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Across the Great Divide: A Centrist Tax Reform Proposal

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U.S. corporate and international tax rules put U.S. multinationals at a disadvantage while raising less revenue than would be expected when compared with the revenue collected by other countries with lower corporate tax rates. U.S.-based companies often do not repatriate profits in the absence of complex and controversial tax planning transactions, and foreign businesses often find the United States inhospitable from a tax perspective.

The time has come for a pragmatic and centrist reform of the U.S. corporate and international tax rules. Such a reform could involve reducing the corporate rate to the OECD average and exempting active foreign dividends from income. It could involve indirectly limiting the deductibility of expenses allocated to exempt dividends by partially taxing the dividends, further restricting the ability of U.S.-based companies to artificially shift profits out of the United States or to engage in round-tripping transactions, reconsidering a variety of corporate tax expenditures, and introducing a VAT.

There may be other revenue-neutral reform ideas that could be integrated into this proposal or that are better alternatives. The question is whether a serious discussion is possible. The answer is yes, and the time is now.

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I. Introduction

Near the end of my tenure at Treasury, a wise man said to me: ''There is no objective truth in international tax policy. Ultimately, the choices are political.'' Some years later, in a prominent lecture, a highly respected congressional staff member expressed a somewhat similar sentiment about tax policy more generally.[1]

These views can be interpreted to mean that either there is no objective measure of good business tax policy or there is objective merit in both sides of the debate. Having lived through years of polarizing arguments about corporate and international tax reform, I can only conclude that both sides have merit.

On one hand, the following propositions regarding corporate taxation generally seem compelling:

- a low rate, accompanied by a broad base, is the best foundation for a tax system;
- the corporate income tax is highly inefficient[2];
- the incidence of the corporate income tax falls on shareholders, employees, or customers, but not ultimately on the corporation itself;
- corporate earnings are taxed twice — once when earned by the corporation and again when distributed to individuals — in the absence of some form of dividend and capital gain relief;

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[1]John Buckley, 2007 Woodworth Memorial Lecture, ''Tax Changes Since Woodworth's Time: Implications for Future Tax Reform,'' 34 *Ohio N.U.L. Rev.* 1, 15 (2008) (''Laws enacted without regard to politics seldom last long.'')

[2]*See* OECD, *Tax Policy Reform and Economic Growth* (Tax Policy Study No. 20) 22 (2010):

> Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity improvements. Also, most corporate tax systems have a large number of provisions that create tax advantages for specific activities, typically drawing resources away from the sectors in which they can make the greatest contribution to growth.

- place of corporate organization is a tenuous ground on which to base significant tax distinctions;
- the lower the corporate tax rate, the less the incentive for planning, sheltering, and other activity creating dead-weight loss in the system;
- job growth is more likely when businesses are more profitable[3]; and
- the more attractive our tax system is to businesses, the more likely we are to attract foreign investment and retain domestic investment.

On the other hand, the following propositions also seem compelling:

- if we reduce corporate tax, we are likely, at least in the short term, to reduce revenue that may need to be recouped through other taxes;
- if corporations do not pay the same tax as other businesses, there will be a bias in favor of doing business in corporate form solely for tax reasons (stated differently, the corporate tax serves as an anti-deferral mechanism);
- if corporations do not bear a specified minimum tax burden, the system may seem unfair, individuals may have less respect for the system, and compliance may suffer;
- although corporate rate reductions may be justified on grounds of competitiveness, there are few, if any, rigorous cross-country comparisons of tax competitiveness, and the United States appears to compare quite favorably with other jurisdictions when competitiveness is evaluated by taking into account all business factors, not just taxes;
- U.S. corporate organization provides some benefits, which may justify the imposition of a corporate income tax; and
- corporate tax rate reductions could be the first step in a race to the bottom that would impair the ability of governments to provide needed services.

Similarly, the following propositions regarding international tax reform seem compelling:

- reduced taxation of foreign earnings would encourage expansion and therefore strengthening of U.S.-based multinationals;
- our current international tax system encourages U.S.-based multinationals to retain earnings abroad;
- our current international tax system appears to put U.S.-based multinationals at a disadvantage compared with competitors in numerous other countries that use a territorial system;
- to the extent that other countries' international tax systems establish an international norm, our current system is inconsistent with that norm;
- our current international tax system is highly complex and appears to encourage planning, sheltering, and other deadweight loss activity;
- our current system relies on complex and continually tested gatekeepers to prevent existing corporations from expatriating, but encourages new businesses to start abroad; and
- our corporate tax base is mobile and becoming more so, and the challenges to imposing corporate tax on multinational businesses and capital are growing, perhaps to the point of being not worth the cost.

On the other hand, the following propositions regarding international tax reform also seem compelling:

- the adoption of a more purely territorial system could encourage companies to move some functions (and thus jobs) overseas where the income generated by those functions would not be subject to U.S. tax;
- there is no clear empirical evidence of the extent to which U.S.-based multinationals are at a competitive disadvantage as a result of the current U.S. international tax system;
- repeal of deferral would eliminate the lockout effect just as effectively as a territorial system;
- a territorial system could be easily manipulated without strong transfer pricing, source, and anti-deferral rules for passive income;
- a territorial system without a limitation on deductions for expenses incurred to earn that income could adversely and inappropriately affect the tax base; and
- exemption of foreign income, which will mostly be availed of by large taxpayers, may seem unfair, create disrespect for the system, and result in reduced compliance.

Both sides of the debate have merit. Despite this, it often seems that the usual players on all sides simply continue to take their predetermined roles

[3]President Obama is reported to have said to business leaders at a meeting: "We want to be boosters because when you do well, America does well." Helene Cooper, "Obama Tries Charm Offensive on Group of Top Executives," *The New York Times*, Dec. 15, 2010. Similarly, former House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., has reportedly stated that he wants businesses to do well because it will be business, not government, that will supply the jobs that keep people working.

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and dig themselves deeper and deeper into positions from which they cannot (or will not) back out. Perhaps as a result, tax reform has moved slowly.[4]

So how best to advance the debate? I believe there are two critical components. First is an acknowledgement that there is no clear right or wrong answer, that people come to the debate with competing policy orientations, and that we all may have to sacrifice some sacred cows.[5] Second is a determination to inform the debate with both (a) empirical research, in particular (if possible) on alternative policies' macroeconomic effect on domestic job and economic growth, and (b) real-world experiences of those responsible for paying the tax and complying with the system.

To address at least the first of these two components, I submit that we should step back to reevaluate our positions and the assumptions that underlie them.[6] It is from this perspective that I offer the views herein.[7] These views, informed by my experiences evaluating and considering tax policy as well as observing the role of taxes in business decision making, represent an attempt to advance the debate about how the United States should tax businesses in today's international economy — or, better yet, an attempt to change the debate. In this spirit, I offer a pragmatic, centrist approach to reforming our international tax policy.[8]

The balance of this report is divided into two parts. Part II describes why the United States needs fundamental tax reform. It is divided into three main sections: (1) an examination of where we've been, with an emphasis on the 1962 debate over subpart F and the Tax Reform Act of 1986; (2) a description of where our tax system is today; (3) a description of recent tax reform proposals; and (4) an analysis of where we're going and what our goals for fundamental tax reform might be.

Part III provides a proposal for fundamental U.S. international and corporate tax reform.[9] Central elements of this reform proposal are similar to those considered by the National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson commission). The proposal would lower the corporate tax rate and exempt from taxation a large portion of, but not all, the dividends of active earnings from foreign corporations to U.S. shareholders. The portion of the dividends that would continue to be taxed, for example, 5 to 10 percent of the dividends, would be a proxy for disallowed

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[4]Perhaps tax reform will move with a quicker pace since President Obama expressed his desire for changes to the tax code in his State of the Union address. He stated:

> To help our companies compete, we also have to knock down barriers that stand in the way of their success. For example, over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. So tonight, I'm asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years — without adding to our deficit. It can be done.

Remarks by the President in State of the Union Address (Jan. 25, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address.

[5]As former House Minority Leader Dick Gephardt explained in recent testimony before the Senate Finance Committee, one pre-Tax Reform Act of 1986 sacred cow actually involved cows:

> Super Dairy Cows were a prime example of [pre-1986 narrow tax benefits that benefited only a few]. There were substantial benefits to taxpayers to invest in dairy cows that could produce higher quantities of milk. Yet, due to dairy programs in the Farm Bill, there was already a glut of milk on the market. There was so much milk in fact, that cheese was literally spoiling in federal warehouses, with no appropriate consumer for the product. Schools, nutrition programs and other users already had their fill. Yet, millions and millions of dollars were invested in these tax shelters — with the federal taxpayer underwriting the benefits — because of some talented lawyers who helped arrange the tax dodge. . . . Nothing should be off-limits in terms of discussion about the design of the code. Remember, until 1986, Super Dairy Cows were also considered sacred.'' Statement of Dick Gephardt Before the Senate Finance Committee, ''Tax Reform: Lessons from the Tax Reform Act of 1986'' (Sept. 23, 2010) [*Doc 2010-20781*, *2010 TNT 185-51*.]

[6]The second component, informing the debate with empirical data and real-world experiences about how our system functions and affects the economy, is beyond the scope of this report and, at least as to developing empirical data, is beyond the author's expertise. That work, however, should be undertaken promptly.

[7]Of course, to be consistent with my approach, I must put forward this proposal as only one contribution to the debate; other proposals may prove superior.

[8]I am aware that some believe that finding common ground to move the debate forward is either a fool's errand or inconsistent with our political system, in which progress is made through a sort of tug-of-war conducted by vigorous partisans. *See, e.g.*, Frank Rich, ''The Bipartisanship Racket,'' *The New York Times*, Dec. 19, 2010; Paul Krugman, ''Let's Not Make a Deal,'' *The New York Times*, Dec. 5, 2010.

