from a substantial interest in a company, including capital gains or losses, is subject to income tax at a reduced rate of 25 percent (compared with a top marginal tax rate of 52 percent).

A taxpayer is considered to have a substantial interest in a company if it, either solely or with its partner, directly or indirectly holds 5 percent of the company's issued capital. If the company has issued multiple classes of shares, a substantial interest also exists if the taxpayer, either alone or with its partner, holds more than 5 percent of the issued capital of a particular class of shares. Rights (such as call options) to obtain 5 percent or more in the (separate class of) share capital of a company are also considered as constituting a substantial interest. If the taxpayer holds a substantial interest in a company, profit-sharing bonds issued by that company and held directly or indirectly by the taxpayer, either solely or with its partner, are regarded as forming part of the substantial interest.

Dividends and capital gains derived from the disposition of shares are taxed at a proportional rate of 25 percent. In the event of capital loss, 25 percent of that loss may be offset against the tax on ordinary income that would otherwise be due.

Taxation on income from savings and investments is based on a presumption of a 4 percent taxable return on net invested capital and is taxed at 30 percent (effectively 1.2 percent). Net invested capital (the value of the assets minus directly related liabilities) is determined as the simple average net capital employed during the calendar year, measured as of January 1 and December 31 of each year. Only capital available for savings and investment is taken into account. Consequently, the value of owner-occupied dwellings as well as linked insurance and capital invested in a taxpayer's own company or in a substantial interest are not taxed as savings and investment income.

D. International Comparison of Tax Systems

The chart on the next page compares dividend taxation in Canada, Germany, and the Netherlands with the panel's proposals.

III. Tax Issues Presented by the Panel's Proposal

A. Foreign Branches

The panel's proposal would treat branches as CFCs for purposes of the proposal. That arguably was done to put CFCs and branches on an equal footing. Thus, subpart F would apply to branch operations, and branch losses would not flow up to the U.S. owner.

Special consideration may need to be given to the treatment of active financing income earned through branches as compared with CFCs, based on the general approach of the proposal to provide parity between these two forms of investment. Those considerations may include whether and what type of transactions and capital may need to be imputed to the branch to provide a similar result to that employed by income earned through a CFC. Also, special provisions may be required for active insurance companies and other primarily financial businesses whose activities extend beyond banking and financing. Those issues may not be susceptible to easy solutions.

The proposal does not specifically address the treatment of foreign affiliates that are disregarded and treated as branches under U.S. law (that is, foreign hybrid branches) as a result of check-the-box elections. Assuming no distinction is intended between actual foreign branches and foreign hybrid branches, the application of the proposal to foreign hybrid branches would have wide-ranging effects on current tax structuring.

Foreign hybrid branches are used for various reasons, including reducing foreign tax burdens of U.S. multinationals. For example, if a U.S. corporate shareholder lends funds to a foreign hybrid branch, under current law the loan may give rise to an interest deduction for foreign law purposes, but the interest income is disregarded for U.S. tax purposes. Under the proposal, the loan and the interest income apparently would become regarded (that is, not disregarded) for U.S. tax purposes and would be subject to full U.S. tax. The same would be true for other types of disregarded transactions that, as a result of being regarded under the proposal, would give rise to U.S. taxes that would not be incurred under current law. The proposal might apply to all existing foreign hybrid branches. In other words, no exception is provided for existing foreign branches, whether actual or hybrid.

It is unclear whether the proposal's treatment of branches as CFCs would result in the deemed transfer of the assets of all existing disregarded single-member entities to new corporations as a result of CFC treatment.

(Text continued on p. 807.)

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Table 1 — International Comparison of Dividend Exemption Systems

Item	Panel Proposal	Canada	Germany	Netherlands
1. Taxation of Corporate Shareholders				
a. General rules for dividends paid out of active foreign business income	Exempt or currently taxable (with a credit for foreign taxes) depending on whether income is classified as "mobile."	Exempt or taxable (with an FTC) depending on whether profits originate in a tax treaty country.	Generally exempt.	Generally exempt.
b. Ownership threshold for dividend exemption	10%, but only if subsidiary is a CFC.	Generally 10%.	None.	Generally 5%, but may be lower in some cases.[a]
c. Foreign subsidiary passive income	Taxed currently under foreign personal holding company regime for CFCs (with an FTC).	Taxed currently (with an FTC).	Taxed currently under CFC rules (with an FTC).	Currently taxable if subsidiary is outside EU, (with an FTC).[b]
d. Foreign subsidiary nonpassive "mobile" income	Subpart F regime would continue to apply with permanent exception for active financial services income.	Generally, subject to current taxation unless the income is paid out of or related to the active business income of another foreign affiliate.	Generally exempt, but CFC rules may apply in specific circumstances.	Generally exempt, unless the income has not been subjected to foreign taxation.
e. Nonexempt dividends	None.	Dividends from income originating from a nontreaty country.	None.	If participation exemption does not apply, taxable with a credit for foreign taxes.
f. Gain on disposition of foreign subsidiary stock	Exempt to the extent of undistributed earnings and profits; no rule for excess gain.	Capital gain is 50% taxable subject to an election to recharacterize all or a portion of proceeds as a dividend subject to exemption or credit system.	Exempt.	Exempt if participation exemption regime applies. Otherwise, taxable with a credit for foreign taxes.
g. Loss on disposition of foreign subsidiary stock	No proposal.	Deductible, subject to limitations.	Not deductible.	Nondeductible if participation exemption regime applies, except for certain liquidating losses.
h. Domestic expenses allocable to exempt income	G&A and interest expenses allocable to exempt income would be nondeductible. Interest would be allocated based on rules adopted in 2004 Act.	Generally not required.	In lieu of expense allocation, the dividend exemption is effectively limited to 95% of dividends (the remaining 5% are deemed nondeductible expenses and taxed without a credit for foreign taxes).	Acquisition costs, including interest on debt used to acquire shares that qualify for participation exemption, are nondeductible.
2. Foreign Partnership and Branch Income				
	Foreign branches treated the same as foreign corporations (no loss flow-through); no proposal regarding treatment of foreign partnerships.	Income/losses of foreign branches and partnerships included in Canadian owners' taxable income on a current basis.	Generally taxable in Germany; however, tax treaties regularly exempt foreign branch income (other than income subject to CFC rules).	Income other than passive income generally is exempt. Otherwise, taxable (with an FTC). Losses may be taken into account subject to limitations.
3. Taxation of Individual Shareholders				
a. Dividends from domestic corporations	Fraction exempt based on prior year share of U.S. taxable income in worldwide income.	Dividend tax credit and capital dividend concept.	50% taxable.	Generally taxable at progressive rates. Interests of 5% or more taxed at a rate of 25%.

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Table 1 — International Comparison of Dividend Exemption Systems

Item	Panel Proposal	Canada	Germany	Netherlands
b. Dividends from foreign corporations	Taxable regardless of extent of corporation's U.S. earnings.	No exemption.	Generally 50% taxable, 100% taxable if CFC rules apply.	Generally taxable at progressive rates. Interests of 5% or more taxed at a rate of 25%. Credit for foreign corporate income taxes and withholding taxes permitted in both cases.
c. Capital gains on domestic stock	25% taxable.	50% taxable.	50% of specified substantial shareholdings or short-term capital gains taxable; remainder exempt from tax.	Generally not taxable. Interests of 5% or more taxed at 25%.
d. Capital gains on foreign stock	Fully taxable.	50% taxable.	50% of specified substantial shareholdings or short-term capital gains taxable; remainder exempt from tax.	Generally not taxable. Interests of 5% or more taxed at 25%, with a credit for foreign taxes.

[a]Fixed 5 percent threshold expected as of 2007.

[b]As of 2007, likely to be exempt from taxation if sufficiently active.

If that is the case, some other tax consequences may need to be considered. Although those types of deemed transfers generally would be expected to qualify for tax-free treatment under section 351, there nevertheless could be many unfavorable tax consequences of those deemed incorporations, including triggering of gain recognition on some deemed asset transfers under section 367(a); recapture of historical branch losses under section 904(f)(3); triggering of branch foreign currency translation gains under section 987 on branch deemed termination; triggering of the provisions of section 367(d) on deemed transfers of intangible property; and recapture of dual consolidated losses under section 1503(d).

If treated as regarded entities, foreign hybrid branch structures would be dismantled when they increase the U.S. taxpayer's worldwide tax liability. The JCT staff in its 2005 report included a separate option to eliminate the ability of taxpayers to treat single-member foreign entities as disregarded for U.S. tax purposes. It is unclear whether the resulting effect of dismantling foreign hybrid branch structures was contemplated in the design of the territorial proposals. The effect of dismantling those structures needs to be considered nonetheless. A primary effect is that U.S. multinationals would pay higher foreign taxes with no apparent benefit to the United States (indeed, to the extent creditable, higher foreign taxes reduce U.S. tax liability).[7]

[7]The JCT scored the single-member disregarded entity proposal as raising $1.2 billion over 10 years relative to current law. That scoring likely reflects the assumption by the JCT that the proposal would reduce foreign investment and cause a corresponding increase in domestic investment.

B. Sourcing and Other Rules

A move to an exemption system conditioned on the income being from foreign sources, as has been the case in other countries that employ such systems, would place increased importance on other rules, including sourcing, expense allocation, transfer pricing, and antideferral rules (which would in effect become antiexemption rules). The increased attention on each of those areas would not necessarily lead to tax simplification; however, the panel proposal would simplify the FTC rules by moving to one overall FTC limitation.

C. Expense Disallowance and Allocation

The panel's proposal would require the disallowance of expenses attributable to exempt foreign-source income. The proposal superficially resembles the dividend exemption systems used in some OECD member countries; however, other countries generally do not require allocation of interest or overhead expenses to exempt foreign-source income, either because there is no legal requirement or because the allocation rules are based on tracing concepts that have little effect. A few countries provide less than a 100 percent dividend exemption (for example, 95 percent in Germany) as a simplified proxy for expense allocation.

D. Antideferral Rules

The panel's proposal would retain antideferral rules for mobile income. The category of mobile income includes many types of foreign-source income, including passive income as well as some active income. The only categories of current-law subpart F income that specifically would not be treated as mobile income under the proposal are inter-CFC dividends and investment in U.S. property (section 956), although the current exception for active financial services income apparently would be made permanent. Thus, depending on the scope of the mobile income category, it is not clear whether the

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proposal would lead to significant simplification of the current antideferral rules. Some have called for reducing the scope of that category of income, particularly for some types of active income.[8]

E. Transition

The panel's proposed exemption would apply to dividends paid after the date of enactment, regardless of when the earnings were earned or accumulated. The JCT staff option would apply the exemption only to dividends paid out of post-effective-date earnings. The panel's approach would simplify computations by eliminating the need to keep track of two separate pools of pre- and post-effective-date earnings.

The proposal would represent a fundamental change in the U.S. taxation of foreign-source income. Fundamental changes in tax law generally are accompanied by a transition rule. One important transitional issue would be the treatment of carryforwards of FTCs. Elimination of those credits would prevent relief from double taxation of some foreign income previously subject to U.S. tax and would likely be recorded as a reduction in deferred tax assets, reducing the taxpayer's reported equity and net income.

Also, this type of fundamental change in U.S. tax law would require the renegotiation of U.S. tax treaties that currently contemplate alleviation of double taxation through an FTC mechanism rather than an exemption mechanism. That renegotiation process likely would take a significant period of time.

F. Individual Shareholder Taxation

As discussed above, the panel's SIT plan would exempt dividends paid to individual shareholders by U.S. corporations out of U.S. taxed income. In its current form, the proposal is complex and would discourage domestic shareholders from investing in U.S. companies with foreign operations as well as foreign companies. For example, if a U.S. company earns 40 percent of its income abroad, 40 percent of its dividends would be taxable to domestic shareholders. In contrast, dividends paid by a U.S. corporation without foreign operations would be tax-free for domestic shareholders.

Under the proposal, the ratio of domestic to worldwide earnings would be computed using adjusted taxable income to measure domestic earnings and U.S. financial reporting principles to measure worldwide income. Given the disparities in tax and financial reporting, substantial adjustments to taxable income would be needed to avoid distortions; however, rules governing those adjustments would likely be complex. Over time, mergers and acquisitions and other changes in corporate organization also would cause distortions in the U.S.-to-worldwide income ratio, inevitably leading to further elaboration and complexity in the rules for calculating the ratio, as well as numerous tax planning opportunities.

The complexity and discriminatory features of the panel's proposal for taxing dividends at the individual shareholder level could be mitigated by treating dividends as paid first out of the accumulated pool of U.S.-source taxable income earned after the effective date of the proposal. That would eliminate the need to calculate the ratio of U.S. taxable income to worldwide earnings. The alternative also would treat equally dividends paid by U.S. multinationals and wholly domestic companies provided dividend payments do not exceed U.S.-source income. This alternative to the panel's proposal is simple enough that it could be made applicable to dividends paid by foreign multinationals. By contrast, the panel proposed to tax all dividends paid by foreign multinationals, even if attributable to U.S.-source income, because it was thought to be too burdensome to calculate and audit the worldwide earnings of foreign-headquartered companies.

IV. Economic Issues

Adoption of a territorial tax system would affect the activities of multinational companies, with varied consequences on the U.S. economy. This section considers how the panel's territorial tax proposal would affect federal revenues, foreign direct investment, cross-border transfer prices, foreign earnings repatriation, R&D, exports, and international competitiveness.

A. Revenue Effect

The dividend exemption option developed by the JCT staff was scored as increasing federal government tax receipts by $54.8 billion over the fiscal 2005-2014 period. The estimated revenue gain occurs because the JCT option:

- denies deductions for some expenses allocated and apportioned to exempt foreign income, including some interest, R&D, G&A, and stewardship expenses;
- allocates some expenses between domestic and foreign income based on the gross income of CFCs, rather than the amount of actual or deemed dividends repatriated;
- prevents use of excess FTCs associated with high-tax dividends to offset U.S. tax on low-tax foreign income (that is, cross-crediting);
- disallows a deduction for branch losses; and
- treats hybrid foreign branches of a U.S. company as regarded entities.

The panel's dividend exemption proposal differs from the JCT staff's option in at least three respects that likely would reduce the projected revenue gain. First, the panel's proposal would not allocate domestic R&D expenses against exempt foreign income and would not allocate domestic G&A and stewardship expenses that are properly charged out to foreign subsidiaries or otherwise recovered through intercompany fees.[9] Second, unlike the JCT option, the panel's proposal may not treat

[8] *See, e.g.*, National Foreign Tax Council, "Critique of the Joint Tax Committee Proposal to Move Toward a Territorial Tax System," submission to the President's Advisory Panel on Federal Tax Reform, http://www.nftc.org/default.asp?Mode=DirectoryDisplay&id=159.

[9] Panel report, *supra* note 1, at 241.

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gain from sale of CFC shares in excess of accumulated earnings and profits as taxable if attributable to assets that generate active business income. Third, the panel's proposal would exempt dividends paid out of earnings and profits accumulated before the effective date.

Revenues might be increased by another difference between the panel's proposal and the JCT staff option. The panel would define some active income not now subject to the antideferral rules (for example, ocean and space income) as mobile income. That apparently would reverse a provision of the Jobs Act that excluded some aircraft and shipping income from the subpart F antideferral regime at an estimated cost of $1 billion over the fiscal 2005-2014 period.[10]

To date, neither the JCT staff nor the Treasury Department has released revenue estimates of the advisory panel proposals. Using 1996 levels, a Treasury economist has estimated that eliminating the allocation of expenses other than interest would reduce territorial tax system revenues by $4.5 billion per year on a static basis.[11] Based on that calculation, the revenue gain, if any, from the panel's proposal, which effectively allocates only interest expense against exempt foreign income, may be negligible.

B. Investment Location

1. Corporate taxation and investment location. One policy concern about a territorial tax system is that it may encourage U.S. companies to invest in low-tax foreign jurisdictions rather than in the United States solely for tax considerations. However, as discussed below, empirical analyses have found little evidence that the incentive to locate investments in low-tax jurisdictions would be increased by the adoption of a dividend exemption system such as proposed by the advisory panel.

Altshuler and Grubert have analyzed the effects of a territorial tax system on the location of investment using three different approaches: (1) comparing the location of investment by multinationals headquartered in territorial countries and U.S. multinationals; (2) comparing the location of investment by U.S. multinationals with and without excess FTCs; and (3) comparing a constructed measure of the marginal tax rate on investment in low-tax jurisdictions under current law and under a territorial tax system. Reviewing the results from those three different analyses, Altshuler and Grubert found "no consistent or definitive evidence that location decisions would be significantly changed if dividends were to be exempt from U.S. corporate tax."[12]

Altshuler and Grubert calculate the effective tax rate on multinational investment under a territorial tax system assuming alternative expense allocation rules. For a representative investment in a low-tax country, Altshuler and Grubert estimate the effective tax rate is 5.4 percent under current law, 9.3 percent under a territorial tax system that requires allocation of all currently allocable expenses, and 7.4 percent under a territorial tax system that requires allocation of interest expense only.[13] Thus, even with expense allocation limited to interest, Altshuler and Grubert conclude that a dividend exemption system could raise the effective tax rate on investment in low-tax jurisdictions compared to current law.[14] The main reasons are that current law allows U.S. tax on income earned in low-tax jurisdictions to be deferred from U.S. tax without disallowance of expenses allocable to that income and permits U.S. tax on foreign royalty income to be offset by excess FTCs attributable to dividends repatriated from high-tax jurisdictions.

2. Individual shareholder taxation and investment location. The panel's SIT proposal would exempt foreign and tax domestic business income at the corporate level, but would tax foreign and exempt domestic business income at the individual shareholder level. In effect, the panel has proposed a territorial tax system at the corporate level and an extraterritorial tax system at the individual shareholder level.

To illustrate, consider a U.S. multinational with investment in a country that taxes corporate income at a 25 percent rate and imposes a 5 percent withholding tax on dividends. Under current law, per $100 of pretax income earned by a company without excess FTCs, the combined foreign and federal tax on income distributed to a domestic shareholder in the top individual income tax bracket is $44.75, the same as for domestic investment, and $39.44 for a company with excess FTCs (see Table 2, next page). By contrast, under the SIT, per $100 of pretax income, the combined foreign and federal tax on income distributed to a domestic shareholder in the top individual income tax bracket is $31.50 for domestic income and $52.26 for foreign income.[15] In this example, the combined tax burden on distributions is more than 20 percentage points greater for foreign than for domestic income under the SIT, while under current law, distributions of foreign income bear the same or a lower combined tax burden than distributions of domestic income. The example shows that the SIT would reduce the combined tax burden on income distributed from domestic investment and increase the tax burden on income distributed from foreign investment of U.S. multinationals.[16]

In conclusion, there is little reason to expect that foreign investment would increase at the expense of

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[10]American Jobs Creation Act of 2004, H. Rep. No. 108-755 (Oct. 7, 2004), pp. 388-390, 795.

[11]Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," 54(4) *National Tax Journal* 816 (December 2001).

[12]Rosanne Altshuler and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," 54(4) *National Tax Journal* 787 (December 2001).

[13]*Id.* at 797, 800.

[14]Altshuler and Grubert assume interest would be allocated under the rules in effect before enactment of the Jobs Act.

[15]The tax burden on foreign income would be even greater if some domestic expenses were allocated to exempt foreign income under the SIT.

[16]This conclusion holds for investment in high-tax countries as well as low-tax countries because the SIT eliminates opportunities to cross-credit excess FTCs and raises the top individual income tax rate on dividends paid out of foreign-source income from 15 percent to 33 percent.

Table 2
Comparison of Tax on Distributed Income Under Current Law and SIT: Example

Item	Current Law				Simplified Income Tax		
	Tax Rate	Domestic Income	Foreign Income		Tax Rate	Domestic Income	Foreign Income[a]
			Excess Limit	Excess Credit			
Worldwide corporate income		**$100.00**	**$100.00**	**$100.00**		**$100.00**	**$100.00**
Foreign		$0.00	$100.00	$100.00		$0.00	$100.00
Domestic		$100.00	$0.00	$0.00		$100.00	$0.00
Foreign corporate income tax	25%	$0.00	$25.00	$25.00	25%	$0.00	$25.00
Foreign dividend		$0.00	$75.00	$75.00		$0.00	$75.00
Foreign withholding tax	5%	$0.00	$3.75	$3.75	5%	$0.00	$3.75
Net foreign dividend		$0.00	$71.25	$71.25		$0.00	$71.25
U.S. corporate income tax before credit	35%	$35.00	$35.00	$35.00	31.5%	$31.50	$0.00
Foreign tax credit		$0.00	$28.75	$35.00		$0.00	$0.00
U.S. corporate income tax after credit		$35.00	$6.25	$0.00		$31.50	$0.00
Dividend to U.S. shareholder		$65.00	$65.00	$71.25		$68.50	$71.25
U.S. shareholder tax[b]	15%	$9.75	$9.75	$10.69	33%	$0.00	$23.51
Net U.S. shareholder dividend		$55.25	$55.25	$60.56		$68.50	$47.74
Worldwide tax on distributed income		**$44.75**	**$44.75**	**$39.44**		**$31.50**	**$52.26**
Foreign tax		$0.00	$28.75	$28.75		$0.00	$28.75
Domestic tax		$44.75	$16.00	$10.69		$31.50	$23.51

[a]Assumes no domestic expenses allocated to exempt foreign income.

[b]Shareholder in top individual income tax bracket.

domestic investment under the panel's territorial proposal, particularly if the panel's proposals for taxing dividends at the shareholder level also were adopted.

C. Income Shifting

Another policy issue concerning a territorial tax system is that it may encourage U.S. companies to shift income from the United States to low-tax foreign jurisdictions through manipulation of transfer prices and other tax planning techniques.

The incentive to recharacterize domestic income as foreign income may be stronger under a territorial rather than a worldwide system because foreign business income is exempt from tax rather than deferred. However, the panel's proposal would also create an incentive to substitute foreign for domestic borrowing to avoid disallowance of U.S. interest expense allocable to exempt foreign income. That has the effect of shifting net income from foreign- to U.S.-source.

To assess the magnitude of income-shifting incentives under a territorial system, Grubert uses 1996 tax return data. He compares royalty and expense rates for CFCs that are subject to high and low average foreign tax rates. High foreign tax rates increase the likelihood of excess FTCs. For U.S. multinationals that expect to have excess FTCs, it generally is advantageous to book expenses abroad, as would be the case under a territorial tax system. For U.S. multinationals that do not expect to have excess FTCs, it generally is advantageous to suppress royalties from low-tax jurisdictions, as would be the case under a territorial tax system.

Grubert concludes that the behavioral responses of U.S. multinationals to enactment of a dividend exemption system could be significant, but would act to offset each other: A reduction in foreign-source royalty income would be offset by a decline in U.S. interest expense.[17] Grubert acknowledges that his analysis does not take into account all income-shifting responses that might occur under a dividend exemption system; however, he points out that similar incentives exist under current law because companies can defer taxation of foreign income.[18]

The ability of taxpayers to manipulate royalty rates and the prices of other intercompany transactions is restricted by numerous antiabuse provisions in the code, including the arm's-length standard and the commensurate with income requirement applicable to transfers of intangible property (section 482); the rules applicable to outbound transfers of intangible property (section 367(d)); and the accuracy-related penalty for substantial valuation misstatements (section 6662(e)). All of those rules would remain in effect under the panel's territorial proposal.

In summary, a dividend exemption system would not eliminate the need for tax authorities to examine prices charged among related U.S. and foreign affiliates to prevent inappropriate income shifting. However, there is little evidence to suggest that the amount of income shifted outside U.S. taxing jurisdictions would increase under a dividend exemption system.

[17]Grubert, *supra* note 11, at 826. Note that Grubert's empirical results may not be applicable to the worldwide system of interest allocation that is included in the panel's proposal.

[18]*Id.*

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D. Repatriation of Foreign Income

Two recent empirical studies confirm that current law causes U.S. companies to reduce repatriations from foreign affiliates. Using Commerce Department survey data for the 1982-1997 period, Desai, Foley, and Hines found that the existing tax system reduces dividend repatriations by 12.8 percent compared to a dividend exemption system and that the cost to companies of suppressing these dividends runs about 2.5 percent of dividend payments, or about 1 percent of pretax foreign income.[19] Using tax return data, Grubert and Mutti estimate that current law reduces dividend repatriations by 15 percent, at a cost to companies of about 0.7 percent of pretax income.[20] The temporary reduction in tax on repatriated foreign earnings enacted in the Jobs Act has resulted in a surge in repatriations, providing additional evidence that the U.S. tax system suppresses repatriation of foreign earnings.[21]

One cost of suppressing dividends is that companies frequently borrow in the United States even though they have idle cash in foreign affiliates invested in bank accounts or other passive assets. Cash in foreign affiliates that is lent to the U.S. parent or pledged as collateral for a U.S. parent loan generally is treated as having been repatriated and subject to tax as a deemed dividend. As a result, the domestic borrowing rate exceeds the return on foreign passive investments. Despite foreign balances, additional domestic borrowing can lower the credit rating of the U.S. company, further raising the company's borrowing rate.[22]

In summary, adoption of a dividend exemption system would lower the cost of capital for domestic investment and eliminate inefficiencies in the corporate financial structures of U.S. multinationals that are caused by the current repatriation tax.

E. Research and Development

R&D activities generally are tax favored under current law. A research credit is allowed for qualifying research and experimentation expenditures, and the costs of R&D are deducted when paid or accrued and are not required to be amortized over the economic life of commercially valuable discoveries. For many companies, a sizable share of the return from research activities comes from royalties paid for the use or license of technology developed in the United States. Royalties paid for the use of U.S. technology abroad typically are subject to no foreign tax other than low or no withholding taxes. Under current law, taxpayers with excess FTCs from high-tax dividends may use those credits to offset U.S. tax on foreign royalties. As a result, some or all of the return from the license of U.S. technology abroad may be free from U.S. tax. By contrast, under a dividend exemption system, foreign royalties generally could not be shielded from home country tax by excess FTCs.

For example, under current law, royalty income earned by a U.S. taxpayer with excess FTCs would bear only foreign withholding tax — say 5 percent. By contrast, under the panel's SIT proposal, the same royalty income would be subject to U.S. corporate income tax at a 31.5 percent rate less a credit for the 5 percent withholding tax. Consequently, the combined U.S. and foreign tax burden on that royalty income would increase by 26.5 percentage points (from 5 percent to 31.5 percent), over one-fourth of the total pretax return from technology used abroad. The SIT also would reduce the net return on domestic R&D activities by repealing the current credit for qualifying research expenses.[23] As a result, adoption of a territorial tax system could lead U.S. companies to reduce domestic R&D and increase R&D in foreign jurisdictions with lower tax rates or more generous R&D tax incentives.

In summary, policymakers should recognize that the panel's SIT proposal would likely reduce domestic R&D even though the proposal would not allocate any domestic R&D expenses to exempt foreign income. To avoid that impact, policymakers may wish to consider offsetting incentives or programs to support domestic R&D.

F. Exports

Since 1971 the United States has adopted a series of income tax incentives to promote exports: the domestic international sales corporation, the foreign sales corporation, and the extraterritorial income regimes (ETI). The replacement of DISC with FSC in 1984, FSC with ETI in 2002, and repeal of ETI in 2004 were each in response to European challenges lodged under multilateral trade agreements. That litigation clarifies that it is permissible under the Agreement on Subsidies and Countervailing Measures for countries to avoid double taxation of foreign income (determined on an arm's-length basis) through the use of a dividend exemption system, but regimes that limit exemption to export-related income will likely fail to withstand challenge.[24]

Adoption of the panel's dividend exemption system seemingly would favor U.S. exports because it would allow the United States to exempt income attributable to the export promotion activities of foreign affiliates. In fact, the panel's territorial proposal would not promote exports, for two reasons. First, the panel's proposal treats foreign base company sales income as "mobile" income subject to current U.S. tax. Thus, unlike in most countries with territorial tax systems, the panel's proposal would not exempt sales income earned by foreign affiliates in

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[19]Mihir Desai, C. Fritz Foley, and James Hines Jr., "Repatriation Taxes, Dividend Remittances, and Efficiency," 54(4) *National Tax Journal* 829-852 (December 2001). Altshuler and Grubert report that the 2.5 percent efficiency cost is equivalent to 1 percent of pretax income.

[20]Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System*, American Enterprise Institute, 2001.

[21]International Strategy and Investment Group, *ISI Portfolio Strategy Report*, Mar. 3, 2006, p. 3.

[22]Standard & Poor's, *Corporate Ratings Criteria*, 2006.

[23]The Joint Committee on Taxation staff's territorial proposal, unlike the panel's proposal, allocates some domestic R&D expense against exempt foreign income, which would further reduce the after-tax return on domestic R&D activities.

[24]*See* Gary Hufbauer, "The Foreign Sales Corporation Drama: Reaching the Last Act?" *Institute for International Economics* (November 2002).

connection with the marketing and distribution of U.S. exports.[25] Second, the panel's proposal apparently would not exempt export income that currently is treated as foreign-source income under the inventory property sales source rules. Under current law, half of the income from the export of inventory property generally may be treated as foreign-source income if title passes abroad; consequently, for taxpayers with excess FTCs, half of export income effectively is exempt from U.S. tax but would be taxable under the panel's proposal.

In summary, the panel's territorial proposal is likely to increase, rather than decrease, the U.S. tax burden on export income. If policymakers wish to avoid that result, consideration should be given to treating income earned from foreign activities related to the export of U.S. affiliates' property as active business income rather than mobile income (as defined under the panel's territorial proposal).[26]

G. Competitiveness

The advisory panel report identifies 21 of the 30 OECD member countries as having foreign dividend exemption systems.[27] In some respects, the panel's dividend exemption proposal would treat multinational investment more favorably than the territorial systems of some countries, which limit dividend exemption to income earned in treaty countries or countries that are determined not to be tax havens. In other respects, the panel's proposal would be less favorable to multinational investment than the territorial systems of other OECD countries. First, the panel's definition of mobile income includes some types of active income, such as foreign base company sales and services income, that generally are excluded from the antideferral rules of other OECD countries. Second, the panel's proposal would require allocation of some indirect domestic expenses to exempt foreign income, causing those expenses to be nondeductible. In practice, allocation of domestic expense generally is not required by countries with territorial tax systems unless the expense is directly traceable to exempt foreign income. Third, the panel's proposal increases the individual shareholder tax on dividends distributed out of foreign-source income.

According to Treasury Department calculations, the SIT would lower the effective federal tax rate on domestic corporate investment from 25.9 percent to 22 percent, in part as a result of lowering the top corporate income tax from 35 percent to 31.5 percent.[28] Taking into account state and local income taxes, which averaged 6.6 percent in 2005, the combined corporate income tax rate on domestic investment would be reduced from 39.3 percent to 36 percent. While that reduction in the top corporate income tax rate would improve the competitive position of the United States, the U.S. rate would still be 7.1 percentage points higher than the OECD average of 28.9 percent.[29]

In summary, the panel's territorial proposal contains features that are both more and less favorable to multinational investment than the territorial systems of competitor countries. Regarding inbound investment, the panel's proposal would make the United States a more attractive location, but the United States would remain a relatively high-tax-rate jurisdiction compared to other OECD countries.

V. Conclusion

The territorial tax system included in the SIT proposal of the president's advisory panel merits careful consideration by both policymakers and taxpayers. The proposal would have widely varying effects on the tax liabilities of U.S. multinational corporations (MNCs), depending on the location and financing of their foreign operations. The proposal would advance some tax policy objectives at the expense of others.

Both the benefits and the criticisms of the panel's proposal are likely overstated. While more than half of the 30 OECD countries have dividend exemption systems, the panel's proposal differs in some respects from international norms to the detriment of U.S. competitiveness. The proposal diverges from international practice by retaining the overbroad U.S. antideferral regime that sweeps in various types of active foreign business income, disallowing some domestic expenses, and imposing higher individual shareholder taxes on dividends attributable to the foreign-source income of U.S. MNCs. For many MNCs, the proposal would increase the tax burden on income derived from exporting and from licensing the fruits of U.S. innovation for use in foreign markets. The simplification achieved by the proposal would be modest, particularly in light of the significant reforms to the FTC adopted in the Jobs Act. And although the proposal would eliminate the tax disincentive to repatriating funds from low-tax jurisdictions, it might increase the incentive to shift income to those jurisdictions for tax purposes.

Given the mixed effects of the panel's territorial tax proposal, policymakers would be well advised to study the details and to compare it with the tax systems used by our major trading partners.

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[25]The JCT has noted that ''the foreign base company sales and services income rules, which arguably are outmoded and distort business decision making, . . . appear to be ineffective as a practical matter in promoting capital export neutrality and reinforcing the transfer pricing rules.'' *See* JCT options pamphlet, *supra* note 2, at 194 n.428.

[26]For a discussion of the foreign base company sales and services rules, see NFTC, *International Tax Policy for the 21st Century*, Dec. 15, 2001.

[27]Panel report, *supra* note 1, at 243.

[28]*Id.* at 130.

[29]Tax Foundation, ''The U.S. Corporate Income Tax System: Once a World Leader, Now a Millstone Around the Neck of American Business.''

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Structuring an Exemption System for Foreign Income of U.S. Corporations

Abstract *- About half the OECD countries provide a tax credit for foreign taxes on foreign source business income earned by multinational corporations; the other half exempt from domestic taxation active business income earned abroad. We undertake a preliminary inquiry here into the potential structure of such an exemption system for the U.S. Most of the issues raised by an exemption system parallel those debated under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Shifting to an exemption system might simplify U.S. international income tax law, but only if simplification is made a priority. Some of the potential simplifications of the rules governing international taxation of business suggested here could be adopted whether or not exemption is enacted.*

The OECD nations have split virtually evenly over the best structure for taxing foreign source business income earned by multinational corporations. About half the OECD countries provide a tax credit for foreign taxes; the other half exempt from domestic taxation active business income earned abroad (OECD, 1991). Discussions of international tax policy often treat this choice as grounded in different philosophies or normative judgments about international taxation. Foreign tax credit systems are frequently said to implement "worldwide" taxation or a "universality" principle, while exemption systems are described as" "territorial" taxation (U.S. Treasury, 2000). Likewise, tax credit systems supposedly implement "capital export neutrality" while exemption systems further "capital import neutrality"[1] (U.S. Treasury, 2000; Joint Committee on Taxation, 1991). However, tax credit and exemption systems are far closer in practice than these dichoto-

[1] Capital export neutrality (CEN) is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return and generally requires that a resident of any nation pays the same marginal rate of income taxation regardless of the nation in which she invests. Capital import neutrality (CIN) requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor. CIN thus subjects all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner. It is well known that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations.

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mies suggest. The OECD nations have all conceded that the country of source—the nation where income is earned—enjoys the primary right to tax active business income, with the residence country—the nation where the business is incorporated or managed—retaining at most a residual right to tax such income.

Since the enactment of the foreign tax credit in 1918, the United States has never seriously considered replacing it with an exemption system (Graetz and O'Hear, 1997; Graetz, 2001). In 2000, however, the U.S. Congress, in an apparently unsuccessful effort to thwart World Trade Organization disapproval of U.S. tax benefits for' "foreign sales corporations," characterized as normal U.S. exemption of foreign business income (Westin and Vasek, 2001; U.S. Congress, 2000). Issues under foreign trade agreements may push the United States to consider replacing the foreign tax credit with exemption. Recent analyses by economists suggest that moving to an exemption system for direct investment (with appropriate anti–abuse rules) could increase U.S. revenues without precipitating any substantial reallocation of capital by U.S. firms (Grubert and Mutti, 1999; Altshuler and Grubert, 2001). Moreover, the existing U.S. foreign tax credit rules are extraordinarily complex, requiring U.S. companies doing business abroad to spend large and disproportionate amounts to comply. One study estimates that nearly 40 percent of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though foreign operations account for only about 20 percent of these companies' economic activity (Blumenthal and Slemrod, 1995). Some analysts are now calling for the U.S. to take a serious look at exemption of foreign source business income, often on the grounds that an exemption system might be simpler than the existing credit system (Graetz, 2001; Chorvat, 2001). To date, however, little work has been done in identifying the issues that must be resolved for exemption to be implemented and discussing the potential structure of an exemption system for the U.S. Such analysis is essential to assess the likelihood of accomplishing simplification goals. We undertake a preliminary foray into those questions here.

Implementing either a foreign tax credit or an exemption system for foreign source business income demands resolution of similar questions. Most of the issues raised by an exemption system parallel those that have been debated over the years under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Domestic and foreign source income must be measured in both systems. Both systems must answer the question of what income qualifies for exemption or credit. Whether income earned abroad by a foreign corporation should be included currently in U.S. income or included only when repatriated as a dividend has long been debated under our foreign tax credit system (Altshuler, 2000). If not all foreign source income is exempt, this question remains important in an exemption system. And it is necessary to decide the appropriate treatment of foreign corporations with different levels of U.S. ownership. Likewise, transfer pricing issues are significant and difficult to resolve under either a credit or exemption system.

Detailed analysis and evaluation of each of these issues is not possible here. We start, therefore, by assuming that the political and economic determinations that have shaped current law will continue to exert great influence over the design of an exemption system. We also assume that if the U.S. were to adopt an exemption system, it would generally resemble exemption systems of other OECD nations that have used exemption rather

than foreign tax credits. But, even with these constraints, investigating the potential structure of an exemption system spurs reconsideration of issues long taken for granted under our foreign tax credit regime. Our analysis illustrates that shifting to an exemption system might well afford an opportunity to simplify U.S. international income tax law, but only if simplification is made a priority in enacting such a change. Our discussion here also points to potential simplification of the rules governing international taxation of business, whether or not exemption is enacted. As a political matter, however, such simplification may be more likely when Congress is making a substantial change in the regime for taxing international business income. We begin with a brief overview of current law and then take up the major issues that must be resolved in an exemption system.

BRIEF OVERVIEW OF CURRENT LAW

Corporations incorporated in the United States are considered U.S. residents. Income earned abroad by branches of U.S. corporations is taxed currently by the U.S. with a credit allowed for any foreign income taxes imposed on the branch's income. Foreign subsidiaries of U.S. corporations are not considered U.S. taxpayers and thus generally are not taxed by the U.S. on income earned outside the U.S. Normally the earnings of foreign corporations are subject to U.S. taxation only when distributed to their U.S. owners as dividends, treatment commonly characterized as "deferral." The U.S. parent is entitled to foreign tax credits (the "indirect" or "deemed–paid" foreign tax credits) for taxes paid by the subsidiary on the foreign source income distributed as a dividend. U.S. parents routinely control the timing of distributions of dividends from their foreign subsidiaries in order to control the timing of U.S. taxation of foreign source income in a manner to maximize the use of foreign tax credits. For corporations owned or controlled by U.S. corporations or other U.S. persons—known as controlled foreign corporations (CFCs)—a variety of limitations apply to limit deferral to active business income. The most important of these "anti–deferral" regimes are found in Subpart F of the Code and in the rules governing passive foreign investment companies (PFICs). The former applies only to CFCs but the latter rules require current taxation (or its equivalent) of foreign source passive income for U.S. owners of interests in foreign corporations not subject to Subpart F but which earn mostly passive income.