[9]Although individual tax reform is beyond the scope of this report, there are at least three reasons why it would be preferable to consider corporate and international tax reform only in conjunction with individual tax reform, or at least business tax reform for both corporations and non-corporate businesses: (1) many more businesses are conducted in noncorporate than corporate form (although the economic impact of the corporate sector is disproportionate to its numbers); (2) the budget and revenue implications of corporate tax reform are far smaller than those of individual reform because the individual income tax is, to quote Willie Sutton, ''where the money is''; and (3) it is suboptimal to consider a VAT, as I do below, outside the context of individual reform, because the incidence of any VAT would fall on individuals more clearly than the incidence of the corporate income tax.

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deductions of expenses incurred in connection with the earning of the otherwise exempt foreign income. Also, safeguards would be included to prevent round-tripping of earnings and to prevent base erosion through artificial cost sharing and other transfer pricing arrangements.[10]

To avoid negative revenue consequences in a period of significant deficits, this proposal suggests several potential offsets.[11] The most significant is one that most economists view as inevitable and most politicians want to believe is off the table: a VAT. But because a VAT can be regressive, it could include exemptions for necessities, as other VATs have done, or the tax could have a broad base but devote a portion of the revenue raised to addressing regresivity, for example through reducing the payroll tax and/or providing refundable credits.[12] Other revenue raisers that should be up for discussion include imposition of the corporate tax on all entities with corporate characteristics,[13] changing depreciation schedules, and reforming other corporate tax expenditures, perhaps using a mechanism like that suggested by the Bowles-Simpson commission (eliminating all tax expenditures, with addbacks paid for by increases in the corporate tax rate). The ultimate decision regarding offsets is obviously highly political, but we should not fail at reform because it is too politically difficult to broaden the tax base.

II. The Case for Reform

The need for tax reform becomes clear from an examination of the assumptions and motivations behind the major features of our current business and international tax system, analyzing whether those assumptions and motivations are true and valid today, and questioning whether the major features of our tax system can successfully accompany the United States into the future.[14]

Section A examines the reasons for several major features of the U.S. corporate and international tax regime. It highlights the past assumptions, motivations, and compromises behind those features.

Section B examines where our tax system and economy is today. It reviews recent economic trends, including the significant growth of non-U.S. markets and the increased integration of the world economy, and it surveys recent trends in business and international taxation, including the significant growth of flow-through businesses and the tax system's increased divergence from the tax systems of other developed countries. Section B also provides a brief overview of several recent proposals to reform the U.S. tax system.

Section C analyzes where the U.S. tax system is going and should be going. It surveys projected revenue trends, highlighting the fiscal challenges facing the United States, and it analyzes the role of tax reform in meeting those fiscal challenges. Next, it considers potential goals of tax reform, including encouraging investment in the United States, enhancing the competitiveness of U.S. multinational companies, minimizing economic distortions, and promoting administrability, simplicity, and certainty.

A. Where We've Been

This section examines the enactment of two pieces of international and corporate tax legislation, respectively, that set the framework for tax reform debate today — the enactment of the anti-deferral rules of subpart F in 1962 and TRA 1986. Examining the context in which subpart F was enacted is useful in evaluating the appropriateness of the current U.S. anti-deferral rules, and the appropriateness of U.S. taxation of foreign income more broadly, in today's economy.[15] Examining TRA 1986 is helpful to understand how the last major tax reform was

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[10]Although there are serious problems with the arm's-length standard, the transfer pricing safeguards suggested herein do not extend to abandoning that standard in favor of a formulary apportionment system.

[11]Some believe tax reductions do not need to be paid for, while others believe we should enact tax reform only if it helps significantly reduce the deficit. This report, consistent with its centrist orientation, takes a revenue-neutral approach. Also, because the focus of the report is on revenue measures, it does not consider any contribution to deficit reduction that could be achieved through non-tax expenditure cuts.

[12]*See* Eric Toder and Joseph Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," at 12-13 (2010), *Doc 2010-7657*, *2010 TNT 67-31*; *see also* Rosanne Altshuler, Katherine Lim, and Roberton Williams, *Desperately Seeking Revenue*, 63 *Nat'l Tax J.* 331 (2010). Both papers are discussed further below.

[13]*See* President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," at 74-77 (2010).

[14]In other words, the case for tax reform can be seen by considering where we've been, where we are, and where we are going. Senate Finance Committee Chair Max Baucus, D-Mont., made a similar statement during a committee hearing: "To consider where we want our tax system to go, we need to understand where we are and understand where we've been." Hearing Statement of Sen. Max Baucus, Regarding Historical Trends in Income and Federal Revenues (Dec. 2, 2010), *Doc 2010-25643*, *2010 TNT 232-44*.

[15]*See* Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," 53 (Dec. 29, 2000), *Doc 2001-492*, *2001 TNT 1-1*; and National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century: A Reconsideration of Subpart F* (1999), for additional background and analysis on the history and debate over subpart F.

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achieved and what it can (and cannot) teach us about conducting tax reform today.

1. Subpart F. The enactment of subpart F in 1962 was spurred by President Kennedy's 1961 call for changes to the U.S. tax treatment of foreign income. In his 1961 message to Congress on tax issues, Kennedy argued that "changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system."[16] He proposed legislation that would tax U.S. corporations on their current share of undistributed profits earned by subsidiaries organized in economically advanced countries, retain deferral for income from investment in developing countries, while "elimin[ating] the 'tax haven' device anywhere in the world" by doing away with deferral for activities "that typically seek out tax haven methods of operation." The president said that "while the rate of expansion of some American business operations abroad may be reduced through the withdrawal of tax deferral[,] such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country."

The business community strongly opposed Kennedy's tax proposal.[17] This appears to have stemmed at least in part from the fact that most multinationals invested primarily in high-tax jurisdictions. Congress ultimately rejected the Kennedy administration's call to end deferral with limited exceptions for investments in developing countries. The House passed a bill in March 1962 that ended deferral only for specified types of income: (1) income from insuring or reinsuring U.S. risks; (2) income from patents, copyrights, and some intellectual property developed in the United States or acquired in the United States from related persons; (3) specified passive income; and (4) income from purchases or sales involving related persons if the property was produced and sold for use outside the foreign corporation's country of incorporation.[18] The House Ways and Means Committee stated:

> Your Committee's bill does not go as far as the President's recommendations. It does not eliminate tax deferral businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.[19]

The Senate Finance Committee adopted the general approach of the House bill.[20] The Senate version was ultimately adopted in conference, and subpart F was enacted in the Revenue Act of 1962.

The debate over subpart F has continued since subpart F's enactment in 1962. Many are dissatisfied with current law, but for different reasons: Some want to eliminate deferral, while others want to eliminate or limit the United States' practice of taxing foreign-source income.[21] Advocates of replacing the current anti-deferral rules with current

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[16]Message of the President's Tax Recommendations (Apr. 20, 1961), *reprinted in* H.R. Doc. No. 87-140. Kennedy described the deferral issue as follows:

> Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to United States tax only when they are returned to the parent company in the form of dividends. In some cases, this tax deferral has made possible indefinite postponement of the United States tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States.

[17]*See* National Foreign Trade Council, *supra* note 14, at ch. 2 ("Trade and business interests reacted swiftly and negatively to the Kennedy foreign income proposals").

[18]H.R. 10650 (1962); H.R. Rep. No. 1447 (1962). The House bill also provided that a U.S. shareholder of a foreign corporation would be subject to tax on the foreign corporation's undistributed earnings not falling into the above categories to the extent those earnings were not reinvested in substantially the same business or a foreign corporation organized in a less-developed country.

[19]H.R. Rep. No. 87-1337, at 62 (1962).

[20]The Finance Committee modified the House version, however, to exempt U.S. shareholders from current taxation if a foreign corporation paid large dividend distributions on a current basis or if the foreign corporation was subject to high foreign taxes. Also, the Senate version allowed deferral for specified kinds of exports the U.S. government was seeking to promote.

[21]*See, e.g.*, The Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018 (abolishing deferral); Daniel N. Shaviro, "Rethinking Foreign Tax Creditability," 63 *Nat'l Tax J*. 709 (2010) (full territoriality, no foreign tax credit); Samuel C. Thompson Jr., "Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation," 53 *How. L.J.* 337 (2010); James R. Hines Jr., "Reconsidering the Taxation of Foreign Income," 62 *Tax L. Rev*. 269 (2009); J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Worse Than

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taxation of the foreign income earned by foreign subsidiaries of U.S. companies have argued that deferral provides a significant tax incentive for U.S. companies to locate operations abroad,[22] while advocates of replacing the current rules with a territorial or other system to exempt foreign-source income from U.S. taxation argue that a reduction in tax of foreign-earned income of U.S. companies is necessary for those companies to be competitive worldwide.[23] Opponents of the current deferral regime also argue that it is overly complex and that it creates a lockout effect, discussed below, that discourages U.S. companies from repatriating the earnings of their foreign subsidiaries.