Foreign tax credits are limited to the amount of U.S. tax that would have been paid on the foreign income.[2] To limit the ability of U.S. corporations to use foreign tax credits on one type of income to offset taxes on a different category of income, the foreign tax credit limitation is now calculated separately for nine different categories or "baskets" of income.[3] The ninth basket—the "residual" or "general limitation" basket—contains almost all active business income, income from manufacturing, marketing, sales of inventory and services other than financial ser-

[2] Generally the foreign tax credit limitation is calculated by multiplying the U.S. tax on worldwide taxable income (before the foreign tax credit) by the ratio of foreign source taxable income to worldwide taxable income.

[3] The categories include a separate basket for passive income, high withholding tax interest, financial services income, shipping income, dividends from each non–controlled §902 corporation, taxable income attributable to foreign trade income, dividends from a DISC or former DISC, distributions from a FSC, and "residual" or all other income. Internal Revenue Code, §904(d). Since income from each non–controlled §902 corporation goes into a separate basket, U.S. corporations may have many more than nine separate baskets limiting their foreign tax credits.

vices, regardless of the rate of tax imposed on such income by the relevant foreign government, and items of passive income subject to foreign tax rates equal to or higher than the U.S. tax rate. The need to allocate income to each of these baskets and calculate separate foreign tax credit limitations for each is a major source of the complexity of current law.

INCOME ELIGIBLE FOR EXEMPTION

Alternatives

The first issue in designing an exemption is deciding what foreign source income is exempt. Potentially such an exemption could apply broadly to all foreign source income or narrowly, for example, only to active business income that is subject to tax by a nation with which the U.S. has an income tax treaty or which taxes income at rates comparable to the U.S. rate. Some OECD countries limit their exemption systems to countries with which they have tax treaties or to income taxed at a certain level abroad; others do not. We consider first the potential structure an exemption system applicable generally to active business income without regard to whether the income is generated in a treaty jurisdiction and without regard to the rate at which it is taxed by the foreign country where it is earned.

Following the practice of other nations which exempt foreign source income, such an exemption would apply generally to the branch profits of any U.S. corporation and to dividends received by U.S. corporate taxpayers from foreign corporations. This means that interest income and royalty income, both of which are deductible abroad and therefore not subject to foreign income tax, would be subject to U.S. tax. Under current law, U.S. businesses are often able to shelter interest and royalties earned abroad from U.S. tax through foreign tax credits. Thus, an exemption system would increase the tax on this type of income for many U.S. companies compared to current law.[4]

Definition of Active Business Income

Since active business income but not other types of income earned abroad would generally be exempt, it becomes essential to determine what constitutes eligible active business income. The Internal Revenue Code today does not provide any direct precedent. Nonetheless, the current Code does provide guidance, which probably would be used in defining eligible active business income. Identifying business income eligible for exemption and determining how to treat income not eligible for exemption raise questions parallel to those under current law in determining what income earned through foreign corporations should be taxed currently or eligible for deferral of U.S. tax until repatriated and how the foreign tax credit should apply when that income is subject to U.S. tax. Business income eligible for exemption might be defined first by excluding income that is "passive," drawing on existing Code provisions that identify and tax currently types of passive income earned abroad, particularly Subpart F of the Code. The rationale for excluding passive income from exemption parallels that for taxing such income currently under Subpart F.

[4] Income received by U.S. corporations from foreign corporations in the form of interest and royalties could conceivably be exempt on a look–through basis (i.e., if allocated to the exempt income of the payor). While such an approach would generally be consistent with our foreign tax credit rules today, it would be unprecedented among countries adopting an exemption system, because it would allow income to go untaxed in both the interest or royalty paying jurisdiction (assuming the interest or royalty is deducted and does not generate a substantial withholding tax) and the interest or royalty earning jurisdiction. Consequently, any exemption system would likely subject interest and royalties from abroad to U.S. tax, as foreign source income eligible for a foreign tax credit.

Because such income has no nexus to business activity, it is highly mobile and easily shifted abroad to low or no tax jurisdictions. Thus, exempting such income would create an unacceptable incentive to move assets offshore and potentially would lose large amounts of revenue. Consequently, income that constitutes passive income (technically foreign personal holding income) under Subpart F (mostly interest, dividends, rents and royalties) would not be eligible for exemption. Special rules will be necessary when such amounts are earned by entities in which a U.S. corporate taxpayer has a certain minimum ownership interest. (In the latter case, as we discuss below, "look–through" rules would be applied to characterize some types of passive income.) The distinction between income eligible for exemption and non–exempt passive income would raise definitional issues similar to those long debated under Subpart F. For example, banks, securities dealers, insurance companies and other finance–related businesses earn interest and other types of "passive" income that are considered active business income under current law; we believe that such businesses should probably be eligible for exemption as are other active businesses, at least when their financial–service business is located predominately in the country of incorporation.[5]

Once passive income earned abroad by U.S. corporations is excluded from exemption—as we believe it should and will be—the risk occurs that an exemption system might become about as complex as current law. For example, every active foreign business utilizes working capital, and earns passive income from the temporary investment of such capital. Without a *de minimis* rule which ignores small amounts of passive income, every corporation will have to take into income some amount of passive income and presumably calculate foreign tax credits allowable with respect to such income. A *de minimis* rule based on a proportion of total gross income or total assets might promote substantial simplification by allowing the income of foreign corporations engaged in an active business to be completely exempt without leading to an unacceptable level of tax planning.[6]

A separate question is whether other "non–passive" types of Subpart F income should be exempt from U.S. taxation. In some cases, for example, Subpart F currently taxes certain sales and services income. In most cases such sales and services income, which is active business income, is taxed currently under Subpart F because of the ability of taxpayers to locate the activities that generate this income in low–tax jurisdictions thereby minimizing both U.S. and foreign source–based income taxes. These Subpart F rules were first adopted in 1962 and some business organizations have recently called for revision, urging, for example, that the transfer pricing rules are adequate to address "abuse" cases (NFTC, 1999). The fundamental policy issue to be faced by an exemption system is whether these (and other) types of "mobile" active foreign business income, which can sometimes be moved to low tax jurisdictions, should be eligible for exemption. Transfer pricing enforcement throughout the OECD has become more vigorous and sophisticated. A simpler system would no doubt result if the transfer pricing rules (which in this case would be enforced by the country from which the sales or services income is deflected to a low or no tax jurisdiction), rather than an exclusion from exemption, could be relied on to constrain tax avoidance.

[5] The Dutch, for example, have a foreign tax credit regime that applies to foreign financial services income on the ground that this income is often subject to low or no income tax abroad.

[6] We believe that to accomplish effective simplification, such a *de minimis* rule should be based on assets or gross income and not limited to a specified dollar amount as is currently the case under Subpart F.

A further question is whether certain types of foreign source active business income that are not likely to be taxed in any jurisdiction on a source basis should be eligible for exemption. For example, income from personal services, which is foreign source income when the services are performed outside the United States, is generally treated as active trade or business income. However, when the services are not attributable to a local fixed base in the nation where they are performed, most countries do not tax the services on a source basis. Similarly, shipping, telecommunications and other types of income from international waters and space clearly are active business income, but these kinds of income typically are not taxed by any foreign jurisdiction unless they are earned by a company residing in that jurisdiction. Many companies earning these kinds of income are resident in low–tax jurisdictions. Extending exemption to such income would inevitably be controversial.

Finally, it will be necessary to determine whether exemption applies to gain on the sale of assets in connection with an active business. A consistent exemption policy should provide that gain on the sale of assets would be exempt if the assets generate exempt income. For example, gains on the sale of business assets used in a foreign branch would be exempt (and losses would be disallowed) if the income from such assets would be exempt.

Likewise, gain on sales of shares in a foreign corporation should also logically be exempt if the dividends of the entity would be exempt, since the gain reflects the present value of the future stream of potentially exempt income. Where not all of the income of the foreign corporation would be eligible for exemption, however, the appropriate treatment of gain when shares are sold is not obvious. An allocation between exempt and non–exempt gain might be required, but such a rule would be complex and the basis for making such an allocation is not completely clear. In principle, gain attributable to retained active business earnings should be exempt. This could be accomplished by adapting the rules of current law that recharacterize gain on the sale of shares of a foreign corporation as a dividend to the extent of retained earnings; the recharacterized dividend would be exempt to the extent that an actual dividend would be exempt.[7] However, exempting gain attributable to the appreciation in the value of assets that produce passive income seems inappropriate, thus probably making necessary a look–through rule when shares of a qualifying foreign corporation are sold. In essence, the purpose of such a look–through rule would be to tax gain attributable to appreciation of passive or other non–exempt assets.[8]

TREATMENT OF NON–EXEMPT INCOME EARNED BY U.S. TAXPAYERS

Foreign Tax Credits

The discussion above makes clear that not all foreign source income earned by a U.S. corporation will be eligible for exemption. Non–exempt income would surely include foreign source interest, rents and royalties not attributable to an active foreign business, dividends on portfolio stock, income from export sales not attributable to an active foreign business and any other types of active business income (perhaps such as space or shipping income or interest and royalties attributable to an active business) that are specifically determined to be ineligible. However, to the extent that these types of income are potentially subject to foreign tax (including withholding tax) on a source

[7] Here we are suggesting modifications to the rules under §1248 of the Internal Revenue Code.
[8] Rules would be necessary to determine such amounts on a per share basis.

basis, the U.S. should make an effort to avoid double taxation. Thus, as under today's rules, such income should probably continue to be allowed a credit for the foreign taxes paid on that income.

If a foreign tax credit is permitted for any income, in principle all the questions that exist today regarding limitations on foreign tax credits would have to be resolved. However, if the nonexempt income were limited to only these classes of income, much simplification would be possible. For example, given this limited application, a single worldwide foreign tax credit limitation could be applied. A worldwide limitation seems reasonable since taxpayers almost always will be subject to tax abroad on these types of income at rates lower than the U.S. corporate tax rate, and therefore they will almost always have foreign tax credit limitations in excess of creditable foreign taxes.[9] A single worldwide limitation would be far simpler than the baskets of current law, and the fact that taxpayers would virtually always have excess foreign tax credit limitations both permits additional simplifying changes and lowers the stakes in applying some rules that would be retained.[10]

If, however, averaging of credits across types of income is of great concern, separate limitations might be applied based on categories of income (similar to today's limitations) or types of taxes (e.g., withholding taxes versus income taxes normally applied to residents). Finally, a separate limitation could be applied to each item of foreign source income not eligible for exemption (much like the so–called "high–tax kickout" limitation on passive income under the current foreign tax credit). However, we see no justification for this level of complexity. In a system that generally exempts active business income, we do not find any policy justification for multiple separate limitations that outweighs the simplification advantages of a single worldwide foreign tax credit limitation.

Treatment of Non–Exempt Foreign Corporation Earnings

If not all income earned by a foreign corporation is eligible for exemption, the question occurs whether non–exempt income should be subject to current inclusion by U.S. corporate shareholders or, alternatively, should not be taxed in the U.S. until distributed as a dividend. Most passive types of income are today subject to current inclusion under Subpart F when earned by controlled foreign corporations. Investors in non–U.S. controlled foreign corporations, which earn mostly passive income, may be subject to current taxation (or roughly equivalent consequences) under the Passive Foreign Investment Company (PFIC) regime or other "anti–deferral" regimes. We see no reason that shifting from a foreign tax credit to an exemption system should delay the imposition of U.S. tax on passive income (which exceeds a *de minimis* amount) that is taxed currently under present law.[11] Thus, we assume that the U.S. would continue to subject passive types of foreign source income to current inclusion.

If some types of active business income also are not exempt, a decision must be made whether to subject that income to

[9] Some analysts have suggested that the fact that U.S. companies would typically have excess foreign tax credit limitations might stimulate other countries to raise taxes, especially withholding taxes. The trend, however, is very much in the direction of lower withholding taxes. The tax treaty between the U.S. and the United Kingdom signed in 2001, for example, is the first time the U.S. has agreed to a zero withholding rate on dividends. We do not believe a shift by the U.S. from a credit to an exemption system would halt or reverse this trend.

[10] See, for example, the discussion below of allocation of research and development expenses.

[11] As we indicated earlier, we do regard shifting to an exemption system as a proper occasion to reconsider the scope of Subpart F with respect to active business income.

current taxation. Here we believe that avoiding the complexity of having three categories of income for U.S.–controlled foreign corporations—exempt income, currently included income and deferred income—is sufficiently important to argue for current taxation of all non–exempt income.[12] If non–exempt income is taxed currently and dividends are exempt, the timing of dividends becomes of no consequence under U.S. tax law. On the other hand, if a category of deffered income is retained, look–through treatment of dividends might be necessary.[13]

Assuming that all income of U.S. controlled foreign corporations is either exempt or currently included, rules are necessary to measure the income in two categories. For example, rules allocating expenses between the two categories of income would be necessary. Likewise, loss recapture rules (similar to those in Subpart F today) would be necessary to prevent losses from income–producing activities from permanently reducing non–exempt currently includable amounts.

In addition, an "indirect" (or "deemed–paid") foreign tax credit would be appropriate to allow U.S. corporate taxpayers to claim foreign tax credits for foreign taxes paid by foreign corporations on non–exempt income. Such a foreign tax credit would require rules allocating foreign taxes between exempt and currently includable income. The rules would also require integration with the foreign tax credit limitation rules discussed above with respect to foreign source income earned directly by U.S. taxpayers. Thus, many of the foreign tax credit issues that exist today would remain although they would apply to a much smaller category of income earned by foreign corporations and therefore might be substantially simplified.

DISTINGUISHING AMONG U.S. CORPORATE SHAREHOLDERS

In addition to rules establishing the scope of exemption and the treatment of dividends received from foreign corporations, it becomes necessary to decide whether all U.S. corporate shareholders should be entitled to exemption. In theory, the answer to this question should be yes; otherwise some international double taxation at the corporate level will occur. However, applying an exemption system, as discussed above, requires that U.S. corporate shareholders receive significant amounts of information from those foreign corporations in which they have the requisite level of ownership. The U.S. recipient would, for example, have to know the amount of the foreign corporation's passive earnings and the amount of foreign taxes imposed on those earnings. It thus seems impractical to apply an exemption system on a look–through basis to all U.S. corporate shareholders of foreign corporations.

In determining whether U.S. tax applies currently or is delayed until earnings are repatriated and for foreign tax credit purposes under current law, the U.S. has

[12] If current taxation of active business income is unacceptable, we would probably opt for expanding the scope of the exemption rather than establishing a third category of deferred income.

[13] Three alternatives exist for allocating dividends between exempt and non–exempt income: pro rata allocation, treating dividends as paid out of exempt income first or treating exempt income as paid out last. Today's law applies a pro–rata approach for foreign tax credit purposes (i.e. dividends are allocated pro rata to each foreign tax credit limitation category). A pro rata rule seems the most equitable and appropriate rule, but also is the most complex rule. On the other hand, treating non–exempt income as paid out first seems unduly harsh, and stacking exempt income last may undermine the rules governing passive income and create too great an incentive to shift such income abroad. We believe that with an appropriate *de minimis* rule (as discussed above) and limiting the Subpart F definition of non–exempt income to passive income (as discussed above) applying a look–through rule on a pro rata basis is the best alternative if a look–through rule for dividends is needed.

three different regimes relevant to this issue:

(1) Subpart F limits deferral but allows foreign tax credits to shareholders owning 10 percent or more of the voting stock in controlled foreign corporations (CFCs). (CFCs are defined as foreign corporations in which U.S. persons each owning 10 percent of the voting stock own a total of more than 50 percent of the stock by vote or value).
(2) To avoid international double taxation, the "indirect" foreign tax credit is allowed to U.S. corporations that own at least 10 percent of voting stock in a foreign corporation which is not a CFC.
(3) No foreign tax credit and no limitation on deferral applies to a U.S. corporation whose ownership in a foreign corporation is less than 10 percent of the voting stock.

In designing an exemption system these categories should be rethought. Today a U.S. corporation, which owns less than 10 percent of the voting stock of a foreign corporation, is treated as a "portfolio" investor. Full double taxation of foreign source income at the corporate level is justified largely on the assumption that such corporate investors cannot get the information necessary to determine their foreign tax credits under U.S. law.

A 10 percent voting stock threshold could also be adopted for distinguishing "portfolio" from "direct" investment for the purpose of applying exemption.[14] The issue remains, however, whether U.S. corporate investors owning less than 10 percent should be fully taxed or fully exempt on dividends (and capital gains). If, as we assume, rules similar to the current Passive Foreign Investment Company regime continue to apply to all investors in foreign corporations that hold predominately passive assets, dividends (and gains) from non–PFIC foreign corporations might be treated as exempt by U.S. corporate shareholders owning less than 10 percent of voting stock in all cases without requiring any significant information and without creating undue potential for tax planning mischief.[15]

A second question is whether any distinction should by made in the application of an exemption system to U.S. corporations that own more than 10 percent but not more than 50 percent of a foreign corporation—in other words, to direct investment in non–CFCs. That decision should probably turn on the kinds of limitations that apply to passive income and whether obtaining the necessary information to apply these limitations would be onerous for U.S. minority shareholders. Under legislation recently passed by Congress, beginning in 2003, the foreign tax credit look–through rules will be applied to 10 percent owners of non–U.S.–controlled foreign corporations, although Subpart F will continue to apply only to foreign corporations meeting the definition of a controlled foreign corporation. An exemption system might reconcile these disparities, applying similar rules to all 10 percent or greater corporate shareholders. This would be much simpler than current law. Alternatively, despite the complexities, an exemption system might follow a path similar to current law, ex-

[14] We have no basis for assessing whether adequate information would be made available to corporate investors with smaller voting interests, 5 percent, for example. The 10 percent threshold is common throughout the OECD.

[15] Because the dividend received deduction of §243 of the Internal Revenue Code, in effect, exempts only 70 or 80 percent of dividends paid by U.S. companies to U.S. parents, there may be concern with providing full exemption for dividend payments by foreign subsidiaries to U.S. parents, notwithstanding the potential imposition of foreign taxes on dividends from abroad. If so, an exemption for 70 or 80 percent of foreign source dividends would respond to this concern without adding complexity.

empting all active business income on a look–through basis, but requiring current inclusion only from foreign corporations that are controlled by U.S. shareholders. This would, however, require creation of a "deferral" category for "10/50" shareholders in foreign corporations, which would add considerable complexity. Countervailing difficulties might result, however, if current inclusion is required with respect to undistributed passive earnings of foreign corporations which U.S. shareholders do not control. In such cases, the U.S. corporation may not be able to obtain the payment of sufficient dividends by the foreign corporation to cover the U.S. tax cost. Under such circumstances, creating a limited class of deferred foreign income might be a practical alternative.

The desire for simplification coupled with concerns about imposing current U.S. tax in circumstances where a corporation cannot compel sufficient dividends to pay the tax suggests a third alternative. Perhaps two categories of investors could be created, for example, by expanding the category of "portfolio" investors to those U.S. corporations that own less than 20 percent of the foreign corporation (by vote and value) and applying an exemption regime with current taxation of non–exempt income to all larger investors.[16] It is likely that a 20 percent or greater investor will be able to participate meaningfully in corporate decisionmaking, including decisions about paying dividends. We believe this alternative has merit as a way of balancing simplification and equity concerns.