2. Tax Reform Act of 1986. TRA 1986 was the last fundamental reform of the U.S. tax system.[24] The reform focused on individual and corporate taxation, with a general approach of lowering tax rates while broadening the tax base. For individual taxes, the number of tax rates was cut from 14 (ranging from 11 to 50 percent) to 2 (15 and 28 percent), with significant changes to the tax base, including the elimination of the consumer interest deduction, restrictions on charitable contribution deductions, the elimination of the sales tax deduction, and changes to the passive loss rules.[25] Corporate tax rates were cut from a top rate of 48 to 34 percent, although, because of base-broadening measures, overall corporate taxes actually went up — the reform raised corporate taxes by $120 billion over five years, which was the largest corporate tax increase in history.[26]

TRA 1986 was generally successful in its goal of lowering tax rates and broadening the tax base, which are two necessary goals of tax reform. The general approach of TRA 1986 alone, however, should not simply be copied by current policymakers considering tax reform. Reform today must consider fundamental issues not addressed in 1986 and reevaluate some critical assumptions made in the 1986 reform. First, TRA 1986 did not fundamentally reform the international tax system.[27] As a result, the post-1986 international tax system continued to rely on the motivations, assumptions, and compromises of 1962. Even since 1986, as examined below, the world has fundamentally changed in a way that militates in favor of a reexamination of the

Exemption,'' 59 *Emory L.J.* 79 (2009); Jane G. Gravelle, ''International Corporate Income Tax Reform: Issues and Proposals,'' 9 *Fla. Tax Rev.* 469 (2009); Paul R. McDaniel, ''Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?'' 8 *Fla. Tax Rev.* 283 (2007); Paul W. Oosterhuis, ''The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy: The Evolution of International Tax Policy — What Would Larry Say?'' 33 *Ohio N.U.L. Rev.* 1 (2007); Report of the American Bar Association Task Force on International Tax Reform, 59 *Tax Lawyer* 649 (2006); Joint Committee on Taxation, ''Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System'' in *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, JCS-3-01 (Apr. 2001), *Doc 2001-12006, 2001 TNT 91-14*; Michael J. Graetz, ''The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,'' 54 *Tax L. Rev.* 261 (2001); Keith Engel, ''Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F,'' 79 *Tex. L. Rev.* 1525 (2001); Peroni, ''Deferral of U.S. Tax on International Income: End It, Don't Mend It — Why Should We Be Stuck in the Middle With Subpart F?'' 79 *Tex. L. Rev.* 1609 (2001); H. David Rosenbloom, ''From the Bottom Up: Taxing the Income of Foreign Controlled Corporations,'' 26 *Brook. J. Int'l L.* 1525 (2001); Treasury Department, *supra* note 14, at 53; Terrence R. Chorvat, ''Ending the Taxation of Foreign Business Income,'' 42 *Ariz. L. Rev.* 835, 850-853 (2000); Peroni, Fleming, and Shay, ''Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income,'' 52 *SMU L. Rev.* 455 (1999); National Foreign Trade Council, ''The NFTC Foreign Income Project: International Tax Policy for the 21st Century: A Reconsideration of Subpart F'' (1999), *Doc 1999-11623, 1999 TNT 58-17*; JCT, ''Overview of Present-Law Rules and Economic Issues in International Taxation,'' JCX-13-99, section IV.D (Mar. 9, 1999), *Doc 1999-9351, 1999 TNT 46-10*; Graetz and Michael M. O'Hear, ''The 'Original Intent' of U.S. International Taxation,'' 46 *Duke L.J.* 1021 (1997); Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform*, 136 (1992); Stanford G. Ross, ''National Versus International Approaches to Cross-Border Tax Issues,'' *Tax Notes*, Feb. 3, 1992, p. 589; JCT, ''Factors Affecting the International Competitiveness of the United States,'' JCS-6-91 (May 30, 1991), *Doc 91-4597, 91 TNT 121-9*, at 5; Daniel J. Frisch, ''The Economics of International Tax Policy: Some Old and New Approaches,'' *Tax Notes*, Apr. 30, 1990, p. 581; William P. McClure and Herman B. Bouma, ''The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed,'' *Tax Notes*, June 12, 1989, p. 1379; American Law Institute, *Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, 318-320 (1987).

[22]*See, e.g.*, Fleming, Peroni, and Shay, *supra* note 20, at 464-468 (explaining three analytical approaches to describe deferral: an interest-free loan; a device to make the treasury a forced equity investor; or a regime for achieving tax-free reinvestment of retained earnings).

[23]*See* Statement of Hines, Testimony Before the Senate Finance Committee (June 26, 2008), *Doc 2008-14200, 2008 TNT 125-47* (''What would represent an efficient international tax policy? It would be to do what most of the world does, and exempt active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by American businesses.'').

[24]See Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (1987), for a comprehensive discussion of the reform efforts.

[25]*Id.* at 288.

[26]*Id.* at app. A.

[27]*See* Statement of Dick Gephardt, *supra* note 5 (suggesting that Congress needs to ''go deeper into some of the areas that the 1986 effort skirted — most important being the international aspects of the tax code. Today, the impact of globalization is felt in all sectors of our society, far more than at that time. Our tax code needs to reflect this fact.'').

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U.S. international tax system. Further, although non-income taxes were considered in the years leading up to TRA 1986, the act ultimately assumed that the United States should continue to rely on the individual and corporate income taxes as its major sources of revenue.[28] As discussed below, given the United States' significant fiscal challenges, policymakers should seriously consider whether current revenue sources are sufficient.

B. Where We Are

This section examines the current state of the U.S. tax system and the U.S. economy. It first provides a brief overview of the United States' current business and international tax rules. It then considers U.S. economic and tax trends. And because any future tax reform will necessarily build on the reform efforts preceding it, this section also examines several recent proposals to reform the U.S. tax system.

1. Overview of current corporate and international tax regime. U.S. corporations generally are subject to U.S. corporate income tax on their worldwide income. The taxable income of a corporation is generally the corporation's gross income less deductions, which may include interest expense, salaries, wages, nonfederal income taxes, and various other expenses. When corporations distribute their profits to shareholders, the distribution is generally taxed as a dividend to the shareholder and is not a deductible expense of the corporation.[29] As a result, corporate earnings are generally taxed twice: once when earned by the corporation and again when distributed to the corporation's shareholders.

Rather than organize as corporations, businesses may also operate as a variety of flow-through entities, including S corporations, partnerships, and sole proprietorships. The income of these entities generally is not subject to tax at the entity level — rather, their income is taxable directly to their owners.

As stated above, U.S. corporations generally are taxed on all of their income, regardless of whether that income is earned in the United States or abroad. Income earned abroad by a foreign subsidiary of a U.S. parent corporation is generally not subject to U.S. tax until that income is distributed as a dividend from the foreign subsidiary to its U.S. parent. As a result, in the absence of special rules, a U.S. corporation can defer U.S. taxation on foreign income until repatriating that income to the United States.[30]

The United States has anti-deferral rules that subject U.S. parent corporations to current taxation of specified passive or mobile income earned by foreign subsidiaries.[31] The most significant anti-deferral rules in the U.S. tax code for U.S.-based multinationals are the controlled foreign corporation rules, which are often referred to as "subpart F" because they are in subpart F of the tax code. Under this regime, U.S. 10 percent shareholders of a foreign corporation that is more than 50 percent owned (directly, indirectly, or constructively) by U.S. persons (taking into account only 10 percent U.S. shareholders) are taxed on their pro rata share of subpart F income earned by the CFC. The U.S. shareholder is subject to this tax regardless of whether any income is distributed to it from the controlled corporation. Subpart F income generally includes dividends, interest, rents, and royalties; insurance income; some income earned from sales involving related parties in which the manufacturing function has been separated from the sales function; income from services performed outside a CFC's country of incorporation for, or on behalf of, a related person; and shipping income.[32] Subpart F income also includes some income earned by a CFC and invested in "U.S. property" (a term including some tangible property in the United States, some stock of a U.S. corporation, some obligations of a U.S. person, and some U.S. intangible property rights).

Because the taxation of a single item of foreign-source income by both the United States and a foreign country would result in double taxation, the United States generally provides a credit for foreign taxes paid or accrued.[33] U.S. corporations may receive a foreign tax credit (which may be used to

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[28]*See* Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, 27 (2008):

> The 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace it with some sort of tax on purchases of goods and services. Given the internationalization of economic activity during the past two decades, TRA 1986's reliance on increased taxation of income from capital and corporate income has made the United States economy less competitive with other national economies that tax corporate income at a relatively lower rate.

[29]Under the recent two-year extension of the 2001 and 2003 tax cuts, dividend income of individuals continues to be taxed at a reduced 15 percent rate rather than ordinary income rates.

[30]The U.S. corporation's postponement of tax payments for income that, if earned directly by the U.S. corporation, would otherwise be currently taxable, means that the foreign income earned by a foreign subsidiary will generally be taxed at a lower effective rate than U.S. income earned by the foreign subsidiary or any income, foreign or domestic, earned by the U.S. corporation as a result of the time value of money.

[31]*See* sections 951-964 (subpart F); sections 1291-1298 (passive foreign investment company rules).

[32]Section 951.

[33]Section 901.