Treatment of Taxpayers Other Than Corporations

Finally, the question arises how to tax foreign source business income of U.S. investors other than corporations. Foreign business income earned directly by individuals could be eligible for exemption. However, since under the U.S. classical system corporate earnings are fully taxed when distributed to non–corporate shareholders, an exemption for dividends paid by foreign corporations to non–corporate U.S. taxpayers would make little sense.[17] The fundamental question is whether all income of such persons that is earned through foreign corporations should be currently included (subject to foreign tax credits) or whether the taxation of some or all of that income should be deferred until repatriated. Parity with corporate investors argues for deferral at least of earnings that would not be currently included by a U.S. corporate owner, and it may well also be simpler to defer taxation of such income to individuals (whether earned directly or through mutual funds) until dividends are paid.

ALLOCATION OF EXPENSES

Under an exemption system along the lines we have described above, there would be three general categories of gross income: U.S. source income, foreign source exempt income, and foreign source non–exempt income. Expenses allocable to U.S. source income would not be affected by changing from a credit to an exemption system. And presumably amounts allocable to non–exempt foreign source income would be taken into account in determining the (one or more) foreign tax credit limitation amounts, much like our rules today. However, because (as we have discussed) U.S. corporations would typically have excess foreign tax credit limitations under an exemption system, the stakes of that alloca-

[16] If U.S. companies or other persons own more than 50 percent of the foreign corporation, a 5 or 10 percent threshhold (rather than the 20 percent suggested in the text) could apply.

[17] This raises the question whether foreign withholding taxes should be creditable to individual shareholders, including whether such credits should be flowed through mutual funds, as under current law. Reexamining this treatment of such portfolio investments by individuals is beyond the scope of our endeavor here.

tion would be far lower than is currently the case. Indeed, usually nothing would turn on such an allocation. On the other hand, expenses allocable to exempt foreign income are properly described as deductions incurred to earn exempt income, which the Code typically disallows. Such deductions should be disallowed or allowed only to the extent they exceed exempt income in any year and are subject to recapture out of exempt income in subsequent years. To the extent the rules allocate expenses to exempt income they will take on heightened importance compared to today's deduction allocation rules. Under an exemption regime, such allocation rules potentially will disallow an amount of otherwise deductible expenses; under current law they serve only to limit foreign tax credits for taxpayers who have excess foreign tax credits.

Consequently, rules will be necessary for allocating expenses to each category of income. To begin with the most important example, interest expense allocation rules will clearly be necessary. But because of the serious consequences to taxpayers that would result from disallowing interest deductions allocated to exempt income, it becomes essential to rethink the rules. A system that allocates interest expense first to interest income (whether or not eligible for exemption) with the remaining interest expense allocated to each category of income pro rata based on assets, but taking worldwide assets into account, would be a better starting point than current law.[18]

We have assumed throughout this article that in an exemption regime, following the general practice in other OECD countries, royalties from foreign corporations would be non–exempt income (and that a complementary rule imputing royalties to foreign branches of U.S. taxpayers would be adopted). Under these circumstances, providing for the allocation of research and development (R&D) expenses would be essential, but would have less serious consequences for taxpayers than current law. R&D expenses need not be allocated to foreign dividend income or to branch profits because the dividend payor or branch would be separately paying a royalty that would be taxable in all cases.[19] Thus, R&D expenses need be allocated only between foreign source income eligible for a foreign tax credit (such as royalty income) and domestic source income. As we have discussed above, in an exemption system, any foreign tax credit limitation will typically be applicable only to income subject to withholding tax and passive trade or business income and therefore would not likely limit the available foreign tax credits of most non–financial multinational corporations. Since the allocation of R&D expense under current law is important only for taxpayers with excess foreign tax credits, how much R&D expense is allocated to foreign source income under an exemption system should have little or no effect on U.S. taxes. Therefore an exemption system would not raise the serious policy issues that exist for R&D allocation under the current foreign tax credit system.

[18] Current law applies a "water's–edge" rather than worldwide allocation, and was adopted in the 1986 Tax Reform Act for revenue reasons. §864(e) of the Internal Revenue Code. A worldwide allocation would generally allocate interest expense worldwide based either on gross income or assets. The "water's–edge" approach of current law excludes borrowing from foreign subsidiaries in making the allocation of interest expense. Some commentators argue that "tracing" rules, similar to those used abroad, are appropriate (Shaviro, 2001). Virtually all commentators regard worldwide allocation as superior to water's–edge allocation (e.g., Brumbaugh and Gravelle, 1999; Sullivan, 1999). Further discussion and analysis of interest allocation rules is not possible within the space limitations of this article.

[19] We are assuming continuation of current law requirements that the use of intangible assets abroad requires a payment back to the U.S. owner (e.g., §367(d) of the Internal Revenue Code). A comparable rule applicable to branches would become necessary under an exemption system along the lines we are discussing here.

Finally, as with interest expenses, the rules that provide today for the allocation of a portion of general and administrative expenses as "stewardship expenses" to foreign source income would become much more important than under current law because such expenses might be allocated to exempt income and disallowed as a deduction. By definition these expenses are not properly charged out to foreign corporations. (Otherwise the expenses would be directly allocated to the income from the charge and thus fully deductible.) If these expenses were allocated to exempt earnings, they would not be deductible in any jurisdiction, an inappropriate result for expenses that clearly are current costs of earning business income. Consequently, it would be important to define the category of allocable "stewardship expenses" narrowly in an exemption regime.[20]

OTHER STRUCTURAL ISSUES

Many other issues present in our foreign tax credit system would persist in an exemption system. For example, transfer pricing issues that arise today would continue to be important under an exemption system, although the incentives would be different in many cases. There would, for example, be an incentive to lower royalties and increase dividends in an exemption system (Grubert and Mutti, 2001; Grubert, 1998; Grubert and Mutti, 1991). Depending on the scope of the exemption, transfer pricing issues might become even more important. The changes we have suggested limiting Subpart F to passive income under an exemption system, for example, assume transfer pricing enforcement by OECD nations in lieu of the Subpart F "base–company" rules when sales or service income is shifted to low or no tax jurisdictions. Likewise, to the extent that rules for determining the source of various categories of income cause problems under current law, these problems would remain important in an exemption system.

The U.S. tax treatment of transfers of property from a U.S. company to a foreign corporation would also continue to be an issue, but rules simpler than those in force today could be adopted in an exemption regime. The transfer to a foreign corporation of assets that gave rise to exempt income prior to the transfer ought to be non–taxable. The transfer of other assets should generally be taxed, but where the income from those assets would continue to be fully taxed either because the assets relate to a U.S. trade or business or because such income (and gain from the sales of related assets) will be subject to current inclusion to all of the shareholders of the foreign transferee, it should not be necessary for the U.S. to impose tax at the time of the transfer.[21]

If an exemption system has only two categories of income—exempt income and income currently taxed—and therefore eliminates the category of deferred income for U.S. corporate investors in U.S.–controlled foreign corporations, substantial simplification could be achieved by eliminating those provisions that under present law terminate deferral in specific circumstances. For example, the provision

[20] Each of these expense allocation issues will exist not only for U.S. taxpayers earning exempt and/or non–exempt foreign income, but also for foreign corporations that have U.S. corporate shareholders that may potentially receive exempt dividends. For such corporations, deductions would need to be allocated between exempt and non–exempt income. Presumably resolutions of these issues similar to those described in the text would be applied for purposes of determining the exempt income of such foreign corporations.

[21] Rules for the transfer of substantial holdings of shares in a foreign corporation to another foreign corporation would not be necessary to the extent gain on the sale of the shares would be completely tax exempt. However, since, as discussed above, complete tax exemption is not likely to be the rule with respect to all sale of shares transactions, gain recognition agreements or other similar rules would likely be necessary with respect to transfers of shares where gain is not recognized.

that treats foreign corporate loans back to U.S. affiliates (and other similar transactions) as constructive dividends to the shareholders could be eliminated. Likewise, the regulations that terminate deferral in certain inbound and foreign–to–foreign reorganization transactions could also be eliminated.

MORE LIMITED EXEMPTION ALTERNATIVES

The exemption system we have described above is premised on the assumption that active foreign source business income would generally be eligible for exemption (except perhaps for some types of active business income now subject to current inclusion under Subpart F). In such an exemption system, all income of eligible U.S.–owned foreign corporations would be divided between exempt income and currently includable income. Some commentators, however, have urged more limited exemption systems, implying that only income taxed comparably to the taxation of U.S. domestic corporate income should be exempt (Graetz, 2001; President's Task Force on Business Taxation, 1970). For example, an exemption system might subject so–called "tax haven" income to U.S. tax even though the income is attributable to an active trade or business outside of the United States. Such a result might be achieved by denying exemption to all income earned in listed tax haven countries or to all income earned in non–treaty countries. Alternatively, exemption might apply only to active business income earned in countries specifically specified by the U.S. Treasury or countries with a statutory (or an effective) tax rate higher than a specified minimum rate, for example, 75 percent of the U.S. rate.

Any of these more limited forms of exemption would make it more difficult to treat all non–exempt income of U.S. controlled foreign corporations as currently includable. If, for example, an exemption system were limited to active business income earned in a treaty country, the current inclusion of similar active business income earned by foreign corporations doing business in (and subject to tax by) non–treaty countries would place great pressure on whether a treaty is in force. Similar pressures would occur if the distinction between exemption and current inclusion turns on the tax rate of the foreign country. Thus, as a practical matter, if a more limited form of exemption system were adopted, three categories of income—exempt income, deferred income, and currently includable income—for dividends from eligible U.S. owned foreign corporations might result. Such a system would likely be at least as complex as today's system. The anti–deferral rules of today's law would continue in force and the rules discussed above with respect to exempt income would also be necessary. On the other hand, if the exemption is limited to income in countries with relatively high tax rates, the justification for reducing the number of baskets for determining the limitation of foreign tax credits—i.e., that companies would be in an excess limitation position—would be as strong as with a broader exemption system.

TRANSITION ISSUES

The most important transition issue in moving from the current foreign tax credit system to exemption is the treatment of income earned by foreign corporations in periods prior to exemption but not yet repatriated to or taxed by the United States. The issue is whether and how U.S. tax should be imposed on future dividends treated as paid out of such deferred income and to gain on the sale of stock of such corporations. Several alternatives are possible.

The simplest approach would be to forgive the U.S. tax on such income with all dividends eligible for exemption (ignor-

ing whether it would qualify as exempt income if earned currently). Taxation of gain on the sale of stock would be unaffected by retained pre–exemption system earnings. Such a generous approach would be consistent with Congress' decision to not tax accumulated DISC income when the FSC regime was enacted in 1984.[22] In that instance, however, Congress had never intended to tax accumulated DISC income, whether or not the DISC regime was changed. Such forgiveness of tax seems unlikely here.

An alternative would be to enact an ordering rule for dividends that would subject dividends paid out of pre–exemption earnings as taxable but eligible for foreign tax credits. If the pre–exempt earnings were treated as being paid last, the complexity of an additional category of earnings would be minimized for a large number of taxpayers. A precedent for this alternative can be found in both the rules applicable to C corporations that elect S corporation status and in the enactment of the 1986 foreign tax credit limitation rules. Presumably, under such a regime gain on the sale of stock in foreign corporations would be taxed as a deemed dividend (with accompanying foreign tax credits) to the extent of pre–exemption retained earnings.

A third alternative would be to levy a toll charge on existing corporate direct investments in foreign corporations as a condition for exemption of dividends in future periods. We regard this as the least appealing alternative. As a practical matter, it would give taxpayers an election between deferral and exemption. It also would provide a large incentive for companies to separate future business income–generating activities from current earnings and profits, a complex task which we have no doubt tax planners could readily accomplish if the stakes are sufficiently large.

CONCLUSION

We have attempted here to identify the issues that Congress must resolve if it were to replace the existing foreign tax credit system with an exemption for active business income earned abroad. In this discussion we have stuck rather close to present law in addressing how these issues might be resolved under an exemption system. In other words, we have treated a potential change to exemption as an incremental move in U.S. international tax policy rather than viewing such a shift as an occasion to rethink fundamental policy decisions reflected in current law.

Our analysis reveals that virtually all of the questions that must be answered in a foreign tax credit regime must also be addressed in an exemption system. There is little simplification necessarily inherent in moving to an exemption system, but such a move does provide an opportunity to reconsider a variety of issues that might simplify the taxation of international business income. While, in principle, much simplification of current law is possible without abandoning the foreign tax credit, it may be politically unrealistic to think that such simplification will occur absent a substantial revision of the existing regime, such as that entailed in enacting an exemption system.

Our analysis suggests that much of the complexity of an exemption system occurs in the scope and treatment of non–exempt income. If this category generally can be limited to passive non–business income with meaningful *de minimis* rules applied

[22] The DISC regime, enacted in 1971, in effect exempted from U.S. tax a portion of profits from U.S. exports if earned by a qualifying domestic subsidiary of the U.S. exporter. The subsidiary was known as a DISC. Following a decision under GATT that DISC constituted an illegal subsidy to exports, Congress replaced the DISC regime with the FSC (Foreign Sales Corporation) regime, which Congress hoped would be acceptable because of the foreign nature of the FSC. The WTO held the FSC regime also to be an illegal export subsidy.

to the treatment of such income, the impact of these rules can be minimized. Surely the basket system limiting foreign tax credits could be eliminated. Moreover, under an exemption system along the lines we have described here, the timing of the payment of dividends would be of no consequence. Thus, under an exemption regime significant simplification could be achieved for many companies and the costs of complying with U.S. international tax rules might well decrease substantially for U.S. corporations.

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Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations

Abstract *- We approach the question of how moving to a dividend exemption system would affect the location incentives of U.S. corporations from three different angles. We start by comparing the U.S. allocation of foreign direct investment in manufacturing across low–tax versus high–tax jurisdictions with that of two major dividend exemption countries, Germany and Canada. The second section demonstrates how the effective tax rate on the typical investment in a low–tax affiliate would change under a dividend exemption system. The final approach uses data from the tax returns of U.S. multinationals to gauge how location decisions will be affected. Taken together, the analysis provides no consistent or definitive evidence that location decisions would be significantly changed if dividends were to be exempt from U.S. corporate tax.*

INTRODUCTION

Under the current tax system both the domestic and foreign earnings of U.S. corporations are subject to U.S. taxation. Parent corporations pay U.S. taxes on active foreign earnings when they are remitted and receive a credit (limited to the U.S. tax liability on foreign earnings) for income taxes paid to foreign governments. This "residence" approach to the taxation of international income is not employed around the world. Many countries have "territorial" tax systems that exempt some (or all) of active earnings generated by foreign operations from home country taxation.

At first glance, one might predict that residence tax systems like the one employed by the United States would dampen the tax incentive to invest abroad in low–tax countries. This contrasts with the tax incentives of firms subject to territorial tax systems. These firms face the local tax rate when investing abroad and the home rate when investing at home. As a result, one might expect that switching from a residence to a territorial system would lead to a substantial reallocation of U.S. investment worldwide. This paper studies how the location decisions of U.S. multinational corporations (MNCs) may change if the U.S. were to adopt a system that exempts foreign dividends from home taxation. Before presenting our analysis, however, some background information on the current U.S. tax system is necessary.

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If foreign operations are organized as subsidiaries (i.e., they are separately incorporated in the foreign country), then active business profits are not generally taxed at home until they are paid to the U.S. parent corporation. This delay in taxation until a subsidiary's profits are actually remitted to the U.S. is known as deferral.[1] Since firms are able to defer U.S. taxation on active business income, residence taxation does not create much of a barrier to investing in low–tax locations abroad. In fact, tax return data shows that the average repatriation rate from U.S. subsidiaries located in low–tax countries (those with average effective tax rates of less than 10 percent) was only about 7 percent of earnings in 1992 (see Grubert and Mutti, 2001). Even if one adds the excess burden associated with restricting dividend repatriations from low–tax countries to the U.S. tax actually paid on repatriations, the overall tax burden is very small.[2]

Once they have been remitted to the parent, foreign profits have been subject to both host country and home country income taxes. To alleviate the double taxation of foreign source income the U.S. allows firms to claim credits for income taxes paid to foreign governments. These tax credits can be used to offset U.S. tax liability on foreign source income.

A limitation on the credit prevents American firms from using foreign tax credits to reduce U.S. tax liabilities on income earned at home. The limit is the amount of tax that would be due if the foreign income were earned in the U.S. and is calculated on a "basket" or type of income basis. A consequence is that foreign tax credits generated from one type of income (highly taxed dividends, for example) cannot be used to offset the U.S. tax liability generated from another type of income (lightly taxed portfolio income, for example). However, foreign tax credits can be averaged across foreign income in the same income basket. This means that excess credits on royalty income, for instance, can be used to offset U.S. tax liabilities on dividends paid from low–tax subsidiaries since both types of income are in the active income basket.

If a firm's foreign tax payments exceed the limitation on the credit, the firm is said to be in "excess credit." A parent in this situation pays no residual U.S. taxes on income repatriations from low–tax countries. Further, no U.S. tax is due on any royalty payments from foreign subsidiaries (which are generally deductible abroad) since they are fully offset by the firm's excess credits. Under current law, excess credits can be carried back to offset any U.S. tax payments on foreign source income made in the previous two years. Credits may also be carried forward without interest and used to offset U.S. tax liability in the following five years.

Firms for which foreign tax payments are less than the limitation are said to be in "excess limitation." These firms pay the difference between the U.S. and the foreign tax on dividends from subsidiaries located in low–tax countries. In addition, firms in excess limitation pay the full U.S. tax on royalty payments.

We approach the question of how location incentives under the current system are likely to be altered under dividend exemption from three different angles. We start by comparing the U.S. allocation of foreign direct investment (FDI) in manufacturing across low–tax versus high–tax jurisdictions with that of two major divi-

[1] The tax code contains provisions that hamper the ability of firms to avoid U.S. taxes on foreign income by retaining it abroad in low–tax jurisdictions. In general, these "anti–tax avoidance" provisions, contained in Subpart F of the tax code, limit deferral to earnings from active business investments abroad. Earnings from financial assets (such as Eurobonds and other passive financial investments) are denied deferral and taxed immediately.

[2] We discuss empirical estimates of the excess burden associated with repatriation taxes in a subsequent section.

dend exemption countries, Canada and Germany. Both Canada and Germany exempt dividends paid by foreign affiliates from home country tax by treaty.[3] An interesting question is whether, relative to U.S. FDI, the distribution of Canadian and German FDI is more skewed toward low–tax countries.

The second part of the paper uses effective tax rate calculations to quantify the burden of U.S. taxes on the typical investment in a low–tax affiliate under the current system and under dividend exemption. The model is an extension of the one developed in Grubert and Mutti (2001), hereafter GM. Although the small effective repatriation burden on dividends would be eliminated under dividend exemption, royalties would be fully taxed at the U.S. rate since no excess credits would be available to offset home country taxes on these payments. Whether effective tax rates increase or decrease relative to the current system depends on how firms respond to the dividend exemption system enacted.

The main focus in our effective tax rate analysis is on the role played by expense allocation rules under dividend exemption. These rules govern whether expenses incurred in the U.S. in support of investment abroad, such as headquarter charges and interest payments, are deductible against U.S. or exempt foreign income. In the absence of any expense allocation rules, parents would minimize tax payments by deducting expenses associated with investments in low–tax countries at the higher U.S. tax rate. This behavior could result in negative effective tax rates on investment projects placed in low–tax jurisdictions.

We assume in our analysis that if the U.S. were to adopt a dividend exemption system it would impose rules that require the parent company's overhead expenses be allocated to exempt foreign income and disallowed as deductions from U.S. taxable income. This treatment of expenses is a natural extension of Section 265 of the Internal Revenue Code, which disallows deductions for expenses related to tax–exempt income. Dividend exemption may, however, be enacted with less stringent expense allocation rules. In our sensitivity analysis we calculate effective tax rates under different expense allocation rules.