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offset U.S. tax owed on foreign-source income) for foreign taxes paid or accrued on foreign-source income that is earned directly by the domestic corporation or foreign taxes paid or accrued by a foreign subsidiary that are deemed paid by the domestic corporation on an actual or deemed distribution from the foreign subsidiary.[34]

2. U.S. tax and economic developments. In considering whether and how fundamental tax reform should be achieved, it is helpful to consider whether the assumptions and motivations that in the past led to the enactment of today's tax system are as compelling today. For example, the world economy is much more integrated than it was when subpart F was enacted in 1962, or even when fundamental tax reform was last achieved in 1986. Non-U.S. markets are growing at a faster rate than U.S. markets. Yet, as business increasingly operates on a global scale, the U.S. tax system appears to be predicated on an assumption that growth abroad to exploit foreign markets should not be encouraged. In this respect, the U.S. system has been unlike those of historically outward-facing economies like that of the Netherlands. Now, as more countries are becoming more outward-facing, the U.S. tax system appears to diverge significantly from the tax systems of many other developed countries.

a. Increasingly global economy. In his December 2010 testimony before the Senate Finance Committee, Mark J. Mazur, Treasury deputy assistant secretary for tax analysis, observed that the world economy has become increasingly integrated in the last several decades. According to Mazur:

> International trade in goods and services is now more important than it once was, for the world and for the United States. In the United States, for example, the traded sector (exports plus imports) has grown from 20 percent of GDP in 1980 to 24 percent in 2009, but the most dramatic changes have occurred in emerging economies, such as China and India, where it more than doubled. Over the same period, cross border investment (both direct and portfolio investment) has also become significantly more important. For example, U.S. cross border foreign direct investment (FDI) in stocks has increased from about 11 percent of GDP in 1980 to about 55 percent of GDP in 2009. In the other G-7 countries, cross border FDI in stocks has increased from 10 percent of GDP to 65 percent of GDP over the same period.[35]

One important reason U.S. companies invest overseas is that, even though the United States remains a dominant world economy, significant economic growth is occurring in non-U.S. markets. U.S. companies cannot grow if they ignore these markets. U.S. GDP grew at a 2.9 percent annual rate from 1995 through 2008. In comparison, China's economy grew at a 9.6 percent rate, India grew at a 6.9 percent rate, Russia grew at a 4.7 percent rate, and Brazil grew at a 3 percent rate.[36] Consumer spending is also growing at a faster rate in many non-U.S. markets. For example, U.S. real household consumption grew at a 3.3 percent annual rate from 1995 through 2008, while China's consumption grew at a 7.2 percent annual rate, Russia's grew at a 6.7 percent annual rate, and India's grew at a 5.1 percent annual rate. Although these countries have less spending power on a per capita basis than the United States, their significant economic growth will continue to provide significant investment opportunities for global companies.

When U.S. multinational companies do business abroad, they must make investments locally. U.S. multinationals often must establish local operations for legal reasons (for example, local content requirements or tariff barriers) and out of basic logistical necessity (for example, reducing transportation costs). Also, local operations are often necessary to understand and cater to local tastes. For example, on-the-ground employees may be necessary for a consumer products company to understand why its soap can be a local success. Further, the nature of some businesses, such as some financial services, may simply require a local, physical presence.

b. Increased divergence from tax systems of other developed countries. Although business has become increasingly global, with foreign companies regularly competing with domestic companies in the United States and U.S. companies regularly competing with foreign companies abroad, the U.S. tax system looks very different than the other tax systems of the developed world. As discussed below, many believe the U.S.'s divergence makes U.S. companies less competitive. Many also believe the U.S. tax system makes the United States a less attractive place for investment, whether domestic or foreign.

The United States last lowered its corporate tax rate with TRA 1986, when the U.S. corporate tax rate was reduced by 14 percentage points. Since

[34]Sections 901, 902, 904, and 960.

[35]Testimony of Treasury Deputy Assistant Secretary for Tax Analysis, Mark Mazur, Senate Committee on Finance Hearing on Tax Reform: Historical Trends in Income and Revenue (Dec. 2, 2010), *Doc 2010-25646*, *2010 TNT 232-54*.

[36]McKinsey Global Institute, *Growth and Competitiveness in the United States: The Role of Its Multinational Companies* 156-157 (2010).

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then, other countries have lowered their tax rates while the United States has actually increased its highest corporate marginal rate by one percentage point.[37] The average corporate tax rate in the OECD has dropped from 47 percent in 1981 to 37.7 percent in 1994 to 25.9 percent in 2010.[38] The United States will soon have the highest corporate tax rate in the OECD because Japan is planning to lower its corporate tax rate by 5 percentage points in April 2011.[39] According to OECD data, the U.S.'s combined federal and state corporate rate is 39.1 percent, compared with the OECD average (excluding the United States) of 25.9 percent.[40]

Further, the United States is now one of only seven OECD countries with a worldwide corporate tax system — only Chile, Ireland, Israel, Mexico, Poland, and South Korea have similar worldwide systems. Each of these other countries, however, has a significantly lower corporate tax rate.[41]

Table 1. Combined Corporate Income Tax Rate of OECD Countries With Worldwide Tax Systems[a]

Country	Combined Corporate Income Tax Rate
Chile	17%
Ireland	12.5%
Israel	25%
Mexico	30%
Poland	19%
South Korea	24.2%
United States	39.21%

[a]*See* OECD Tax Database, Basic (Non-Targeted) Corporate Income Tax Rates (Table II.1), *available at* http://www.oecd.org/ctp/taxdatabase (using 2010 combined corporate income tax rate (adjusted central government corporate income tax rate plus subcentral government corporate income tax rate)).

The United States also relies on income taxes (at all levels of government) for a much greater percentage of its total tax revenues than other developed countries. In 2006 the United States raised 48.3 percent of its revenue from federal, state, and local income taxes, compared with an average of 35.1 percent in other OECD countries.[42] In contrast, OECD countries rely more heavily on consumption taxes, including VATs. Consumption taxes made up 32 percent of the average OECD countries' revenues in 2006, compared with 16.8 percent in the United States. Also, the number of OECD countries with a VAT has increased dramatically in the past 30 years. In 1980, 14 OECD countries had a VAT.[43] In 2011, 33 of the 34 OECD countries (that is, all except the United States) have a VAT. Worldwide, approximately 150 countries have a VAT.[44]

c. Growth of flow-through businesses. Another significant U.S. tax trend that should be considered in evaluating whether our current tax rules reflect current realities is the dramatic increase in business income earned by flow-through entities (S corporations, partnerships, limited liability companies, and sole proprietorships), which are not subject to the corporate income tax. In recent years, these flow-through entities included 26 million non-farm sole proprietorships, four million S corporations, and three million partnerships.[45] In contrast, there are slightly less than six million C corporations.[46]

In 2007 94 percent of all U.S. businesses were organized as flow-through entities.[47] These entities earned 47 percent of all total U.S. business income and accounted for 66 percent of U.S. businesses reporting a profit of more than $1 million.[48] In comparison, in 1980 flow-through entities also made up a large percentage of U.S. businesses (83 percent) but earned only 21 percent of total business income.[49]

A significant amount of the income earned by flow-through business entities is passed through to taxpayers in the top tax brackets: In 2006 taxpayers in the highest two tax brackets made up only 8 percent of all taxpayers receiving any flow-through

[37]It should be noted, however, that "these rate reductions have often been accompanied by base-broadening efforts, so that overall corporate tax revenues as well as average and especially marginal effective tax rates have declined considerably less." George R. Zodrow, "Capital Mobility and Capital Tax Competition," 63 *Nat'l. Tax J*. 865 (2010).

[38]OECD, *supra* note 2, at 37.

[39]*See* Stanley White, "Japan PM Kan Orders 5 Percentage Point Corporate Tax Cut," Reuters (Dec. 13, 2010). Another country lowering its corporate tax rate is Canada, which lowered its rate to 16.5 percent effective January 1, 2011. *See* Phred Dvorak, "Canada Slashes Business Levies," *The Wall Street Journal*, Dec. 30, 2010.

[40]*See* OECD Tax Database, Basic (Non-Targeted) Corporate Income Tax Rates (Table II.1), *available at* http://www.oecd.org/ctp/taxdatabase (using 2010 combined corporate income tax rate (adjusted central government corporate income tax rate plus subcentral government corporate income tax rate)).

[41]China, a non-OECD country, also has a worldwide tax system. Like the OECD countries that tax on a worldwide basis, however, it has a significantly lower corporate tax rate than the United States: 25 percent compared with 39.21 percent.

[42]Mazur testimony, *supra* note 35.

[43]*Id.*

[44]William Gale and Benjamin H. Harris, "A Value-Added Tax for the United States: Part of the Solution" (July 2010), *Doc 2010-16324*, *2010 TNT 141-38*.

[45]Nina Olson, "National Taxpayer Advocate Report to Congress: Fiscal Year 2011 Objectives," 10 (June 30, 2010), *Doc 2010-15078*, *2010 TNT 130-15*.

[46]IRS, 2007 Statistics of Income, Corporation Income Tax Returns 1 (2007), *available at* http://www.irs.gov/pub/irs-soi/07coccr.pdf.

[47]Mazur testimony, *supra* note 35.

[48]*Id.*

[49]*Id.*

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income or loss but received 72 percent of the net flow-through income.[50] Four percent of the taxpayers reporting flow-through income fell into the highest tax bracket, accounting for 61 percent of flow-through income.