Our final approach involves using data from the tax returns of multinationals to gauge how location decisions will be affected by a move towards dividend exemption. As explained above, not all parents pay tax at the U.S. rate when they receive active income from operations located in low–tax countries under the current system. The last section of the paper compares the actual behavior of firms that face no residual U.S. taxes on low–tax foreign earnings (those with excess foreign tax credits) with those that are taxed at the U.S. rate (those without excess foreign tax credits). The idea is to use the former group of firms as a control group to predict the extent to which low taxes will attract U.S. affiliate investment under dividend exemption.

We use Treasury tax return data from the 1996 files to estimate the sensitivity of investment location decisions of U.S. MNCs to host country taxes. Since firms may switch into and out of situations in which they have excess credits (and this may affect economic behavior), we use measures that indicate whether a parent is likely to be exempt from residual U.S. taxes on foreign income in any year. These measures, which include the parent's average tax rate on foreign source income and foreign tax credit carryforwards as a fraction of foreign source income, allow us to test if parents that are "deep in

[3] Foreign affiliates must be at least 10 percent owned by home country residents to qualify for dividend exemption under both Canadian and German tax law.

excess credit" are any more sensitive to differences in effective tax rates abroad.

Taken together, our analysis provides no consistent or definitive evidence that location decisions would be significantly changed if dividend remittances were to be exempt from U.S. corporate taxation. However, each of our three approaches suggest that there is some possibility that U.S. MNCs will make adjustments to the allocation of assets held in operations abroad. Although we find that U.S. investment in Asia is more skewed towards the low–tax countries with which Germany and Canada have exemption treaties, the picture that emerges for Europe is mixed. Compared to the U.S. (and Germany), Canadian investment in the European Union is heavily weighted towards Ireland. Whether U.S. firms will shift towards a similar regional distribution in Europe is an open question. However, the evidence from our cost of capital and empirical analysis does not seem to support any large outflow of U.S. investment to low–tax locations.

Our effective tax rate calculations show that expense allocation rules and the full taxation of royalties under dividend exemption play a fundamental role in determining how the relative attractiveness of low–tax countries will change. Under the current system, we estimate that the typical investment in a country with an effective local tax rate of 7 percent faces an overall (home plus host country) effective tax rate of only 5 percent. If the U.S. were to exempt dividends and, at the same time, eliminate required expense allocations (or impose allocations that are easily avoidable), overall effective tax rates on low–tax investments abroad would fall somewhat to 3 percent. In contrast, if firms were required to allocate overhead expenses to exempt income under the new system, the same investment would face an overall effective tax rate of about 9 percent. As a result, investment in low–tax countries would not be encouraged relative to the current system.

The results from our third approach raise the possibility that U.S. MNCs may be somewhat more responsive to differences in effective tax rates under dividend exemption. We find that the sensitivity of location choices to host country effective tax rates does not increase as the parent's average tax rate on foreign source income increases. Other alternative measures of the extent to which a firm is "deep in excess credit" also failed to distinguish an effect on tax sensitivity. However, when we use the size of foreign tax credit carryforwards as an indicator of the likelihood that dividend remittances will face residual U.S. taxation, we do uncover a differential effect. The influence of host country taxes on location choice increases as a parent's foreign tax credit carryforward grows. Although the size of the effect is not quantitatively very significant, the results indicate the possibility that there will be an increase in investment in low–tax countries under dividend exemption.

A CROSS–COUNTRY COMPARISON OF FOREIGN DIRECT INVESTMENT PATTERNS

We start by discussing recent information on the distribution of foreign direct investment for the United States, Germany, and Canada. Some information on how the German and Canadian tax systems treat international income is necessary at this point. Although both Germany and Canada run worldwide tax systems with deferral and credit features, both exempt dividends received from foreign affiliates resident in countries with which they have tax treaties from home country taxation. The two countries differ in the way they treat expenses that are related to exempt dividend income. Both, however, seem to allocate much less expense than would be indicated by current U.S. practice. Under German tax law, 5 percent of dividends received from affiliates in

treaty countries are deemed to be expenses that are directly linked to exempt income. These "expenses" are disallowed so that effectively 95 percent of the dividend is exempt from German taxation. At present, Canada does not impose expense allocation rules. Under the Canadian system, parent corporations may fully deduct interest expense associated with debt used to finance affiliate investment.

In addition to the "exemption by treaty" features of the Canadian and German tax systems, there are many other features of the U.S. tax system that may increase the relative cost of U.S. investment in low–tax jurisdictions. For instance, the U.S. tax code appears to contain more stringent rules regarding what types of income qualify for deferral. Taken together, the differences in home country tax systems may result in U.S. investors facing higher tax burdens than German and Canadian investors in low–tax countries.

Previous research on the impact of home country tax systems on foreign investment has focused on FDI in the United States (see Hines, 1997 and 1999 for reviews of the literature on taxes and FDI). The results of this literature is mixed. Slemrod (1990), for example, uses time–series data to compare the tax responsiveness of FDI from exemption and foreign tax credit countries. His finds no difference between the two groups of countries in the sensitivity of FDI to U.S. corporate tax rates. Hines (1996) tests whether the responsiveness of manufacturing FDI to state tax rates differs across exemption and foreign tax credit countries. He finds a significant difference between the two groups of countries in terms of tax effects with exemption countries, as expected, exhibiting more responsiveness than foreign tax credit countries to differences in state tax rates. Our focus, while related, is on the distribution of outward FDI across low and high tax jurisdictions worldwide.

Table 1 shows the stock of FDI in manufacturing operations in low–tax countries as a percentage of total manufacturing FDI in Asia and the European Union (excluding Germany) in 1998.[4] For this table, a low–tax country is one that had an exemption treaty with Canada and Germany as well as an average effective tax rate of less than 10 percent.[5] In Asia, there are two countries with exemption treaties and low effective tax rates: Singapore and Malaysia. In Europe, only Ireland falls into our low–tax category. Note that our comparisons of the ratio of FDI in low–tax locations to all locations in a region assume that the distribution of assets in a particular region is independent of home coun-

TABLE 1
U.S., GERMAN, AND CANADIAN FOREIGN DIRECT INVESTMENT IN MANUFACTURING IN 1998

	U.S.	Germany	Canada
Asia			
Singapore and Malaysia as a share of total Asia	0.269	0.153	0.066
Europe			
Ireland as a share of European Union (except Germany)	0.067	0.016	0.170
Ratio of Ireland to U.K.	0.181	0.095	0.278

Sources: Survey of Current Business (Sept. 2000), Deutsche Bundesbank: Kapitalverflechtung mit dem Ausland (May 2000), and data released by request from Statistics Canada, Balance of Payments Division.

[4] The stock of foreign direct investment does not correspond directly to a measure of real assets since it excludes third party debt and includes other financial assets. We use foreign direct investment since it is the only comparable measure available. The FDI data include branches (which, at least for the U.S., accounts for a very small percentage of investment in manufacturing) and both direct and indirect holdings. The ownership threshold for inclusion in the FDI data is 20 percent for Germany, and 10 percent for both the U.S. and Canada.

[5] We use the average effective tax rate of U.S. CFCs to identify "low–tax" countries. This assumes that German and Canadian affiliates face effective tax rates that are similar to the ones faced by U.S. affiliates.

try tax rates. This assumption would not seem to bias the results either for or against finding differences in the distribution of investment across locations for the three countries.

Our cross–country comparison gives a mixed picture of how location incentives may change under dividend exemption. In Asia, U.S. affiliates in manufacturing hold a larger share of investment in low–tax countries than Germany and Canada. Almost 27 percent of the total stock of manufacturing FDI of U.S. firms in Asia was located in Singapore and Malaysia in 1998. For Germany this percentage is only 15 percent and for Canada it is just under 7 percent. This suggests that exempting dividends from U.S. taxation may not induce a significant reallocation of investment across low–tax jurisdictions in Asia. The evidence from Europe, however, suggests a more guarded prediction.

German affiliates hold a substantially smaller share of manufacturing FDI in Ireland (as a share of the European Union) than U.S. affiliates: 1.6 percent versus 6.7 percent. In contrast, Canadian manufacturing assets are heavily skewed to Ireland. Canadian investment in Ireland makes up 17 percent of the stock of FDI in the European Union (excluding Germany).[6] Further, the ratio of the investment in Ireland relative to Great Britain is 28 percent. For the United States, this ratio is only 18 percent. Thus, the Canadian experience in Europe hints that dividend exemption may have some effect on the location decisions of U.S. MNCs. Taken as a whole, however, the evidence from the FDI data presents a mixed picture. In the next section we quantify how the incentive to invest in low–tax countries like Ireland will change if the United States were to move to a dividend exemption system.

EFFECTIVE TAX RATES UNDER EXEMPTION

Will exempting dividends paid out of active income earned abroad from U.S. taxation reduce the overall tax cost of investing in low–tax jurisdictions abroad? To answer this question, one must accurately capture the tax incentives for low–tax investment both under the current system and under a "model" dividend exemption system. Graetz and Oosterhuis (2001) stress the heightened importance of allocation rules in their analysis of the issues involved in adopting a dividend exemption system for the United States. We follow GM and assume that dividend exemption will be paired with rules that allocate parent overhead expenses, such as interest, to exempt income.

There is no international norm with respect to the deductibility of parent overhead expenses if the taxpayer earns exempt foreign income. Canada is an example of a country that provides for full interest deductibility. The Netherlands and Australia, on the other hand, deny interest deductibility on funds that are traceable to foreign direct investment if dividends from the investment are exempt from home country taxation. Some other European countries have limits on interest deductibility; however, it is not clear to us whether they are based on "tracing" methods, in which an attempt is made to identify exactly which funds are used for a specific investment. Due to the fungibility of funds, the impact of tracing rules can be easily avoided. We assume that to the extent that interest expense allocations are imposed they would require pro–rata allocations based on the ratio of exempt foreign to worldwide assets instead of tracing.

[6] The Canadian data reported in the table for the United Kingdom does not include assets held in Northern Ireland.

We start by deriving the user cost of capital for investment in a low–tax country abroad. The model assumes that firms select investment to maximize profits, which entails investing in assets abroad until the present value of net returns just equals the outlay. This equality can be used to solve for the user cost of capital —the real pre–tax return on the marginal investment that just allows the firm to cover economic depreciation and earn the required real after–tax return. The goal of our exercise is to calculate the effective tax burden under the two systems for a typical (marginal) investment in a low–tax affiliate. The (marginal) effective tax rate is the difference between the real pre–tax return, C, and the required after–tax return, r, as a percent of the real pre–tax return.

The investment abroad is comprised of both tangible and intangible assets. Tangible assets, which are financed with both equity and debt, generate a potential flow of dividend income from the affiliate to the parent. We assume that the host country allows for economic depreciation on the tangible capital and grants no investment tax credit. Therefore the host country statutory rate equals the average local effective tax rate on net equity income from tangible capital. Intangible assets generate a flow of royalty income from the affiliate to the parent. Since royalties are (usually) deductible abroad at the local rate, the local effective tax rate on intangible capital is zero.[7] Finally, we assume, realistically, that the investment requires "other" overhead expenses, besides interest and R&D (which is allocated to royalty income).

Differences in the Taxation of Low–Tax Affiliates under the Two Systems

There are four important components of the taxation of foreign investment to consider in our comparisons of the user cost of capital under the two systems: the taxation of dividend and royalty income and the allocation of interest and "other" overhead expenses. Table 2 compares the tax treatment of these four components under the two systems and summarizes the discussion in this section.

We start with the taxation of dividend income. Although firms with excess credits currently pay no U.S. taxes on dividends, firms in excess limitation owe residual taxes to the U.S. Treasury when dividends are remitted from low–tax operations. Do these repatriation taxes have any impact on the cost of capital, and hence, location decisions? We follow GM and assume that repatriation taxes impose an additional tax burden for investment in low–tax affiliates and therefore must be incorporated in the cost of capital.[8] The repatriation burden in their formulation (and ours) is made up of two components: the repatriation tax itself and the deadweight loss from restructuring dividend remittances to minimize U.S. tax liabilities.[9] The effective repatriation tax, t_r, on net local equity income is written as follows:

[7] A few developing countries do not permit a deduction for royalties or impose a withholding tax that is equivalent to the basic corporate tax rate.

[8] The "new" view of dividend repatriation taxes, which dates back to Hartman (1985), and recent work by Weichenrieder (1996) and Altshuler and Grubert (forthcoming) suggest that these taxes are irrelevant to the affiliate's long–run capital stock for investment funded at the margin with retained earnings. It will become apparent later in the analysis that our qualitative results on the difference between effective tax rates under the two systems do not depend on which view is incorporated into the model (or, put alternatively, on the marginal source of funds for foreign investment). We incorporate the excess burden to be conservative in our effective tax rate calculations.

[9] Even though firms may have many alternatives to dividend repatriation, using these strategies to avoid the tax will create an excess burden that should be included in the cost of capital. See Grubert (1998), Weichenrieder (1996), and Altshuler and Grubert (forthcoming) for analyses of alternatives to dividend repatriation.

TABLE 2
COMPARISON OF TAX FEATURES OF THE CURRENT SYSTEM AND A DIVIDEND EXEMPTION SYSTEM

	Current System		Dividend Exemption System
	Excess limitation firms	Excess credit firms	
U.S. tax on dividend remittances	Pay residual U.S. tax plus cost of avoiding dividend repatriation.	No residual U.S. tax.	No residual U.S. tax.
U.S. tax on royalty payments	Taxable at U.S. rate.	No U.S. tax paid since U.S. tax liability absorbed by excess credits.	Taxable at U.S. rate.
Allocation of interest expense	The interest allocation rules have no impact on the parent's foreign tax credit. Thus, the allocation of domestic interest against foreign income has no effect on domestic interest deductions.	The interest allocation rules are binding. The allocation of domestic interest expense against foreign source income reduces the foreign tax credit limitation and therefore decreases foreign tax credits. Similarly, interest deductions in high-tax countries reduce foreign source income.	Interest expense must be allocated against exempt income.
Allocation of "other" overhead expenses	Same impact as above for interest expense.	Same impact as above for interest expense.	"Other" overhead must be allocated against exempt income (as above for interest expense).

[1] $t_r = p(t_{US} - t_g)/(1 - t_g) + EB$

where p equals the dividend payout ratio from foreign equity income, t_{US} is the statutory corporate tax rate in the U.S., t_g represents the gross–up rate on dividend repatriations, and EB is the excess burden due to restricting repatriations to avoid residual U.S. taxes. The gross–up rate reflects the effective foreign tax rate on the foreign equity income underlying the dividend. The total tax rate on net local equity income is the sum of the local tax rate, t_f, and the effective repatriation tax burden, t_r. For notational simplicity we denote this rate θ_f where $\theta_f = t_f + t_r$. Under dividend exemption the total tax rate on net local equity income is simply t_f since there are no residual U.S. taxes.

Like the taxation of dividend income, the taxation of royalties under the current system depends on the parent's foreign tax credit position. Firms in excess limitation pay full U.S. taxes on royalty remittances received from abroad. Firms in excess credit positions can shield U.S. taxes owed on royalty remittances with excess credits and therefore pay no U.S. tax on royalties. Under dividend exemption, royalties would be taxed at the U.S. tax rate since there would *never* be any excess foreign tax credits to offset the home country tax.

Next we turn to the allocation of interest expenses. For simplicity we assume in our analysis (and effective tax rate calculations) that the real interest rate equals the required after–tax return r.[10] The after–tax cost of debt finance is a function of where interest expense is deducted and may differ significantly under the two systems. In the absence of any interest allocation rules firms would maximize interest deductions by placing debt on the

[10] We abstract from any complications resulting from inflation or from differential interest rates around the world.

parent's (or any other high–tax affiliate's) books. Under the current system, however, interest allocation rules significantly reduce the benefit of placing debt on the parent's books if firms are in excess credit positions. According to these rules, a fraction of ***domestic*** interest expense (currently based on the ratio of foreign assets net of debt to worldwide assets net of foreign debt) is allocated against foreign source income. Since firms in excess credit positions are constrained by the foreign tax credit limitation, any decrease in foreign source income decreases the foreign tax credit that may be claimed in any year. As a result, any allocation of domestic interest expense to foreign source income is lost as a deduction.

We assume in our base case that under dividend exemption any domestic interest expense used to support the foreign project will be allocated against exempt income and therefore will not deductible at the U.S. rate. In response to the parallel treatment of interest expense, we assume that firms under dividend exemption and firms in excess credit under the current system restructure their borrowing and deduct all interest expense at the local rate (instead of at the U.S. rate). We incorporate these behavioral adjustments into our calculations to present a realistic picture of how investment incentives will differ under the two systems. An alternative assumption, which we reject, is to assume that parents will have no response to what could be a significant increase in after–tax borrowing costs.

Firms in excess limitation will find it attractive to carry the debt associated with marginal investments in low–tax jurisdictions on their own books (or on the books of affiliates in high statutory tax rate countries). Since the interest allocation rules currently in place are not binding for these firms, the value of the tax deduction is larger in the U.S. (or other high–tax affiliates) than in the low–tax affiliate by a factor equal to the difference in the after–tax interest rates, $r(t_{US} - \theta_f)$. Parents may, however, face constraints on the amount of debt that can be placed in high–tax jurisdictions. As a result, parents in excess limitation may place some debt in the low–tax affiliate. We conservatively assume that only one–half of the debt used to finance the project in the low–tax country is placed on the parent's books.

The final component of the cost of capital that may differ under the current system and exemption is the tax treatment of overhead deductions other than interest and R&D such as headquarter expenses. We assume that under the current system firms in excess limitation are able to deduct 75 percent of these "other" overhead expenses against U.S. taxable income (or taxable income in other high–tax affiliates). In contrast, firms currently in excess credit are unable to benefit from deducting "other" overhead at the higher U.S. rate (or against any other high–tax income in other foreign operations) since these deductions will reduce the (binding) foreign tax credit limitation. We assume that firms in excess credit deduct all of these expenses at the local rate to avoid losing foreign tax credits. Similarly we assume that under exemption "other" overhead expenses would be allocated to exempt income and therefore deducted at the local tax rate.

The Cost of Capital for Firms in Excess Limitation under the Current System

The cost of capital presented below, C_T, is the pre–tax required rate of return on tangible capital net of depreciation. Given the assumptions discussed above, the general formula for the cost of capital faced by excess limitation firms for a marginal investment in tangible capital can be written as follows:

$$[2] \quad C_T = \frac{r(1 - b\theta_f - .5b(t_{US} - \theta_f))}{1 - \theta_f + .75v(t_{US} - t_f)}$$

where b equals the fraction of marginal capital funded with debt and v equals overhead expenses on the marginal investment as a fraction of the pre–tax return. The last term in the numerator, $.5b(t_{US} - \theta_f)$, shows the benefit of deducting some portion of interest expense (50 percent under our assumptions) at the U.S. rate. The last term in the denominator, $.75v(t_{US} - t_f)$, shows the benefit of deducting 75 percent of overhead expenses at the U.S. rate.

The user cost of capital for investment in an intangible asset, C_I, is straightforward: $C_I = r/(1 - t_{US})$. Since the effective tax rate is simply the U.S. rate there is no tax advantage to exploiting the intangible in the low–tax affiliate. The user cost of capital for a marginal investment that is comprised of both tangible and intangible assets is a weighted average of the two user costs:

$$[3] \quad C = kC_T + (1-k)C_I = k\left[\frac{r(1 - b\theta_f - .5b(t_{US} - \theta_f))}{1 - \theta_f + .75v(t_{US} - t_f)}\right] + (1-k)\left[\frac{r}{1 - t_{US}}\right]$$

where k equals the percentage of the marginal investment that is made up of tangible assets.

The Cost of Capital for Firms in Excess Credit Positions under the Current System

Firms in excess credit positions receive both dividend and royalty remittances free of U.S. tax. However, as discussed above, these firms lose the ability to deduct interest and other overhead expenses against high–tax income and therefore are assumed to deduct all interest expense associated with the project at the local rate. As a result, the benefit of deducting expenses at the U.S. rate is completely lost and the last terms in the numerator and denominator of equation [2] vanish. On the other hand, however, there is no residual tax on dividends and thus the tax rate applied to net local equity income is t_f instead of θ_f. Therefore, the cost of capital for a marginal investment in tangible capital for the excess credit case is:

$$[4] \quad C_T = \frac{r(1 - bt_f)}{1 - t_f}.$$

Comparing [4] with [2] reveals that the firms in excess credit positions may actually face a higher cost of (marginal) tangible capital in the low–tax country than those in excess limitation.

The user cost for an investment in intangible capital, C_I, is simply r since royalties paid to the parent are shielded from any U.S. tax by excess credits. Thus, the cost of capital for a marginal investment made–up of both tangible and intangible capital is:

$$[5] \quad C = k\left(\frac{r(1 - bt_f)}{1 - t_f}\right) + (1-k)r.$$

The Cost of Capital under Exemption with Expense Allocations

It is easy to adjust the cost of capital formulas to capture the dividend exemption system we have described. Recall that we have assumed that under exemption all expenses are allocated against exempt income and, in response, firms will deduct all interest expense at the local rate. In addition, the benefit of deducting "other" overhead expenses at the high–tax rate vanishes. Therefore the user cost of capital for tangible investment is the same as in the excess credit case. Since there are no excess credits to shield U.S. taxes on royalties, the user cost of intangible capital equals $r/(1 - t)$ as in the excess limitation case. Therefore, the weighted average cost of capital under exemption for a marginal investment abroad is:

$$[6] \quad C = k\left(\frac{r(1 - bt_f)}{1 - t_f}\right) + (1-k)\left(\frac{r}{1 - t_{US}}\right).$$

Effective Tax Rates under the Two Systems

Table 3 presents effective tax rate calculations for investment in a low–tax country under the two systems. Our effective tax rate calculations assume that the low–tax affiliate is located in a country with a 7 percent effective tax rate, t_f, which is the average effective tax rate faced by U.S. subsidiaries in countries with average effective tax rates below 10 percent (see GM).[11] The U.S. statutory rate, t_{US}, is set at 35 percent. To calculate the average effective repatriation tax, t_r, we use parameter values for t_g, p, and EB that are based on GM's estimates from Treasury data. Repatriation rates from manufacturing affiliates in low–tax countries are quite low, about 7 percent or less for firms located in countries with effective tax rates below 10 percent in 1992.[12] Accordingly we set p equal to .07 in our effective tax rate calculations. Evidence from tax returns suggests that firms are able to time repatriations to occur when they face effective tax rates that are temporarily high thus resulting in higher dividend gross–up rates for the purpose of the foreign tax credit and lower repatriation taxes (see

TABLE 3
EFFECTIVE TAX RATES FOR INVESTMENT ABROAD IN A LOW–TAX COUNTRY

	Investment comprised of:		
	All tangible assets	All intangible assets	85% tangible and 15% intangible assets
Dividend exemption	**4.8%**	**35.0%**	**9.3%**
Current system			
(assuming 25% of firms in excess credit)	**1.7**	**26.3**	**5.4**
Excess limitation firms	0.7	35.0	5.8
Excess credit firms	4.8	0.0	4.1

Assumptions
Statutory and effective tax rates:
- the U.S. statutory tax rate is 35 percent
- the host country statutory tax rate and effective tax rate is 7 percent

Investment:
- tangible capital receives economic depreciation allowances and no investment tax credits
- intangible capital generates royalty income, which is deductible in the host country but taxable in the United States
- "other" overhead expenses (expenses besides interest and R&D) account for 10 percent of the pre–tax required rate of return (net of depreciation) on capital

Financing:
- marginal tangible investment is funded one–third with debt and two–thirds with equity
- the required after–tax rate of return on capital equals the real interest rate
- firms repatriate 7 percent of net of host tax earnings on marginal tangible capital and gross–up dividends for the purpose of the foreign tax credit at 15 percent
- the deadweight loss from restricting dividend repatriations for firms in excess limitation is 1.7 percent of net of host tax earnings on marginal tangible capital

Interest and "other" overhead deductions:
- Under the current system, firms in excess limitation deduct 50 percent of interest expense and 75 percent of "other" overhead expenses against U.S. or other high–tax income. Firms in excess credit deduct 100 percent of interest expense at the 7 percent rate and lose the advantage of deducting overhead at the 35 percent rate.
- Under exemption, allocation rules require that all expenses be allocated against exempt income. Firms deduct 100 percent of interest expense at the 7 percent rate and lose the advantage of deducting overhead at the 35 percent rate.

[11] Recall that since the low–tax country is assumed to offer no investment incentives the effective tax rate equals the statutory rate, t_f.

[12] The 1996 data shows even lower dividend repatriation rates. We continue to use the GM estimate of a 7 percent dividend payout rate to be conservative.

Grubert, Randolph, and Rousslang, 1996; and GM). We use a gross–up rate, t_g, of .15, which is conservative based on estimates from Treasury data. Finally, the excess burden parameter (*EB*) is .017, GM's estimate of the ratio of the efficiency loss associated with restricting repatriations to pre–tax earnings and profits of foreign affiliates with effective tax rates less than 10 percent. Using these parameter estimates from Treasury data, we calculate (using equation [1]) an overall effective repatriation tax burden for income earned in low–tax countries of just 3.3 percent of pre–tax earnings on equity income. This very small repatriation burden on dividend income substantially reduces the effective tax rate of investing abroad under the current residence–based system.

Table 3 shows effective tax rates for investments in tangible assets, intangible assets, and for a "typical" investment. The typical investment is made up of 15 percent intangible and 85 percent tangible assets.[13] We assume that tangible assets are financed two–thirds with equity and one–third with debt (b = 1/3). Data from tax returns indicates that overhead expenses are, on average, approximately 10 percent of the pre–tax return.[14] Accordingly, we set v equal to .10. Notice that the effective tax rate for the current system is a weighted average of the excess limit and excess credit rates based on the observation from the Treasury tax files that about 25 percent of the manufacturing income of U.S. affiliates abroad was associated with firms in excess credit positions in 1994.

The first column of Table 3 shows that effective tax rates are higher under exemption than under the current system for a marginal low–tax investment abroad in tangible assets. This is not at all surprising given the low estimated effective tax rate on dividend remittances combined with the ability of excess limit firms to deduct some portion of interest and overhead expenses at the 35 percent tax rate. In fact, effective tax rates for tangible investments in low–tax countries are lower for firms in excess limitation under the current system than for firms in excess credit which pay no residual U.S. taxes on dividend income!

Our calculations show that for the typical investment in a low–tax country abroad, dividend exemption with expense allocations is likely to increase effective tax rates relative to the current system. This result reflects that the majority of firms are in excess limitation and that the typical investment is weighted towards tangible assets. As the first column clearly shows, firms in excess limitation face very low effective tax rates on tangible capital placed in low–tax locations.

It is interesting to consider how sensitive our estimate of the current effective tax rate is to the repatriation burden parameter. As mentioned above, the 3.3 percent repatriation burden we use in our calculations is based on GM's estimates from tax return information. GM's prediction of how exemption would affect repatriations from low–tax countries is based on a dividend equation that includes a range of variables that may influence repatriation behavior. The independent variables include non–tax parent and subsidiary characteristics along with tax parameters that may influence dividend payments. Both the excess limit and ex-

[13] The importance of intangible assets is based on Commerce Department data. According to the 1994 Commerce Benchmark Survey of U.S. investment abroad, majority–owned manufacturing affiliates of non–bank parents paid $10.3 billion of royalties to their parents. This is 15.5 percent of the total pre–tax capital income base (net income + foreign income taxes + royalties+ interest paid). Using royalties based on tax returns, which are reported on the Form 1118, would yield a higher ratio.

[14] Other (non–R&D, non–interest) allocations in the general active non–financial basket were $14.04 billion in 1994. This is 12.7 percent of the total pre–tax capital income base reported in the 1994 Commerce benchmark for majority–owned non–financial affiliates of non–bank parents. Since some of the allocation is attributable to non–exempt income like sales source income, we assume 10 percent.

cess credit tax price of dividends are included since credit positions may be uncertain. While the excess limit tax price on dividends has a coefficient that is highly significant, the projected increase in dividends resulting from exemption (setting the repatriation tax to zero) is not enormous. Dividends (net of subpart F income) in the less than 10 percent effective tax rate group more than double but from a low base.

We could ignore all the other variables in GM's repatriation equation such as withholding taxes, which become more significant under exemption, and use the simple relationship between repatriation rates and local effective tax rates reported in GM to calculate the overall effective repatriation burden. To do this we assume that in the absence of any repatriation tax subsidiaries located in countries with effective tax rates below 10 percent repatriate the same percentage of after–tax earnings and profits as subsidiaries located in countries with effective tax rates between 20 and 30 percent. The latter group of subsidiaries had a repatriation rate of about 43 percent of (positive) earnings and profits in 1992 which is significantly larger than the (about) 7 percent repatriation rate of the former group (see Table 2 of GM).[15] This exercise gives an efficiency loss of about 5 percent. If we use an efficiency loss estimate of 5 percent rather than 1.7 percent, the effective tax rate under the current system increases to 7.3 percent, which is still below the exemption rate of 9.4 percent.

At the aggregate level, our deadweight loss and dividend change estimates appear to be similar to the ones estimated in Desai, Foley, and Hines (2001) using information from the Bureau of Economic Analysis Annual Survey of U.S. Direct Investment Abroad. These authors estimate that repatriation taxes reduce aggregate dividends by 12.8 percent. The repatriation equation we use projects about a 15 percent overall decrease. Desai, Foley, and Hines report an overall efficiency loss of 2.5 percent of dividends. However, when this is expressed in relation to total pre–tax income by adding back retained earnings and foreign taxes it appears to be about 1 percent, which is only slightly larger than the GM estimate of about .7 percent.

An important difference, besides expense allocations and dividend repatriation taxes, between the two systems is the taxation of the royalties generated from intangible assets. Table 3 shows that the advantage of placing intangible capital in low–tax locations will be significantly higher under exemption for firms in excess credit. For instance, the effective tax rate under exemption for an investment made up of 15 percent intangible capital is more than two times the effective tax rate currently faced by a parent in excess credit.

As Grubert stresses in his companion piece on dividend exemption and tax revenues, it is likely that firms facing increased tax burdens of investing abroad will make adjustments to their operations in an attempt to lower their effective tax rates (see Grubert, 2001). For instance, as we have already assumed, parents may shift the portion of debt currently on their books to the foreign affiliate where it can obtain a full interest deduction at the local tax rate. Parents also face strong incentives to reduce royalty payments (and substitute them with dividends, for example). Grubert (2001) suggests that there may be a significant decline in royalty payments that would have a substantial effect on the revenue cost of switching to a dividend exemption system. And Hines

[15] We do not consider the repatriation behavior of the group of subsidiaries with effective tax rates above 30 percent since this category includes those with 'excess' dividends because of negative tax prices. The dividend repatriation rate for this group of subsidiaries was 54 percent which is not much larger than the group facing effective tax rates between 20 and 30 percent (again, see Table 2 of GM).

(1995) and Grubert (1998 and 2001) have found that royalty payments received by U.S. MNCs from affiliates are responsive to tax prices. Using our formulas, we can calculate how effective tax rates would change if firms substituted dividends for royalty payments. For instance, if the royalty payout rate from intangible assets was decreased from 100 to 75 percent, the effective tax rate on the "typical" investment under exemption would fall by about 1.3 percentage points. This suggests that even a substantial switch from royalties to dividends may still leave firms with greater tax incentives to place capital in low–tax countries under the current system than under exemption *with expense allocations.*

What if exemption were passed without any expense allocation rules? Table 4 shows effective tax rates for the typical investment under exemption systems that do not require all overhead expenses to be allocated against exempt income. If allocation rules only for interest expense (and not "other" overhead expenses) are imposed the effective tax rate falls to 7.4 percent. This scenario, in which the parent deducts all interest at the local rate and 75 percent of "other" overhead at the U.S. rate, is shown in the second row of Table 4. Consider, on the other hand, a scenario in which firms are not required to allocate high–tax (or parent) *interest* expense used to finance investment in the low–tax affiliate against exempt income. Assume that under this system firms behave exactly as they did under the current system when the interest allocation rules do not bind and deduct one–half of interest expense at the U.S. rate. Assume further that no allocation rules for "other" overhead expenses are imposed and, as in the excess limitation scenario, firms deduct 75 percent of these expenses at the U.S. tax rate. In this case, shown in the third row of Table 4, the effective tax rate falls to 5.3 percent, which is almost identical to our estimate of the effective tax rate under the current system.[16] If exemption were passed with ***no*** expense allocations, the effective tax rate would fall even further. The last row of the table considers the case in which firms are able to make the same expense allocations as excess limit firms under the current system—50 percent of interest expense and 75 percent of "other" overhead is deducted at the U.S. rate.[17] In this case, the effective tax rate falls to 3.2 percent and investment in the low–tax affiliate becomes even more attractive.

TABLE 4
EFFECTIVE TAX RATES UNDER DIVIDEND EXEMPTION FOR VARIOUS EXPENSE ALLOCATION ASSUMPTIONS

	Effective tax rate for an investment made up of 15% intangible and 85% tangible assets
Base case[1]	9.3%
Exemption system with interest allocation rules[2]	7.4
Exemption system with no interest allocation rules[3]	5.3
Exemption system with no expense allocation rules[4]	3.2

Notes:
1. Allocation rules require all expenses (interest and "other" overhead) to be allocated against exempt income. Same assumptions as in Table 3.
2. Assumes that interest expense must be allocated against exempt income. Seventy–five percent of all "other" overhead expenses, however, are assumed to be deducted at the U.S. rate.
3. Assumes that one–half of interest expense is deducted at the local 7 percent rate and one–half is deducted at the U.S. rate. All "other" overhead expenses are allocated against exempt income.
4. Assumes that one–half of interest expense is deducted at the local 7 percent rate and one–half is deducted at the U.S. rate and that 75 percent of "other" overhead expenses are deducted at the U.S. rate.

[16] The cost of capital in this case is $kr[1 - bt_f - .5b(t_{US} - t_f)]/(1 - t_f) + (1 - k)r/(1 - t_{US})$.
[17] The cost of capital in this case is $kr[1 - bt_f - .5b(t_{US} - t_f)]/[1 - t_f + .75v(t_{US} - t_f)] + (1 - k)r/(1 - t_{US})$.

Our effective tax rate calculations make three noteworthy points. First, the treatment of allocations is a primary determinant of how investment incentives will change under dividend exemption. Second, the taxation of royalties has an important impact on the cost of capital abroad. Firms that locate relatively large fractions of intangible capital in low–tax countries will face relatively higher effective tax rates under exemption. These firms will have strong incentives to substitute dividends for royalties (which has revenue consequences for the U.S. Treasury). Finally, it is interesting to note that under the current system, firms that do pay residual taxes on dividend remittances—those in excess limitation—face effective tax rates on typical low–tax investments abroad that are substantially less than the U.S. rate (and, depending on the fraction of intangible assets, the host country rate). As stressed above, this is a result of the tax minimizing repatriation behavior of U.S. MNCs and their ability to deduct overhead expenses at the U.S. tax rate.

EXPLORING THE LOCATION DECISIONS OF U.S. MNCS UNDER DIVIDEND EXEMPTION

Economists have provided ample empirical evidence that the assets held in U.S. multinational corporations are responsive to variations in effective tax rates across foreign locations.[18] In fact, Altshuler, Grubert, and Newlon (2001), hereafter AGN, find that the investment location choices of U.S. manufacturing parents have become more responsive to taxes in recent years. To measure the sensitivity of location decisions to host country tax rates, AGN regress a measure of real capital held in each of the 58 countries in their sample on tax variables and measures of nontax characteristics of countries. These regressions yield an elasticity that measures the sensitivity of demand for capital in a country to changes in after–tax returns (for a given pre–tax return). Their elasticity estimates suggest that a 1 percent increase in after–tax returns led to a 1.5 percent increase in the real capital stock of manufacturing affiliates in 1984 and an almost 3 percent increase in 1992.

What does the recent empirical work say about moving to the type of dividend exemption system considered in this paper? The country–level analysis in the recent literature, and the effective tax rate calculations presented above, suggests that the current system provides similar tax incentives to the ones we would expect under a system in which dividends are exempt from home country taxation. However, one critique of this interpretation of the literature is that the empirical tests do not explicitly test the impact of residual home country taxes on location behavior. The empirical specification in AGN, for example, includes measures of host country effective tax rates only, not the combined effect of host and home country rates.[19]

The most recent work on this topic using country–level data appears in GM. They add measures of repatriation taxes to their asset location regressions and find that these taxes do not seem to affect the choice among investment locations abroad. GM also presents some interesting new evidence on the relevance of U.S. repatriation taxes to location decisions derived from firm–level data from the 1992 Treasury tax files. Their results, which are the starting point for our analysis, suggest that parents that pay no U.S.

[18] For recent evidence see, for example, Grubert and Mutti (1991, 2000, 2001), Hines and Rice (1994), and Altshuler, Grubert, and Newlon (2001).

[19] However, one could argue that since the repatriation tax for excess limit firms is highly correlated with host country tax rates, the regressions suggest that U.S. taxes on income repatriations are not significant determinants of investment location choices.

repatriation taxes on dividend remittances (those in excess credit positions in 1992) are not any more sensitive to differences in host country tax rates than parents that do pay residual U.S. taxes on foreign source income (those in excess limitation). In what follows, we extend this firm–level analysis to further explore the consequences of moving towards a dividend exemption system.

There are few important issues to address before using the Treasury data to make predictions of how firm location behavior will change under dividend exemption. The first concerns the extent to which firms that are currently in excess credit positions face the same incentives as firms that operate under territorial tax systems. Since our focus is on the consequences of moving to a tax system in which firms will *never* face residual U.S. taxes on dividends, it is important to distinguish firms that expect to persistently find themselves with excess credits from those who may temporarily transit into excess credit positions. It is possible that an important fraction of the firms in excess credit positions in any year are only temporarily exempt from residual taxes on dividends. These firms will behave as if they are in excess limitation if they expect that through carrybacks or carryforwards they will be able to claim their excess foreign tax credits.[20] In the analysis presented below we develop measures of excess credit positions that attempt to identify those firms that are "deep in excess credit."

Another difficulty in conducting the type of policy experiment we have in mind is a familiar one. Firms that are more sensitive to differences in host country tax rates are more likely to invest in low–tax countries and therefore are more likely to end up in excess limitation. This suggests that we control for factors that may be correlated with mobility. Further, it points out an econometric problem—credit positions are, to some extent, endogenous to location decisions. We have tried to correct for this potential endogeneity problem by using exogenous predictors of credit position in our regressions and through instrumental variable techniques.

We use a probit analysis to examine the determinants of location choice. This allows us to measure the impact of host country taxes and expected foreign tax credit positions on the probability that an affiliate is located in a particular country. By interacting our host country effective tax rate measure with our foreign tax credit measure we can test whether the location decisions of firms that expect to be in excess credit are more responsive to differences in host country tax rates. Before turning to a discussion of our tax variables, we describe the data and the non–tax independent variables. Summary statistics for all of the variables used in the regressions are included in an appendix table.