The amount of business activity conducted by noncorporate businesses in the United States stands in contrast to other OECD countries. In a 2007 OECD study of 15 OECD countries, only Mexico had an unincorporated business sector representing a larger share of the total number of businesses.[51] The United States also has a larger proportion of flow-through businesses among all large businesses. As stated above, 55 percent of U.S. businesses reporting profits of $1 million or more are not incorporated, compared with 27 percent in Mexico, 26 percent in the United Kingdom, and 17 percent in New Zealand.[52]

A small percentage of flow-through businesses and C corporations earn most of the income earned by all flow-through businesses and C corporations, respectively. In 2007 the 9,597 largest C corporations (that is, those with assets greater than $500 million; approximately 0.2 percent of all C corporations) earned approximately 84 percent of all corporate income.[53] Approximately, 0.5 percent of partnerships (that is, those with assets exceeding $100 million) earned approximately 67 percent of all partnership income.[54]

d. Increased use of expiring tax provisions. The number of expiring tax provisions appears to have significantly increased in recent years. In his testimony before the Finance Committee, Randall D. Weiss observed that ''at the beginning of 1985, 25 provisions were scheduled to expire in the next two years. As of early 1989, after the [1986] Act and other legislation resolved some of these issues, there were 14 provisions that expired either that year or the previous one. In contrast, as of early 2010, there were 141 provisions that expired in that year or the previous one.''[55]

The frequent use of expiring provisions creates uncertainty for taxpayers. Recently, after Congress failed to extend the tax provisions expiring on December 31, 2009, businesses faced considerable uncertainty in deciding whether to make investments or conduct transactions affected by the provisions, not knowing whether Congress would retroactively extend them. Further, the expiring provisions create administrative burdens for the IRS. As IRS Commissioner Douglas Shulman noted in December 2010 letters to the leaders of the taxwriting committees regarding the pressing need for action on expiring tax provisions:

> While I know you and your colleagues have a difficult challenge to enact legislation this year, I want to stress that it would be extremely detrimental to the entire tax filing season and to tens of millions of taxpayers if tax law changes affecting 2010 are deferred and then retroactively enacted in 2011. Specifically, it would be an unprecedented and daunting operational challenge to open the tax filing season under one set of tax laws with respect to AMT and extenders, begin accepting tax returns, and then have the law change.[56]

C. Recent Reform Proposals

1. 2005 President's Advisory Panel on Federal Tax Reform. The 2005 President's Advisory Panel on Federal Tax Reform (the 2005 reform panel) made two alternative business taxation proposals.[57] The Simplified Income Tax Plan would lower the corporate tax rate to 31.5 percent, create a simplified depreciation system, and enact a territorial system (under which dividends paid by a foreign affiliate out of active foreign earnings would not be subject to U.S. corporate tax), and would treat a business as a resident of the United States (and thus subject to U.S. tax) if the business is resident in the United States or if the United States is the business's place of primary management and control.[58]

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[50]Treasury Conference on Business Taxation and Global Competitiveness, ''Background Paper,'' 15 (July 23, 2007), *Doc 2007-17146*, *2007 TNT 142-14*.

[51]*Id.* at 16.

[52]*Id.*

[53]*See* IRS, 2007 Statistics of Income, Returns of Active Corporations, Table 2 — Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets (using total income after credits as income figure).

[54]*See* IRS, 2007 Statistics of Income, Table 15, All Partnerships: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Size of Total Assets (using total net income (less loss) as income figure).

[55]Statement of Randall D. Weiss, ''How Did the 1986 Tax Reform Act Attract So Much Support?'' Testimony Before the Senate Committee on Finance (Sept. 23, 2010), *Doc 2010-20794*, *2010 TNT 185-53*.

[56]Letter from IRS Commissioner Douglas Shulman to Baucus (Dec. 2010), *Doc 2010-25521*, *2010 TNT 231-17*.

[57]*See generally* President's Advisory Panel on Federal Tax Reform, ''Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System'' (Nov. 1, 2005), *Doc 2005-22112*, *2005 TNT 211-14*.

[58]*Id.* at 124-135.

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The 2005 reform panel's Growth and Investment Plan would create a cash flow tax.[59] The base of the tax would be sales or receipts less the cost of materials, labor services, and purchases of business assets. There would be several modifications, including immediate expensing of capital expenditures, special rules for financial institutions, loss carryforwards with accrued interest, and taxation of international transactions under a destination basis principle.

The 2005 reform panel also considered a VAT, but could not reach a consensus on whether a VAT option should be recommended.[60] The VAT proposal studied by the panel would combine a 15 percent VAT, a top individual income tax rate of 15 percent, and a top corporate tax rate of 15 percent. According to the report:

> Some members were . . . concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government — in other words, that the VAT would be a ''money machine.'' Other Panel members suggested that studies of the international experience and domestic policies realities did not support the ''money machine'' argument. Some argued that adopting a VAT . . . would make it more likely that higher taxes would be used to solve the nation's long-term fiscal challenges. . . . Others expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund entitlement programs, or service as a possible replacement for payroll taxes.

The panel also considered, but rejected, a national retail sales tax.[61] The panel concluded that replacing the income tax with a retail sales tax, absent a way to ease its burden on lower- and middle-income Americans, would not satisfy the panel's mandate that its recommendations be appropriately progressive. Providing cash grants to minimize the burden of the tax on lower- and middle-income Americans would ''inappropriately increase the size and scope of government.'' The tax rate would be at least 34 percent, the federal administrative burden would likely be similar to the current system, and taxpayers would need to continue filing state tax returns, thus limiting potential simplification gains.

2. Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010. In February 2010 Finance Committee member Ron Wyden, D-Ore., and former Sen. Judd Gregg of New Hampshire, introduced the Bipartisan Tax Fairness and Simplification Act of 2010 (Wyden-Gregg).[62] Their plan would reform the individual tax system. It would reduce the number of brackets to three (15, 25, and 35 percent), eliminate the alternative minimum tax, triple the standard deduction, and preserve the mortgage interest deduction, the charitable contribution deduction, the child tax credit, the earned income tax credit, and the dependent care credit. For business tax reform, Wyden-Gregg would reduce the corporate tax to a flat 24 percent, eliminate deferral, provide 100 percent expensing for small businesses, and eliminate the value of inflation from a corporation's interest deduction. The bill would also eliminate many individual and corporate tax expenditures, such as some employee tax exclusion provisions, deductions for moving expenses, deferral of interest on savings bonds, the domestic production deduction, the deduction for punitive damages, and some special expensing provisions.

3. 2010 President's Economic Recovery Advisory Board tax reform subcommittee. Obama tasked the President's Economic Recovery Advisory Board (PERAB) tax reform subcommittee with preparing a report on ''options for changes in the tax system to achieve three broad goals: simplifying the tax system, improving taxpayer compliance with existing tax laws, and reforming the corporate tax system.''[63] As the subcommittee noted in the preface to its August 2010 report, it ''was not asked to recommend a major overarching tax reform. . . . We received many suggestions for broad tax reform, and some members of the PERAB believe that such reform will be an essential component of a strategy to reduce the long-term deficit of the federal government. But consistent with our limited mandate, we did not evaluate competing proposals for overarching tax reform in this report.''[64]

The PERAB tax reform subcommittee did, however, make several observations about the U.S. business tax system. It noted that the United States has the second-highest statutory corporate income tax in the OECD but has a relatively narrow corporate tax base compared with the size of the overall

[59]*Id.* at 162-175.
[60]*Id.* at 191-205.
[61]*Id.* at 207-222.
[62]S. 3018.
[63]PERAB, *supra* note 13, at V.
[64]*Id.*

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business sector.[65] It also noted that "the combination of a high statutory rate and numerous deductions and exclusions results in an inefficient tax system that distorts corporate behavior in multiple ways."[66]

The tax reform subcommittee discussed the advantages and disadvantages of several corporate tax reform measures to reduce marginal corporate rates or broaden the tax base, but consistent with its mandate, did not make any recommendations on which option may be preferable. Regarding reducing marginal corporate rates, the report considered reducing the statutory corporate tax rate and increasing incentives for new investment/direct expensing. Regarding broadening the tax base, the report considered providing more level treatment of debt and equity financing, reviewing the boundary between corporate and noncorporate taxation, and eliminating or reducing tax expenditures.

The tax reform subcommittee also described options for reforming the international tax system, observing that international tax reform involves consideration of:

> 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. [multinational corporations] operating in low-tax jurisdictions compared to their foreign competitors; reducing the incentives for U.S. [multinational corporations] 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.[67]

The subcommittee considered four major options for international tax reform: (1) moving to a territorial system; (2) maintaining the current system of worldwide taxation but lowering the corporate rate and eliminating deferral; (3) tightening or ending deferral with no change in the corporate tax rate; and (4) retaining the current system but lowering the tax rate.

4. Ryan 'Roadmap for America's Future.' House Budget Committee Chair Paul Ryan, R-Wis., has proposed a "Roadmap for America's Future."[68] In addition to reforming healthcare, Medicare, Medicaid, Social Security, job training programs, and the budget process, Ryan's plan would reform the individual and business tax systems. Regarding individual taxation, Ryan's plan would allow taxpayers a choice between the current system and a new system, referred to as the "simplified" system. Under the simplified system, the first $100,000 (for joint filers) or $50,000 (for single filers) of a taxpayer's adjusted gross income would be subject to a 10 percent rate while the balance of a taxpayer's AGI would be taxed at 25 percent.[69] Interest, capital gains, and dividends would not be taxed. For business taxation, the Ryan plan would eliminate the corporate income tax and replace it with a subtraction-method, border-adjustable "business consumption tax" of 8.5 percent on goods and services.

5. 'Restoring America's Future' report by the Debt Reduction Task Force of the Bipartisan Policy Center. In November 2010 the Bipartisan Policy Center, a nonprofit organization established by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, released a report by its Debt Reduction Tax Force on "a long-term plan to reduce the national debt and place our nation on a sustainable fiscal path."[70] Regarding taxes, the task force recommended (1) lowering marginal rates on individuals and corporations, with 15 and 27 percent brackets for individuals and a 27 percent rate for corporations; (2) eliminating itemized deductions and the standard deduction and instead allowing all taxpayers a 15 percent credit for home mortgage interest expenses (up to $25,000) and a 15 percent credit for charitable contributions; (3) restructuring tax provisions benefiting low-income taxpayers and families with children; (4) ending almost all tax expenditures for both individuals and corporations; (5) creating a new 6.5 percent "debt reduction sales tax" (that is, a credit-invoice VAT with a broad base); and (6) implementing a Social Security payroll tax holiday in 2011.[71]

The Debt Reduction Task Force plan does not specifically address international tax issues and, as a result, assumes the United States would maintain the current system of deferral:

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[65]*Id.* at 65.

[66]*Id.*

[67]*Id.* at 81-82.

[68]*See* Roadmap for America's Future Act of 2010, H.R. 4529; Senate Budget Committee Republicans, A Roadmap for America's Future, *available at* http://www.roadmap.republicans.budget.house.gov/.

[69]Under the Ryan plan, the standard deduction would be $25,000 for joint tax filers and $12,500 for single filers. The personal exemption would be $3,500. Nearly all individual tax expenditures would be eliminated.

[70]Bipartisan Policy Center, Debt Reduction Task Force, "Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System," 2 (2010), *Doc 2010-24611*, *2010 TNT 222-29*.

[71]*Id.* at 31-45.

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> The Task Force plan leaves in place the provision that allows U.S. multinationals to defer taxation of the profits of their foreign subsidiaries until those profits are repatriated to the U.S. parent (deferral). Some view deferral as an incentive for U.S.-based companies to invest overseas, but others believe eliminating deferral would damage the ability of U.S. corporations to compete with foreign-based corporations and note that most of our major trading partners have enacted territorial systems that exempt completely the active foreign income of their corporations. While the Task Force plan does not address our complex system of taxing international income flows of corporations, the substantially lower corporate tax rate that the Task Force proposes will increase the incentive for both U.S. and foreign-based multinationals to invest in the United States.[72]

6. The National Commission on Fiscal Responsibility and Reform (Bowles-Simpson commission). The Bowles-Simpson commission created by Obama was "charged with identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run."[73] The commission released its report in December 2010 with the approval of 11 of the commission's 18 members, falling short of the 14 votes necessary to officially approve the report.[74] Regarding tax reform, the commission stated:

> America's tax code is broken and must be reformed. . . . The corporate income tax hurts America's ability to compete. On the one hand, statutory rates in the U.S. are significantly higher than the average for industrialized countries (even as revenue collection is low), and our method of taxing foreign income is outside the norm. The U.S. is one of the only industrialized countries with a hybrid system of taxing active foreign-source income. The current system puts U.S. corporations at a competitive disadvantage against their foreign competitors.[75]

The commission's report recommended enacting a single corporate tax rate between 23 and 29 percent, eliminating all tax expenditures for business, and moving to a territorial tax system. The tax expenditures eliminated would include the domestic production deduction, inventory methods, and general business credits. Regarding moving to a territorial tax system, the report argued that the U.S. tax system should be brought "more in line with our international trading partners" by exempting active income earned by foreign subsidiaries and branches.[76] The report recommended that passive foreign-source income continue to be taxed.

7. Auerbach 'modern corporate tax' proposal. Alan Auerbach, a professor of economics at the University of California, Berkeley, in collaboration with the Center for American Progress and the Hamilton Project (an economic policy initiative at the Brookings Institution), released in December 2010 a paper proposing a "modern corporate tax."[77] Auerbach proposed to replace the current corporate income tax with a destination-based cash flow tax. Under the cash flow tax, depreciation deductions would be replaced with immediate expenses for all tangible investments in plants, equipment, inventories, and net financial investment (that is, net lending less net borrowing). All taxes (and tax credits) on foreign-source income and all cross-border transactions, regardless of their nature, would be eliminated from the calculation of a company's tax base. For example, sales abroad would not be included in receipts, and purchases from abroad would not be deductible.

D. Where We Are (and Should Be) Going

1. Potential goals for reform. When considering fundamental tax reform, policymakers should ask themselves whether today's tax system, which in many cases was designed to reflect the realities of a prior era, can carry out the U.S.'s goals for the 21st century. These goals may include meeting the U.S.'s fiscal challenges; enhancing the U.S. economy by encouraging investment in the United States and enhancing the competitiveness of U.S. multinationals; and minimizing undesirable economic distortions.

a. Meeting the U.S.'s fiscal challenges.

i. Revenue trends. The United States faces many fiscal challenges. As the report of the Bowles-Simpson commission states:

> Spending is rising and revenues are falling short, requiring the government to borrow huge sums each year to make up the difference. We face staggering deficits. . . . Since the last time our budget was balanced in 2001, the

[72] *Id.* at 130 n.89.

[73] "Executive Order — National Commission on Fiscal Responsibility and Reform" (Dec. 18, 2010), *available at* http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform.

[74] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (Dec. 2010), *Doc 2010-25486*, *2010 TNT 231-35*.

[75] *Id.* at 24.

[76] *Id.* at 29.

[77] Alan J. Auerbach, "A Modern Corporate Tax" (Dec. 2010), *Doc 2010-25625*, *2010 TNT 233-104*.

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> federal debt has increased dramatically, rising from 33 percent of GDP to 62 percent of GDP in 2010. The escalation was driven in large part by two wars and a slew of fiscally irresponsible policies, along with a deep economic downturn. We have arrived at the moment of truth.

In its June 2010 report, ''The Long-Term Budget Outlook,'' the Congressional Budget Office projected that even if the 2001 and 2003 tax cuts were to expire as scheduled and the expanded reach of the AMT were not curtailed, federal debt held by the public would continue to grow from an estimated 62 percent of GDP in 2010 to about 80 percent by 2035.[78] Interest payments on the federal debt, which currently amount to more than 1 percent of GDP, would rise to 4 percent of GDP by 2035. If most provisions of the 2001 and 2003 tax cuts were extended, the reach of the AMT was limited, and some healthcare spending restraints were not continued, the fiscal situation would be considerably bleaker: Debt would reach 87 percent of GDP by 2020 and 185 percent in 2035. Interest payments would equal 9 percent of GDP by 2035 and by 2055 would exceed that year's total federal revenues.

ii. Tax considerations. I do not believe policymakers should consider raising taxes on U.S. businesses as a leading option to address the U.S.'s economic challenges. In 2009 the corporate income tax comprised only approximately 7 percent of U.S. revenue, compared with the 45 percent of revenue raised by the individual income tax and 30 percent raised by Social Security taxes.[79] Given that raising the already high corporate income tax rate would likely negatively affect investment in the United States, it appears that raising the corporate income tax is an undesirable strategy for addressing the United States' revenue needs.

Conversely, we should not put ourselves in a straightjacket by ruling out all tax increases. As described below, we should consider corporate base-broadening measures, which might result in tax increases on some business sectors. I also believe a VAT should be on the table.

But I believe we will be led out of this deficit the way we have been led out of all our deficits — with economic growth. And while it is hard to correlate every tax increase with reduced growth and every tax cut with increased growth, common sense tells us that corporations, which are highly responsive to tax incentives, will help spur economic growth if they are more profitable on an after-tax basis.

We must consider reforming the corporate and international tax system to make the United States a more attractive place for investment. Further, we should consider reforming our tax system to make U.S.-based multinationals, which have a significant impact on the U.S. economy, more competitive globally. A tax system that serves these goals would help create a more robust U.S. economy and generate increased tax revenue and U.S. employment.

b. Enhancing the U.S. economy.

i. Encouraging investment in the United States. The U.S. tax system should encourage investment in the United States by both U.S. and foreign-owned companies. It is true that many nontax factors, such as a strong legal and regulatory framework, infrastructure, economic stability, and a skilled workforce, are key to investment location decisions. It is also true, however, that taxes are often another important factor in a business's investment decisions.

As a result, the high U.S. corporate tax rate may be a significant impediment for firms to make investments in the United States. Economic literature suggests that tax systems affect firms' foreign direct investment decisions. For example, Ruud de Mooij and Stef Ederveen, analyzing 25 foreign direct investment studies, found that a 1 percentage point reduction in a host country tax rate raises foreign direct investment by 3.3 percent.[80] Other studies have similar results, and ''there is a general consensus that this empirical evidence demonstrates that [foreign direct investment] is in fact sensitive to tax factors, and suggests that this sensitivity may be increasing over time.''[81]

It is sometimes argued that many U.S. companies have lower effective rates than the statutory rate and thus the effective rates must be analyzed in assessing the U.S. corporate tax burden. Although I agree that effective rates should be considered as one factor, I note that high statutory tax rates are

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[78]CBO, ''The Long-Term Budget Outlook'' (2010), *Doc 2010-14510*, *2010 TNT 126-19*.

[79]*See* Office of Management and Budget, Historical Tables: Budget of the U.S. Government, Fiscal Year 2011, at 31 (2010), *available at* http://www.gpoaccess.gov/usbudget/fy11/pdf/hist.pdf.

[80]Ruud A. de Mooij and Stef Ederveen, ''Taxation and Foreign Direct Investment, A Synthesis of Empirical Research,'' 10 *Int'l Tax and Pub. Fin*. 673 (2003); *see also* de Mooij and Ederveen, ''Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Investment,'' Tinbergen Institute Discussion Paper (2005), *available at* http://ftp.tinbergen.nl/discussionpapers/05108.pdf.

[81]George R. Zodrow, ''Capital Mobility and Capital Tax Competition,'' 63 *Nat'l. Tax J.* (2010); *see also* Altshuler, Harry Grubert, and T. Scott Newlen, ''Has U.S. Investment Abroad Become More Sensitive to Tax Rates?'' in James R. Hines Jr. (ed.), *International Taxation and Multinational Activity* 9-32 (2001); Roger H. Gordon and Hines, ''International Taxation,'' *Handbook of Public Economics* (1995).

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significant because (1) lower effective rates are often the result of base-narrowing provisions that benefit only a few taxpayers; (2) corporations may engage in a significant amount of tax planning (which may come at high costs) to achieve lower tax rates; (3) statutory rates can be significant as corporations assess where to do business; and (4) the benefits of income-shifting are driven by the statutory rate. In fact:

> the benefits of income shifting are determined primarily by the statutory tax rate, as firms face obvious incentives to shift revenues to jurisdictions with relatively low statutory tax rates and deductions to jurisdictions with relatively high statutory tax rates . . . if income shifting is sufficiently important, competition in statutory tax rates may be more important than competition in effective marginal tax rates in attracting mobile capital.[82]

ii. Enhancing competitiveness of U.S. multinationals. U.S. multinationals play a significant role in the U.S. economy. A 2010 study by the McKinsey Global Institute found that ''relative to their size, U.S. multinational companies contribute disproportionately to private sector real GDP growth (or value added) and labor productivity.''[83] The study found that U.S. multinationals operate primarily in the United States — in 2007 U.S. multinationals generated 60 percent of their collective sales, employed two-thirds of their workforce, paid three-quarters of their total wages, and held 60 percent of their assets in the United States. Further, in 2007 U.S. multinationals accounted for more than a third of U.S. private sector sales and nearly 25 percent of U.S. private sector GDP.