The data is formed from the 1996 Treasury tax files, which link information from parent tax forms and subsidiary information forms. The basic corporate tax form, Form 1120, provides information on the parent's income, expenses, and assets (as well as the parent's date of incorporation). Information on foreign source income, allocable and "not directly allocable" expenses, foreign tax credits, and the foreign tax credit limitation comes from the form filed to claim a foreign tax credit, Form 1118.[21] Since we are interested in how taxes affect the location of real business activity we have limited our analysis to the manufacturing affiliates of manufacturing

[20] In fact, in any given year, firms may view their foreign tax credit status as uncertain. For this reason, Grubert (1998), GM, and Altshuler and Grubert (forthcoming), for example, include both excess limit and excess credit repatriation taxes as independent variables in their regressions.

[21] We include only those parent firms that had a positive foreign tax credit limitation in our analysis. This eliminates about a third of parent firms from the analysis.

parents. Affiliate level information is provided on the Form 5471, which presents information on income and balance sheet items of controlled foreign corporations (CFCs) of U.S. parents.[22]

The parents in our sample, taken as a group, had affiliates in 60 different locations in 1996. Each observation in our analysis therefore consists of parent information linked to country information for each of the 60 potential locations. The dependent variable for each observation is set equal to one if the parent has at least one CFC in a country and zero otherwise. There are 365 parent firms in our dataset, which gives us 365*60 (=23,200) observations.[23]

The Non–Tax Control Variables

We control for both parent and country non–tax characteristics that may affect a firm's decision to locate an operation in a particular country using the same variables as GM. Starting with parent characteristics, we include information on both advertising and R&D expenditures (scaled by sales) to control for the possibility that these firms are more mobile internationally.[24] Firms with relatively large expenditures on these items are likely to possess a technology that can easily be exported and exploited outside the U.S. We also control for the labor and capital intensity of the parent under the presumption that labor–intensive firms are more mobile than capital–intensive firms. Labor intensity is measured by wage compensation as a fraction of sales; capital intensity is measured as expenditures on tangible capital (real plant and equipment) as a fraction of sales. We include the age of the parent to control for the effect of maturity on mobility—for any level of R&D and advertising expenditures, older firms may be more likely to be in a location if age is positively correlated with the presence of profitable intangible assets. Finally, we control for the size of parents under the assumption that larger firms, all else equal, may be more likely to find it profitable to set–up operations abroad. The log of operating assets measures the size of parents.

Country characteristics include GDP and GDP per capita as well as a trade variable that is constructed to measure the degree of openness of each country's economy. GDP and GDP per capita (obtained from World Bank, 1996) are included to control for differences in country demand and supply characteristics. The trade variable, obtained from the *World Development Report* (World Bank, 1987), runs from zero (most open) to three (most restrictive).[25] This openness indicator is interacted with our host country tax variable to control for the possibility that the benefit of locating in a country with low tax rates may be smaller in more restrictive trade regimes. We also include regional dummy variables to control for any region–specific effects that may impact location decisions.

The Tax Variables

The basic measure of the host country tax rate is the country average effective tax rate (hereafter, ETR) which is calcu-

[22] A controlled foreign corporation is a corporation that is at least 50 percent owned by a group of U.S. shareholders each of whom hold at least a 10 percent interest in the company.

[23] The probit analysis treats each parent–country observation as an independent observation. It is possible that there is a country effect that induces correlation of errors across different companies. We experimented with random effects estimation and found no substantial effect on our results.

[24] The R&D variable comes from the form firms file to claim the research and experimentation tax credit. In some cases it is supplemented with data from Compustat.

[25] This measure is based on observations from 1973 to 1985 of (i) the country's effective rate of protection, (ii) its use of direct controls such as quotas, (iii) its use of exports, and (iv) the extent of any overvaluation of its exchange rate.

lated by dividing total taxes paid by all CFCs in a particular country by their earnings and profits (using only those CFCs with positive earnings and profits to avoid a downward bias in the ETR). Both variables are available on the Form 5471. Following previous work we use the log of (1–ETR) as the local tax measure. In this way, the estimated coefficient gives the impact of variation in the after–tax rate of return in a country (for a given pre–tax return) on the probability of locating a CFC in that country.

Our focus is on the location decisions of firms that are unlikely to face any U.S. residual tax on active income earned abroad—firms that are "deep in excess credit." We experimented with several different methods of measuring a parent's likelihood of being in excess credit in 1996. These credit position measures are described in turn with our regression results. The key variable from our standpoint is the interaction between log of (1–ETR) and the foreign tax credit measure. The estimated coefficient on this variable will indicate whether firms that are effectively exempt from U.S. taxes on active income remittances are more sensitive to differences in host country tax rates.

Regression Results

Table 5 presents the results of our probit analysis. Our discussion of the results will focus on the foreign tax credit position and interaction terms since results from this type of location regression have been presented elsewhere in the literature using similar datasets (see GM and the working paper version of Grubert and Mutti, 2000). Before turning to our main discussion, we note that the estimated coefficients on the parent and country control variables have the expected signs and economic significance. Further, the results in Table 5 continue to confirm the results in the literature that host country tax rates are extremely significant determinants of firm location choice. In addition, the trade–tax interaction variable is always negative and highly significant. More restrictive trade regimes lessen the influence of low host country taxes on the probability of attracting U.S. affiliate location.

In column (1), we use the average tax rate on foreign source income, hereafter FSI, to gauge the extent to which a parent is in excess credit. The average tax rate on FSI, hereafter FATR, is measured using information from the foreign tax credit form.[26] To calculate the firm's FATR, we subtract any foreign tax credit carryovers from total foreign taxes paid (including withholding taxes and gross–up taxes on dividends) and divide by net FSI.[27] This gives us a measure of the average foreign tax rate paid on *current* FSI. As the FATR increases, parents become less likely to face U.S. residual taxes on FSI due to the presence of excess credits that soak up any residual U.S. tax liability. Interestingly, the estimated coefficient on the FATR is negative and statistically significant. Firms become *less sensitive* to host country tax rates as the average tax rate on foreign source income increases.

As mentioned above, the firm's FATR (and credit position) are endogenous to its location decisions. This endogeneity could lead to biased estimates of our credit position measure and interaction term. To find an exogenous indicator of expected credit positions, we regressed variables taken from the foreign tax credit form (Form 1118) on FATR. We found that the most significant determinants of FATR are "not directly allocable" expenses as a share of gross FSI, the share of dividends in total gross FSI, and the dividend gross–

[26] We calculate the FATR for the "active" income basket which includes remittances of earnings on active business investments abroad and contains the majority of foreign source income for manufacturing affiliates.

[27] This variable is truncated at one. Our results are not sensitive to this truncation.

TABLE 5
PROBIT ANALYSIS OF THE EFFECT OF FOREIGN TAX CREDITS ON AFFILIATE LOCATION
(SAMPLE CONSISTS OF MANUFACTURING CFCS OF U.S. MANUFACTURING PARENTS)[1]

	(1)		(2)		(3)		(4)		(5)	
	Coefficient	t–stat	Coefficient	t–stat	Coefficient	t–stat	Coefficient	t–stat	Coefficient	t–stat
Intercept	–5.80	(25.32)	–5.91	(25.85)	–5.88	(25.65)	–5.86	(25.77)	–5.88	(25.81)
Host country variables[2]										
Log of GDP	0.36	(34.42)	0.36	(34.41)	0.36	(34.39)	0.36	(34.41)	0.36	(34.44)
Log of GDP per capita	–0.00	(0.07)	–0.00	(0.12)	–0.00	(0.09)	–0.00	(0.09)	–0.00	(0.09)
Trade regime	–0.14	(4.88)	–0.15	(4.94)	–0.14	(4.91)	–0.14	(4.90)	–0.15	(4.90)
Parent variables										
R&D/sales	7.19	(11.14)	6.13	(9.42)	7.12	(11.01)	6.63	(10.34)	7.22	(11.14)
Advertising/sales	4.51	(11.31)	4.94	(12.35)	4.68	(11.75)	4.68	(11.73)	4.41	(11.00)
Labor costs/sales	0.42	(3.22)	0.47	(3.59)	0.47	(3.60)	0.45	(3.42)	0.38	(2.85)
Capital/sales	–0.50	(7.94)	–0.47	(7.66)	–0.50	(8.04)	–0.51	(8.22)	–0.50	(8.00)
Log of operating assets	0.21	(20.32)	0.21	(21.08)	0.21	(20.95)	0.21	(21.33)	0.21	(20.37)
Age	0.01	(21.63)	0.01	(22.04)	0.01	(21.73)	0.01	(22.16)	0.00	(21.59)
Host country tax variables										
Log (1–ETR)	1.51	(8.19)	1.18	(7.18)	1.32	(7.34)	1.19	(9.22)	1.22	(9.64)
Trade regime * log (1–ETR)	–0.24	(2.53)	–0.25	(2.61)	–0.25	(2.57)	–0.25	(2.56)	–0.25	(2.59)
Foreign tax credit position measures										
Average tax rate on FSI[3]	0.25	(1.79)			0.23	(2.10)			0.56	(8.47)
Average tax rate on FSI * log(1–ETR)	–0.94	(1.94)			–0.22	(0.58)				
"Not directly allocable" expenses/gross FSI			0.42	(3.12)						
"Not directly allocable" expenses/gross FSI * log(1–ETR)			0.28	(0.59)						
FTC carryforwards/net FSI										
FTC carryforwards/net FSI * log(1–ETR)							0.11	(1.07)	0.03	(0.41)
FTC carryforwards/net FSI * log(1–ETR) *							0.83	(2.14)		
average tax rate on FSI									1.30	(2.89)
Log–Likelihood	–7,939		–7,953		–7,953		–7,965		–7,931	

Notes: 1. Number of observations for all regressions equals 23,220 (= 365 parents * 60 potential locations).
2. All regressions include regional dummies (see appendix table for details).
3. Average tax rate on FSI equals total taxes paid abroad on foreign source income. In columns (1) and (5), this average tax rate is calculated net of foreign tax credit carryforwards. In column (3), the average tax rate calculation includes foreign tax credit carryforwards.

up rate (gross–up taxes on the foreign equity income underlying the dividend divided by total grossed–up dividends). The latter two measures are endogenous to firm location choice and repatriation behavior and, as a result, will not be appropriate instruments. The first measure, "not directly allocable" expenses, include overhead expenses such as interest, R&D, and headquarters charges. Although any economic variable like R&D spending or how leveraged a firm is may be endogenous to firm behavior, "not directly allocable" expenses seem to be an appropriate exogenous predictor of the extent to which a parent is "deep in excess credit." The higher are a parent's "not directly allocable" expenses the lower is the foreign tax credit limitation. Given a level of foreign taxes paid, this means that higher "not directly allocable" expenses are associated with an increase in the likelihood of being in excess credit.

Column (2) of Table 5 uses "not directly allocable" expenses (as a percent of gross foreign source income) as a measure of the extent to which firms expect to face repatriation taxes on dividend remittances. The estimated coefficient on the key interaction term, log (1–ETR) * "not directly allocable" expenses, is now positive but is not statistically different from zero.[28]

We also used "not directly allocable" expenses as an instrument for FATR. The results from the instrumental variables estimation (not reported) produced similar estimates to those in column (1) on our key interaction term. The coefficient on the fitted average tax rate interacted with the log of (1–ETR) was negative and not statistically different from zero.

The remaining columns in Table 5 use measures of credit positions that incorporate foreign tax credit carryovers. Since parents are allowed to carryback any excess foreign tax credits for two years, we can assume that any firm claiming a carryover in 1996 had been in an excess foreign tax credit position for at least three years.[29] Including foreign tax credit carryovers (which average 7 percent of net FSI) should produce a more accurate measure of the probability that a firm will pay U.S. taxes on dividend remittances. By netting carryovers from our FATR calculation in column (1), we have failed to distinguish between firms that may have the ability to absorb current excess credits through carrybacks and those that cannot. It is possible that this latter set of firms is more sensitive to differences in host country taxes.

In column (3), we include carryforwards in the foreign average tax rate calculation. Adding carryovers to the FATR increases the coefficient on the tax interaction term relative to the estimate in column (1), but makes it statistically no different from zero. The sensitivity of location choices to after–tax rates of return abroad does not change as the average tax rate *including carryovers* on FSI increases.

In column (4) we measure excess credit positions simply by the size of the foreign tax credit carryforward as a percentage of net FSI. It seems reasonable to assume that the higher is the carryforward, the less likely the parent is to transit out of an excess credit position in the future. This formulation results in a positive and statistically significant coefficient on the interaction term. Increases in the size of carryforward (relative to net foreign source income) do increase the sensitivity of location choice to host country taxes. This suggests that firms that do not expect to pay repatriation taxes are more attracted by low–tax rates abroad.

[28] The size and magnitude of this estimated coefficient is unaffected by the addition of interaction terms that allow tax sensitivity to differ according to the R&D or advertising intensity of the firm. These interaction terms test whether intangible asset intensive firms are more (or less) responsive to taxes. If there is a correlation between "not directly allocable" expenses and intangible capital, the interaction term could be biased. Our estimates, however, do not seem to be affected by this bias.

[29] About 7 percent of affiliates were associated with parents that claimed foreign tax credit carryforwards in 1996.

Column (5) breaks our measure of FATR into two components: current foreign taxes paid on FSI as a percent of net FSI and carryforwards (past taxes) as a percent of net FSI. This allows us to control for both the size of the parent's foreign tax credit carryforward and its foreign average tax rate on current income. The interaction term of interest is now between three variables, *carryforwards/net FSI* ∗ *FATR net carryforwards* ∗ *log* (1–*ETR*), and is positive and statistically different from zero. To gauge the economic significance of the coefficient consider the effect of an increase in the interaction term on the probability of investing in a low–tax relative to a high–tax location. At the means of the variables, with the interaction term set at zero, the ratio of the probability of a firm investing in a country with an effective tax rate of 5 percent, for example, relative to one with an effective tax rate of 40 percent is 1.80. Consider a CFC associated with a parent that has a FATR of 50 percent and carryforwards as a percentage of net FSI equal to 20 percent. This gives an interaction of .1 (=.5∗.2) and applies to about 6 percent of CFCs in our sample. Increasing the interaction term from zero to .1 increases the ratio of the probabilities of investing in the low–tax relative to a high–tax jurisdiction to 1.86. The effect is about a 3 percent increase in the likelihood of investing in the low–tax relative to the high–tax location. Although small, this suggests that low–tax rates are more attractive to firms that are effectively exempt from dividend taxation. If firms without foreign tax credit carryforwards (or small amounts) behave similarly under dividend exemption, there may be some reallocation of foreign direct investment to low–tax jurisdictions.

CONCLUSIONS

We have looked at the issue of dividend exemption on location incentives in several ways. The cost of capital analysis indicates that investment in low–tax countries is not likely to be encouraged as long as U.S. companies have to allocate overhead expenses to exempt income. The data on foreign direct investment in manufacturing by two major dividend exemption countries, Germany and Canada, revealed modest investment in low–tax countries in Asia. In Europe, Germany also has a relatively small share of its European investment in Ireland. But Canada has a substantially larger share than the United States. The analysis of the location choices by U.S. companies under current law also presents a somewhat inconsistent picture. Most of our attempts to identify the tax sensitivity of "deep in excess credit" companies failed to find any excess responsiveness to local tax rates. However, companies with large carryforwards of tax credits do seem to have a greater investment in low–tax countries, although the size of the effect was not very significant. Overall we cannot make any firm prediction of how location behavior would change if the U.S. were to adopt a dividend exemption system. However, the analysis provides no consistent or definitive evidence that dividend exemption would induce a large outflow of investment to low–tax locations.

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APPENDIX TABLE

SAMPLE STATISTICS

	Mean	Standard deviation
Host country variables		
Log of GDP	4.48	1.81
Log of GDP per capita	8.64	1.52
Trade regime (runs from 0 = most open to 3 = most restrictive)	2.11	1.14
North America dummy	0.03	0.18
Asia dummy	0.20	0.40
EEC dummy	0.20	0.40
Latin America dummy	0.28	0.45
Parent variables		
R&D/sales	0.01	0.02
Advertising/sales	0.02	0.03
Labor costs/sales	0.17	0.09
Capital/sales	0.27	0.23
Log of operating assets	13.52	1.21
Age	41.59	32.17
Host country tax variables		
Log (1–ETR)	–0.25	0.13
ETR	0.22	0.10
Trade regime * log (1–ETR)	–0.29	0.37
Foreign tax credit position measures		
Average tax on FSI	0.32	0.23
Average tax on FSI net carryforwards	0.26	0.18
Average tax on FSI net carryforwards * log(1–ETR)	–0.07	0.06
FTC carryforwards/net FSI	0.07	0.24
Percent with value greater than .50	0.04	0.19
FTC carryforwards/net FSI * average tax on FSI	0.03	0.17
Percent with value greater than .25	0.02	0.12
FTC carryforwards/net FSI * log(1–ETR) * average tax on FSI	–0.01	0.05
"Not directly allocable" expenses/gross FSI	0.22	0.19
"Not directly allocable" expenses/gross FSI * log(1–ETR)	–0.05	0.06

Rosanne Altshuler

Rosanne Altshuler is a Professor in the Economics Department at Rutgers University. She holds a B.A. from Tufts University and a Ph.D. in Economics from the University of Pennsylvania. Rosanne has been active in both the academic and policy worlds throughout her career. She returned to Rutgers University in September of 2010 after spending a year as the Director of the Urban-Brookings Tax Policy Center. Prior to taking the helm at the Center she was its co-director and a Senior Fellow of the Urban Institute. During previous leaves from Rutgers University, she served as Senior Economist to the President's Advisory Panel of Federal Tax Reform (2005) and acting Special Advisor to the Joint Committee on Taxation (2004). She has been a consultant to the U.S. Treasury Department and Finance Canada. Rosanne has published numerous articles in scholarly journals and books. Her work has also appeared in *Tax Notes* and *Tax Notes International*. She has taught at many universities including Columbia University, Princeton University, and New York University's School of Law. Rosanne has served on the Board of Directors of the National Tax Association and edited the *National Tax Journal* from 2001 through 2006.

STEVE EDGE
CORPORATE TAX PARTNER

SLAUGHTER AND MAY
LONDON

Steve, who qualified with Slaughter and May in 1975, acts for a very wide range of clients across the full range of our practice.

Steve advises on tax structuring and the tax aspects of documenting both private and public mergers, acquisitions, disposals and joint ventures. He acts for investment banks in relation to their structured finance businesses and has for many years been a leading practitioner in the tax aspects of corporate finance.

Steve has an extensive tax consultancy practice which includes advising on business and transaction structuring, dealing with in-depth tax investigations and tax litigation and doing a large amount of work in the transfer pricing/thin capitalisation area. Much of this involves dealing or negotiating with HM Revenue & Customs.

A large part of Steve's practice involves advising non-UK multinationals (particularly those based in the US) on cross-border transactions of various types. As a result of such extensive international tax exposure, Steve has established excellent relationships with other leading tax advisers around the world. For many years, Steve has been a regular contributor to a wide variety of tax publications and he is a regular speaker at conferences (particularly in Europe and the US).

Jason Furman

Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council

Jason Furman is a Deputy Assistant to the President for Economic Policy and the Deputy Director of the National Economic Council. Furman took leave from the Brookings Institution to become the Economic Policy Director of Obama for America, where he helped develop and communicate the campaign's policies. He was a Senior Fellow in Economic Studies and Director of the Hamilton Project at Brookings. He began his career in public service during the Clinton administration, as a Staff Economist at the Council of Economic Advisers and subsequently a Special Assistant to the President for Economic Policy at the National Economic Council. In addition, he was a Senior Adviser to the Chief Economist and Senior Vice President of the World Bank. Furman has also worked on research and in academia as a Visiting Scholar at NYU's Wagner Graduate School of Public Service, as a visiting lecturer at Yale and Columbia Universities, as a Senior Fellow at the Center on Budget and Policy Priorities and at the Brookings Institution. He has conducted research in a wide range of areas, including fiscal policy, tax policy, health economics, Social Security, and monetary policy. Published in a variety of scholarly journals and popular publications, he recently edited two economic policy books. Furman earned his Ph.D. in economics and a M.A. in government from Harvard University and an M.Sc. in economics from the London School of Economics. He is married with two young children.