In addition to generating a significant amount of economic activity in the United States directly, U.S. multinational companies also have a significant indirect effect on the U.S. economy. According to the McKinsey study, U.S. multinationals purchase approximately 90 percent of their intermediate input from other U.S.-based firms.[84] When the indirect effects of U.S. multinationals are added to their direct contributions to the U.S. economy, U.S. multinationals contribute more than one-third of U.S. private sector GDP and are responsible for 28 percent of U.S. employment.[85]

American households have a significant stake in the success of U.S. multinationals. Although U.S. multinationals constitute less than 1 percent of U.S. businesses, they directly employ nearly 20 percent of the private sector work force and pay a quarter of private sector workforce wages. In 2007 U.S. residents held 86 percent (approximately $17.5 trillion) of the total market value of all U.S. companies' equity, either directly as individual investors or indirectly through pensions, retirement accounts, and insurance accounts.[86]

As explained above, the success of U.S. multinationals increasingly depends on overseas investment, as does the success of all countries' multinationals. In 2007 the net income of U.S. parent corporations was $701.3 billion, while the net income of the U.S. corporation's foreign affiliates was $765.2 billion — the foreign affiliates accounted for more than half of the worldwide net income of U.S. multinationals.[87] When these multinationals establish affiliates overseas, the overseas investments are generally made in furtherance of foreign investments and not as substitutions for U.S. investments. For example, a study by Prof. Matthew J. Slaughter found that nearly 90 percent of sales by foreign affiliates majority-owned by U.S. companies are into the host-country market or other foreign markets — only 10.5 percent of affiliate sales are back to the United States.[88] Studies have also suggested that this overseas activity supports U.S. activities. Profs. Mihir Desai, Fritz Foley, and James Hines have found that a 10 percent increase in U.S. multinationals' foreign direct investment was associated with a 2.6 percent increase in domestic investment, while a 10 percent faster foreign sales growth was associated with a 6.6 percent increase in U.S. exports.[89]

The global economy has changed significantly in the nearly 50 years since subpart F was enacted. As Treasury has recognized:

> The U.S. system was developed at a time when the United States was the primary source of

[82]Zodrow, *supra* note 81.

[83]McKinsey Global Institute, *supra* note 36. The McKinsey study's primary source for data on U.S. multinational companies was the U.S. Direct Investment Abroad surveys conducted by the U.S. Bureau of Economic Analysis. The study used the same definition of ''U.S. multinational company'' (a company that maintains its headquarters in the United States and holds at least a 10 percent equity interest in a foreign affiliate) as the bureau.

[84]*Id.* at 11.

[85]*Id.*

[86]*Id.* at 10.

[87]Matthew J. Slaughter, ''How U.S. Multinational Companies Strengthen the U.S. Economy: Data Update,'' at 8 (Mar. 2010), *available at* http://businessroundtable.org/uploads/studies-reports/downloads/BRT_USCIB_White_Paper_Revised_Synopsis_3_23_10_FORMATTED_FINAL_v2_1.pdf.

[88]*Id.* at 7.

[89]Mihir A. Desai, C. Fritz Foley, and Hines, ''Domestic Effects of the Foreign Affiliates of U.S. Multinationals,'' 1 *Am. Econ. J. Econ. Pol.* 1 (2009).

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capital investment and dominated world markets. The global landscape has shifted considerably over the past several decades, with other countries challenging the U.S. position of economic preeminence. The United States is now a net recipient of foreign investment rather than the largest source.[90]

When subpart F was enacted in 1962, a U.S. company's decision whether to invest abroad or in the United States may well have been a choice. Today, however, U.S. companies must invest abroad because markets and growth are abroad. We must recognize that U.S. companies do not invest abroad at the expense of America; rather, these companies invest abroad to grow and compete, which benefits American workers and the U.S. economy.

c. Minimizing economic distortions. In considering reforming our corporate and international tax system, we may wish to determine whether there are significant economic distortions that should be addressed. For example, many believe that the current U.S. international tax system, which generally does not tax active foreign income of U.S. companies' foreign subsidiaries until that income is repatriated to the United States, creates a lockout effect that discourages foreign earnings repatriation. Others would focus on the distortive effect of deferral itself, which allows foreign subsidiaries to accumulate income tax free and benefit from the time value of money. These distortions could be addressed by two different approaches: one that would tax all foreign-source income currently, without regard to whether it is active or passive, or one that would exempt foreign income from U.S. taxation. Economic distortions created by the double tax on corporate profits include the bias against equity investment, the bias against incorporation, and the bias against dividend distributions.

d. Other objectives: administrability, simplicity, and certainty. Policymakers should strive to reform the tax system to enhance administrability and lower compliance costs. Both of these goals may be furthered by simplifying current rules when possible, which may reduce errors, improve compliance, reduce taxpayers' planning expenses (and perhaps planning opportunities), and enhance the IRS's ability to administer the rules.

Another goal of tax reform may be certainty: The tax rules should allow taxpayers to determine with relative certainty the tax consequences of their transactions. For example, expiring tax provisions and retroactive tax changes generally should be avoided.

III. A Proposal for Tax Reform

A. Overview

Tax reform should be based on today's realities. We must recognize that the United States, compared with other developed countries, has high corporate tax rates that create too great an incentive for tax planning and a disincentive for U.S. and foreign firms to invest in the United States. We also must recognize that the global economy is becoming more competitive. If the United States does not encourage U.S. investment, that investment will go elsewhere, and if the United States does not encourage U.S. firms to grow their foreign presence, they may not grow at all. Further, we must recognize that our international tax rules may create a disincentive for U.S.-based companies to reinvest foreign earnings in the United States.

The reform proposal described here is designed to encourage investment in the United States, to make U.S.-based companies more competitive across the globe, and to improve the economic inefficiency of taxing repatriated income. As detailed below, this proposal recommends (1) exemption for receipt of dividends that are paid out of active income; (2) a limitation on the deductibility of expenses allocated to exempt income; (3) a limitation on transfers of intangibles to offshore locations; and (4) a limitation on "round-tripping" transactions.[91] Further, as discussed in Part III.C, the proposal also recommends lowering the corporate tax rate along with several additional base-broadening measures and other revenue-raising measures.

B. International Tax Reform

I propose that the United States enact a dividend exemption regime under which dividend distributions from active income are not subject to U.S. tax. Passive income earned by foreign subsidiaries of U.S. corporations would continue to be taxed currently.[92]

A dividend exemption proposal is neither radical nor new. Many of the United States' closest trading

[90]Treasury, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century" (Dec. 2007), *Doc 2007-27866*, *2007 TNT 246-31*.

[91]Although I expect that my proposal could be enacted on either a revenue-neutral or revenue-raising basis (depending on which features were adopted), I have not commissioned a revenue estimate of my proposal.

[92]Mobile income, which has been the subject of much attention since 1997 (*e.g.*, Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, *98 TNT 12-8*; section 954(c)(6)), should be taxed currently to the extent that policymakers determine that income

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partners have similar regimes. Further, similar proposals have been made by a recent presidential tax reform commission and well-respected economists.[93]

1. Reasons for change. I describe below three major arguments in favor of moving the U.S. international tax regime toward a dividend exemption system.[94] In sum: (1) the current international tax rules collect little tax but appear to distort behavior; (2) corporate residence appears to be a precarious basis for taxation; and (3) all of the United States' major trading partners have or are moving toward territorial regimes.

a. The current rules distort behavior without raising significant revenue. The current U.S. international tax rules result in very little tax being collected on the foreign-source income of U.S.-based multinationals. Rosanne Altshuler and Harry Grubert have found an overall effective repatriation tax burden for income earned in low-tax countries of just 3.3 percent of pretax earnings on equity income.[95] In 2009 the Obama administration observed that ''in 2004, the most recent year for which data is available, U.S. multinational corporations paid about $16 billion of U.S. tax on approximately $700 billion of foreign active earnings — an effective U.S. tax rate of about 2.3 percent.''[96]

Although the tax on repatriated foreign income raises little revenue, it appears to encourage U.S. companies to keep income abroad. One example of this apparent incentive is the 2004 enactment of a one-year reduced tax of 5.25 percent on repatriations, which resulted in $360 billion in repatriations in 2005, compared with an average of about $60 billion per year from 2000-2004.[97] Executives of U.S. multinational companies have also said that the tax on repatriated foreign income discourages them from bringing that money back to the United States.[98]

The economic literature supports the proposition that repatriation taxes affect behavior. Analyzing the behavior of U.S.-owned affiliates over the 1982 to 1997 period, Desai, Foley, and Hines have found that ''repatriation taxes imposed by current U.S. tax rules reduce the volume and efficiency of financial flows between affiliates and their American parents.''[99] They determined that ''U.S. repatriation taxes reduce aggregate dividend repatriations by 12.8 percent annually.''[100] Hines and Glenn Hubbard have estimated that a 1 percent decrease in the tax on repatriation is associated with a 4 percent increase in dividend payments by foreign subsidiaries.[101]

The tax on repatriation also appears to distort corporate behavior in other ways. In a survey conducted by Profs. John R. Graham, Michelle Hanlon, and Terry Shevlin, firms reported incurring nontax costs to finance U.S. operations in a manner that would result in tax on repatriated earnings.[102] For example, firms reported that they had incurred debt in the United States instead of bringing cash back. Other firms said that they had accepted a lower rate of return by investing foreign cash overseas instead of in the United States.