Michael J. Graetz

Michael J. Graetz is the Isidor and Seville Sulzbacher Professor of Law and the Columbia Alumni Professor of Tax Law at Columbia Law School. Before coming to Columbia in 2009, he was the Justus S. Hotchkiss Professor of Law at Yale University, where he had taught since 1983. Before Yale, he was a professor of law at the University of Virginia and the University of Southern California law schools and Professor of Law and Social Sciences at the California Institute of Technology. His publications on the subject of Federal taxation include a leading law school text and more than 60 articles on a wide range of tax, international taxation, health policy, and social insurance issues in books and scholarly journals. His most recent book is *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States,* published by Yale University Press, in 2008. His previous books include *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth* (Princeton University Press; 2005); *True Security: Rethinking Social Insurance* (Yale University Press, 1999); and *The U.S. Income Tax: What It Is, How It Got That Way and Where We go From Here*, (W.W. Norton & Co, 1999) (a paperback edition of the book originally published as *The Decline (and Fall?) of the Income Tax*) and *Foundations of International Income Taxation* (Foundation Press, 2003.) He is also the co-author of a leading law school coursebook, *Federal Income Taxation: Principles and Policies,* (Foundation Press; 2009).

During January-June 1992, Michael Graetz served as Assistant to the Secretary and Special Counsel at the Treasury Department. In 1990 and 1991, he served as Treasury Deputy Assistant Secretary for Tax Policy. Professor Graetz has been a John Simon Guggenheim Memorial Fellow, and he received an award from Esquire Magazine for courses and work in connection with provision of shelter for the homeless. He served on the Commissioner's Advisory Group of the Internal Revenue Service. He served previously in the Treasury Department in the Office of Tax Legislative Counsel during 1969-1972. He is a fellow of the American Academy of Arts and Sciences.

Professor Graetz is a graduate of Emory University (B.B.A. 1966) and the University of Virginia Law School (J.D. 1969). A native of Atlanta, Georgia, Michael Graetz is married to Brett Dignam and has five children.

Charles H. Gustafson

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Biography

Professor Gustafson pursues his interest both in tax law and policy and in international law at the Law Center. He teaches Tax I, International Tax Planning, International Business Transactions, International Law, and The Art of the Washington Lawyer. He is the author of articles on taxation and international law issues, co-author of three casebooks on taxation, has been active in various committees on tax and international law of the American Bar Association and the American Law Institute, and serves as an arbitrator in domestic and international contract disputes. He has lectured on matters of international importance, taught courses for the Internal Revenue Service, and served for five and a half years as the Associate Dean for International and Graduate Programs. Before joining the Law Center faculty in 1972, his professional experiences ranged from attorney advisor at the State Department to lecturer in law at the Ahmadu Bello University in Zaria, Nigeria, where he assisted with the organization of the first law degree program in that country. He also practiced privately as an associate with the New York firm of Shearman and Sterling and the D.C. firm of Surrey and Morse. Professor Gustafson has lectured at universities and to professional groups in every inhabited continent.

James R. Hines Jr.

James Hines teaches at the University of Michigan, where he is the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and the L. Hart Wright Collegiate Professor of Law in the law school. He also serves as Research Director of the Office of Tax Policy Research at the Ross School of Business. His research concerns various aspects of taxation. He holds a B.A. and M.A. from Yale University and a Ph.D. from Harvard, all in economics. He was on the faculties of Princeton and Harvard prior to moving to Michigan, and has held visiting appointments at Columbia University, the London School of Economics, the University of California-Berkeley, and Harvard Law School. He is a research associate of the National Bureau of Economic Research, research director of the International Tax Policy Forum, co-editor of the American Economic Association's *Journal of Economic Perspectives*, and once, long ago, was an economist in the United States Department of Commerce.

Dr. Jack Mintz

The James S. & Barbara A. **Palmer Chair** in Public Policy

Dr. Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of ***International Tax and Public Finance*** **and the** ***Canadian Tax Journal**,* and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to the National Post, and has frequently published articles in other print media.

Dr. Mintz presently serves on several boards including Brookfield Asset Management, Imperial Oil Limited, Morneau Sobeco, and Royal Ontario Museum.

Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen's University, Kingston, 1978-89. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C. D. Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; Chair of the federal government's Technical Committee on Business Taxation in 1996 and 1997; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993 – 1995. He was founding Editor-in-Chief of ***International Tax and Public Finance**,* published by Kluwer Academic Publishers from 1994 – 2001, and recently chaired the Alberta Financial and Investment Policy Advisory Commission reporting to the Alberta Minister of Finance. He served as a member of the Economic Advisory Council to advise on economic planning, and recently was the research director for the Federal-Provincial Territorial Minister's Working Group on Retirement Income Research.

In 2002, Dr. Mintz's book, ***Most Favored Nation: A Framework for Smart Economic Policy**,* was winner of the Purvis Prize for best book in economic policy and runner-up for Donner Prize for best book in public policy.

Dr. Mintz has consulted widely with the World Bank, the International Monetary Fund, the Organization for Economic Co-operation and Development, the governments of Canada, Alberta, New Brunswick, Ontario, and Saskatchewan, and various businesses and nonprofit organizations.

William H. Morris

Senior International Tax Counsel
& Director, European Tax Policy

General Electric International

Will Morris is currently Senior International Tax Counsel, and Director, European Tax Policy, in General Electric's corporate tax department. Since August 2003 he has been based in London, England and before that in Fairfield, CT.

At GE, Will works on a wide range of international tax matters relating to GE's foreign operations, with principal responsibility for coordinating GE's European tax policy program.

Will has degrees in history, law, and theology from Trinity College Cambridge, the University of Virginia, and St Mellitus College, respectively. He is qualified as a US attorney and an English solicitor.

After private practice in London and Washington, DC, he joined the IRS in 1995, moving to the Office of Tax Policy at the US Treasury in January 1997 to work on international tax policy. Will was Associate International Tax Counsel at the US Treasury until March 2000.

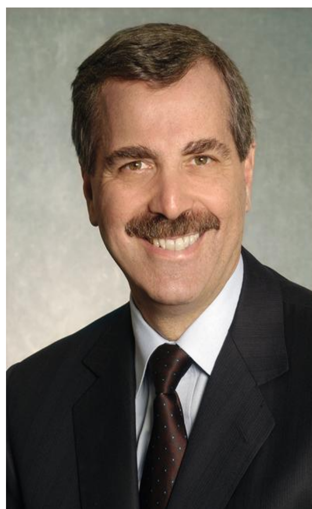
Will was recently appointed Chair of the CBI Tax Committee, is also Chair of the AmCham EU Tax Taskforce, and is the Chair-Elect of the BIAC Tax Committee.. He is also chair of the European Tax Policy Forum, a registered UK charity that sponsors independent academic research into business tax issues.

Paul W. Oosterhuis

Mr. Oosterhuis is an international tax partner in the Washington, D.C. office of Skadden, Arps, Slate, Meagher & Flom LLP and is the firm-wide leader of its various regulatory practice groups. Mr. Oosterhuis has had extensive experience in cross-border acquisition and disposition transactions, financing arrangements and tax planning for U.S. and foreign-based multinational corporations. He also frequently represents clients on international tax controversy matters, as well as regulations and rulings proceedings, with the Internal Revenue Service. In particular, he frequently represents clients in intercompany pricing matters, including in Advance Pricing Agreement and Competent Authority negotiations.

He received his B.A. from Brown University and his J.D. Degree from Harvard Law School. In 1973 he became a Legislation Attorney for the Joint Committee on Taxation, U.S. Congress, and in 1977 and 1978 served as the Committee's Legislation Counsel. He entered private practice in 1979. He has also served as an Adjunct Professor at Georgetown University Law Center, where he taught International Taxation in the Master of Taxation graduate law program.

He is a member of the bar of the District of Columbia and is admitted to practice in the U.S. Tax Court.



Profile for

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Profile:

Nick is an international tax partner in the Toronto office of PricewaterhouseCoopers LLP and the leader of the firm's Canadian National Tax Services group. A former leader of the firm's International Tax Services group, he is recognized as one of Canada's leading tax advisors with over 25 years experience in providing corporate income tax advice to a number of Canada's largest corporations, including advising on various tax policy initiatives and facilitating dialogue on such initiatives with the Department of Finance. In December 2007, Nick was appointed by federal Finance Minister James Flaherty to serve as a member of the Advisory Panel on Canada's System of International Taxation.

Nick is a regular speaker at tax and business conferences on taxation matters, including conferences sponsored by the Canadian Tax Foundation, the International Fiscal Association, and the Tax Executives Institute. He has written numerous papers on various tax matters. He is a former co-editor of the International Tax Planning feature of the Canadian Tax Journal and a recipient of the Douglas J. Sherbaniuk Distinguished Writing Award, presented annually by the Canadian Tax Foundation.

Nick joined PricewaterhouseCoopers in 1980 and was admitted to the partnership in 1991. He holds a Bachelor of Commerce degree from the University of Toronto and became a Fellow Chartered Accountant in 2006. He is a former Adjunct Associate Professor of international tax at the University of Waterloo Master of Taxation program and a former lecturer and the course coordinator at the Canadian Institute of Chartered Accountants Advance International Tax Course. He is a former and founding member of the Canadian Institute of Chartered Accountants Tax Policy Committee and a past governor of the Canadian Tax Foundation. Currently, he is a member of the C.D. Howe Institute's Fiscal and Tax Competitiveness Council and is the Vice-President of the Canadian Branch of the International Fiscal Association.

Stephen R. Richardson

Biographical Notes
December, 2010

Stephen R. Richardson recently retired as Associate Deputy Minister, Department of Finance, Government of Canada, following a long career in public service and private practice.

Prior to his appointment as Associate Deputy Minister in 2007, Mr. Richardson was Director and Chief Executive Officer of the Canadian Tax Foundation, an independent tax research organization that provides the public and the Government of Canada with expert impartial tax research on current issues of taxation and government finance.

From 1975 to 2001, Mr. Richardson was engaged in the practice of tax and corporate law with Torys LLP (from 1981 as a partner) in Toronto, where he focused on the taxation aspects of corporate finance, mergers and acquisitions and other corporate transactions, with emphasis on international transactions.

On leave from law practice, from 1983 to 1985, he served as Director of Tax Policy -- Legislation, at the Department of Finance, Canada. From 1993 to 1994, he also took time off from his law practice to act as Visiting Professor at the University of Toronto, Faculty of Law and Professor of Policy at the Institute for Policy Analysis.

From 2001 to 2003, Mr. Richardson served as Senior Assistant Deputy Minister, Tax Policy, at the Department of Finance, Canada.

He has written extensively on taxation and finance and has been a lecturer on related issues at the, the University of Toronto, Faculty of Law, and the Tax Programme at the University of Waterloo, School of Accountancy.

Mr. Richardson received a B.A. (with High Distinction) from Wayne State University in 1968, and an M.A. from the University of Michigan in 1970. In 1973, Mr. Richardson earned an LL.B (with Honours) from the University of Toronto, Faculty of Law. He has been a member of the Ontario Bar since 1975.

John M. Samuels

John Samuels is GE's Vice President and Senior Counsel for Tax Policy and Planning. He is responsible for GE's worldwide Tax Organization and for the Company's global tax planning and tax compliance operations. He is a member of GE's Corporate Executive Council, the GE Capital Corporation Board of Directors, the GE Finance Council and the GE Pension Board.

Prior to joining GE in 1988, he was a partner in the law firm of Dewey, Ballantine in Washington, D.C. and New York City. From 1976 to 1981 Mr. Samuels served as the Deputy Tax Legislative Counsel and Tax Legislative Counsel of the U.S. Department of Treasury in Washington, D.C.

Mr. Samuels is the Chairman of the International Tax Policy Forum, a Fellow of the American College of Tax Counsel, and a member of the University of Chicago Law School Visiting Committee. Mr. Samuels was an adjunct professor of taxation of NYU Law School (1975 to 1986), and currently is the Jacquin D. Bierman Visiting Lecturer at Yale Law School where he teaches courses in international taxation.

Mr. Samuels is a graduate of Vanderbilt University (1966) and the University of Chicago Law School (1969), and received an LLM in taxation (1976) from NYU Law School.

CHIZURU SUGA

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EDUCATION

THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA **Philadelphia, PA**
Master of Business Administration; Major in Healthcare Management **2007-2009**

UNIVERSITY OF TOKYO **Tokyo, JAPAN**
Bachelor of Arts in Law, Concentration: M&A and International Financial Law **1999-2003**

PROFESSIONAL EXPERIENCE

GOVERNMENT OF JAPAN, MINISTRY OF ECONOMY, TRADE AND INDUSTRY **Tokyo, JAPAN**
Government Lawyer/Economist **2003-Present**

Deputy Director, **International Tax Systems, Trade and Investment Facilitation Division**

May '09 – Present

- Introduced the corporate tax breaks for certified foreign companies, for the first time in the history of Japan, to attract foreign direct investment and maintain Japan's position as the Asian business hub.
- Liberalized and clarified Japan's CFC rules to help Japanese multinational corporations with the regional headquarters (RHQs) and with the subsidiaries in China, Korea, Indonesia and Malaysia.

Chief Assistant Director**, Agency for Natural Resources and Energy**

Oct '04 – Jul '07

- Navigated post-Kyoto climate change negotiations through G8 Gleneagles and St. Petersburg summits.
- Co-authored 'Kyoto Protocol Target Achievement Plan', which provides the road map for Japan national climate change policies in the next 5 years.
- Took initiative for the strategic utilization of Official Development Assistance (ODA) for energy diplomacy.
- Oversaw the downsizing and the energy conservation of 2000 shippers and 300 transportation companies to cope with environmental risks.
- Participated in G8 summit, WTO and IEA meetings as an energy expert.

Staff, Trade Finance and Economic Cooperation Division

Apr '03- Sep '04

- Planned the institutional reform and privatization of National Agency (NEXI) on a special task force. Opened up the short-term export credit insurance market in Japan.
- Engaged in reconstruction assistance for Afghanistan and Iraq.

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Practice Experience

Gary M. Thomas concentrates on international tax planning and tax controversies. He is registered as a Japanese zeirishi (licensed tax attorney), fully qualified to practice before the National Tax Agency (NTA) and the National Tax Tribunal, the only US tax lawyer with such qualifications. He has worked in Japan for over 25 years and is fluent in spoken and written Japanese. Mr. Thomas also is a member of the California Bar and the Illinois Bar and is registered in Japan as a gaikokuho jimu bengoshi.

Mr. Thomas advises US, European, Japanese and other companies in connection with tax planning and defense and resolution of tax controversies in audits, domestic appeals, and government-to-government consultations under tax treaties. He is well known as an expert in transfer pricing planning and documentation, audits, competent authority procedures and advance pricing arrangements (APAs) involving Japan. He also has handled cases involving permanent establishment issues for foreign firms.

In addition, he provides advice concerning US and Japanese tax law and international tax treaties for various transactions involving Japan, including M&A, joint ventures, partnerships, and inbound and outbound investments.

Mr. Thomas is listed as a "Band 1" leading individual for Tax in Japan by *Chambers Asia,* which described him in 2010 as "the best tax litigator in Japan" and in 2009 as *"the go-to guy for transfer pricing in Japan."* He also has been named as a leading individual in the International Tax Review's *World Tax Guide 2011*, the sixth consecutive year since 2006, as well as in the Tax Directors Handbook 2011. He has also been listed in *Best Lawyers International* in Japan for Tax.

Mr. Thomas was the Chair of the Taxation Committee of the American Chamber of Commerce in Japan (ACCJ) from 2000 through 2002. He was deeply involved in the effort to encourage the US and Japan to negotiate a new US/Japan income tax treaty, which went into force in 2004. He headed the tax subcommittee which contributed to ACCJ's 2010 "Growth Strategy Task Force." He also served as the principal ACCJ representative on a tax task force

Bars and Courts

California State Bar, admitted 1977

Illinois State Bar, admitted 1978

Registered as Gaikokuho Jimu Bengoshi in Japan, 1993

Registered as a Zeirishi (Licensed Japanese Tax Attorney), 1997

Education

B.A., University of Washington in Seattle, 1973, Political Science and Japanese Languages

J.D., Harvard Law School, 1977

LL.M., Masters of Japanese Law, Asia University, 1989, Taxation and Masters of Japanese Accounting, Asia University

Professional Associations

California State Bar Association

Illinois State Bar Association

Dai-ni Tokyo Bar Association

Tokyo Zeirishi Association

Citizenship

United States

Languages

English, Japanese

Gary M. Thomas

Partner

Tokyo

established with the Japan Chamber of Commerce that issued recommendations for improving the Japanese tax system to facilitate international business.

He served as instructor in the advanced international tax course at Japan's National Tax College, the in-house training institute of the NTA, and lectured on international tax treaties at the International Seminar for Taxation in Asian Countries (ISTAC), a training institute operated by the NTA for foreign tax officials.

Mr. Thomas has written and lectured extensively (in both Japanese and English) on transfer pricing, international tax planning, and dispute resolution. He is the author of the Japanese transfer-pricing chapter in BNA Tax Management's Foreign Income Portfolio series.

He received his Bachelor of Arts in Political Science and Japanese Language from the University of Washington in 1973, his law degree from Harvard Law School in 1977, and master's degrees in law (taxation) and business administration (accounting) from Asia University, Tokyo.

William M. Treanor

Professor of Law; Executive Vice President and Dean of the Law Center
B.A., J.D., Yale; Ph.D., Harvard

Dean Treanor joins the Law Center from Fordham Law School, where he had been dean of the law school since 2002 and Paul Fuller Professor. He had been on the Fordham faculty since 1991. He has also been a visiting professor at the Sorbonne. From 1998-2001, Dean Treanor served as Deputy Assistant Attorney General in the Office of Legal Counsel, U.S. Department of Justice. From 1987-1990, he was associate counsel, Office of Independent Counsel, during the Iran/Contra investigation, and in 1990 he served as a special assistant U.S. attorney, Misdemeanor Trial Unit, Office of the U.S. Attorney for the District of Columbia. Dean Treanor was law clerk to the Honorable James L. Oakes, U.S. Court of Appeals for the Second Circuit, Brattleboro, Vermont. He has published widely, with a focus in constitutional law and legal history.

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Mike Williams

Mike Williams is Director Business and Indirect Tax at HM Treasury. As such he is responsible for corporation tax, capital gains tax, value added tax, other consumption taxes and environmental taxes. His main tax expertise is in international tax and banking.

Mike is the UK delegate to the OECD's Committee on Fiscal Affairs and a vice-chair of the CFA's Bureau. He is also a member of the Steering Group of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Among previous posts, Mike was:

- Director Personal Tax and Welfare Reform at HM Treasury from January 2008 to March 2010. This involved responsibility for income tax, social security contributions, inheritance tax, tax credits, savings and pensions and social security benefits;
- Director International Tax at HM Treasury from July 2004 to January 2008. As such he was responsible for cross-border aspects of direct and indirect tax, including VAT, and for the conduct of and responses to tax litigation before the European Court of Justice;
- Deputy Director, International at the Inland Revenue from 2001 to 2004, with responsibility for business tax, in which role he was Competent Authority under the UK's tax treaties.

Mike has a degree in physics from Balliol College, Oxford.