The lockout effect of current law likely comes at a cost to the U.S. economy.[103] The amount of income kept abroad is significant. Even after the 2005

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earned in high-tax jurisdictions is deflected to low-tax jurisdictions and provides too great an incentive for investment outside the United States that would displace U.S. investment and job creation.

[93]President's Advisory Panel on Federal Tax Reform, *supra* note 54; Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* (2001).

[94]Some argue that because the current system is so close to an exemption system, the transition costs are not worth the change. I would let that question be sorted out in the political process.

[95]Altshuler and Grubert, ''Where Will They Go If We Go Territorial?'' 54 *Nat'l Tax J.* 787 (2001).

[96]Treasury, ''Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas'' (May 4, 2009), *Doc 2009-10037*, *2009 TNT 84-44*.

[97]PERAB, *supra* note 13, at 82.

[98]*See, e.g.*, John Chambers and Safra Catz, ''The Overseas Profits Elephant in the Room,'' *The Wall Street Journal*, Oct. 20, 2010 (Cisco CEO John Chambers and Oracle President Safra Catz writing: ''By permitting companies to repatriate foreign earnings at a low tax rate — say, 5 percent — Congress and the president could create a privately funded stimulus of up to a trillion dollars. They could also raise up to $50 billion in federal tax revenue. That's money the economy would not otherwise receive.''). *But see* editorial, ''Fool Me Twice,'' *The New York Times*, Oct. 23, 2010 (''Large multinationals are not refraining from investing in the United States because their money is locked up abroad. Many have large piles of cash in the United States, too. Interest rates are near historic lows, and banks will trip over themselves to lend to big multinationals sitting on mountains of cash. If they are not investing, it is because of the uncertain economic outlook.'').

(Footnote continued in next column.)

[99]Desai, Foley, and Hines, ''Repatriation Taxes and Dividend Distortions,'' 54 *Nat'l Tax J.* 829 (2001).

[100]*Id.*

[101]Hines and R. Glenn Hubbard, ''Coming Home to America: Dividend Repatriations by U.S. Multinationals,'' in *Taxation in the Global Economy* 161-208 (1990).

[102]John R. Graham, Michelle Hanlon, and Terry Shevlin, ''Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits,'' 63 *Nat'l. Tax J.* 1111 (2010).

[103]*See* Foley et al., ''Why Do Firms Hold So Much Cash? A Tax-Based Explanation,'' 60 *J. Fin. Econ.* 187 (2007) (finding that firms that face higher repatriation tax burdens hold higher levels of cash, hold cash abroad, and hold cash in affiliates that would trigger high tax costs when repatriating earnings).

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reduced rate on repatriations, U.S. companies reported more than $1 trillion of permanently reinvested earnings on 2008 financial statements.[104] Investment of deferred earnings in the United States, even in the form of a loan, is taxed on a current basis. No other OECD country has a provision like section 956 that operates in this manner.

The current rules also cause taxpayers to incur significant transaction costs in avoiding the repatriation tax. Several recent transactions have been publicized in which U.S. multinationals have tried to bring large amounts back to the United States with little or no tax.[105] Also, rather than directly repatriating funds to the United States, firms may engage in other investment strategies that have ''the effect of achieving the equivalent of repatriation without incurring the home country tax on direct repatriations of low-tax income.''[106] Altshuler and Grubert have found that ''controlled foreign corporations that face high repatriation taxes make greater investments in related affiliates and send a greater share of their dividends to other foreign affiliates. In addition, they also pay off more local debt as they accumulate retained earnings.''[107]

b. The significance of corporate residence. As described above, the United States generally taxes U.S. corporations on their worldwide income (subject to an FTC for foreign income taxes paid on foreign-source income).[108] Foreign corporations, however, are subject to U.S. tax only on their U.S. effectively connected income (on a net basis) and U.S.-source fixed or determinable income (on a gross basis).[109] As a result, whether a corporation is treated as foreign or domestic generally controls the extent to which it is taxed by the United States.

Whether corporate residence is a meaningful concept is debatable. Many large corporations are not predominantly based in only one country — their employees, business activities, shareholders, and income may be spread across the globe. As a result, it may make little sense to base the entire U.S. international tax regime on the concept of residence.

Further, the U.S. rule for determining corporate residence is essentially based on a legal formality and may not correlate with where a corporation's economic activity occurs. The United States determines whether a corporation is treated as domestic or foreign by reference to its place of organization.[110] Unlike many other countries, the United States does not consider where the corporation is managed and controlled, although there have been several recent proposals to do so.[111] Nor does it tax economic activity on a formulary basis. The place of organization as a basis for taxation provides taxpayers with a great deal of electivity in determining whether a corporation should be subject to U.S. tax as a domestic corporation (and thus taxed on its worldwide income) or a foreign entity (and thus taxed on only U.S.-source income and income effectively connected with a U.S. trade or business). The electivity of the current regime also provides an impetus for inversions.[112]

Further, the current rules also provide a significant incentive for original incorporations of firms overseas. As Daniel Shaviro writes, ''foreign incorporation — often in jurisdictions such as Bermuda and the Cayman Islands that lack significant domestic income tax systems — has become more common, and I have heard U.S. tax lawyers joke that recommending (or even not objecting to) U.S. incorporation of an intended global business verges on being malpractice per se.''[113] Although it is true that a full empirical assessment of the electivity of corporate residence on new incorporations is difficult because it ''would require worldwide data on incorporations, and an empirical strategy that credibly identifies the relevant counterfactual — i.e., incorporations that would have occurred in the United States, but occurred in other countries for tax reasons,'' recent studies have shown that new incorporations in recent years appear to be tax

[104]PERAB, *supra* note 13, at 82.

[105]*See, e.g.*, Notice 2006-85, 2006-2 C.B. 677, *Doc 2006-19944*, *2006 TNT 185-6*; Notice 2007-48, 2007-1 C.B. 1428, *Doc 2007-13117*, *2007 TNT 106-13* (responding to ''Killer B'' transactions); Notice 2008-10, 2008-1 C.B. 277, *Doc 2007-28315*, *2007 TNT 250-9* (responding to ''Deadly D'' transactions); *Schering-Plough Corp. v. United States*, 651 F. Supp.2d 219 (D.N.J. 2009), *Doc 2009-19512*, *2009 TNT 167-3*; Jesse Drucker, ''Dodging Repatriation Tax Lets U.S. Companies Bring Home Cash,'' Bloomberg (Dec. 29, 2010).

[106]Altshuler and Grubert, ''Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy,'' 87 *J. Pub. Econ.* 73 (2001) (describing alternatives to repatriation, including subsidiary investment in passive assets against which the parent corporation may borrow, and subsidiary investment in high-tax foreign affiliates).

[107]*Id.*

[108]Sections 1, 11, 61, and 901-904.

[109]Sections 882, 871, and 881.

[110]Section 7701(a)(4) and (5).

[111]Stop Tax Haven Abuse Act, S. 506; JCT, ''Options to Improve Tax Compliance and Reform Tax Expenditures,'' JCS-02-05 (2005), at 178-181, *Doc 2005-1714*, *2005 TNT 18-18*; President's Advisory Panel on Federal Tax Reform, *supra* note 57, at 179.

[112]Although the enactment of the anti-inversion rules of section 7874 in 2004 attempted to curb U.S. corporations reincorporating overseas, the continual cat-and-mouse game that is the recent history of anti-inversion rules seems to illustrate a poorly functioning system.

[113]Daniel Shaviro, ''The Rising Tax-Electivity of U.S. Corporate Residence'' (Oct. 2010), *available at* http://www.law.nyu.edu/ecm_dlv1/groups/public/@nyu_law_website__alumni/documents/documents/ecm_pro_066815.pdf.

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motivated.[114] Desai and Dhammika Dharmapala have found that the ratio of initial public offerings (IPOs) on the New York Stock Exchange and NASDAQ from 2005 through 2009 for firms incorporated in countries that Desai and Dharmapala define as ''tax haven jurisdictions'' compared with IPOs for firms incorporated in the United States was 1:10, with a peak of 1:3 in 2008. No firms were incorporated in tax havens early in the period for which data were available (approximately 1988-1990).[115] Desai and Dharmapala found that the same pattern did not exist for IPOs in the stock markets of France and Germany, which both have territorial tax systems.

In sum, ''the principal function of corporate residence is to determine whether a corporation will be taxed by the United States on its worldwide income or whether it will be subject to limited source-based taxation.''[116] Although some alternatives to the place of residence test might reduce the ease with which corporations may essentially choose the extent to which they are subject to U.S. tax when deciding whether to carry out business through a U.S. or foreign corporation, the fundamental difference in U.S. taxation of domestic and foreign corporations, and the economic distortions resulting from that difference, would remain. The stakes of corporate residence may best be reduced by modifying U.S. tax law to make the treatment of foreign income more neutral and depend less on whether it is earned by a U.S. or foreign corporation.

c. Aligning our rules with our trading partners. Another argument supporting a change in the U.S.'s current system of taxing foreign income is that most of the United States' major trading partners, whose multinationals are the major competitors of U.S.-headquartered companies, have territorial (exemption) tax systems.[117] Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Hong Kong, Japan, the Netherlands, Norway, Russia, Singapore, Spain, Sweden, Switzerland, and the United Kingdom all have territorial tax systems.[118]

Two countries with historic worldwide taxation systems, the United Kingdom and Japan, both adopted territorial systems in 2009. Both countries sought to improve the global competitiveness of their corporations as well as encourage companies to repatriate funds into the local economy.

The new Japanese system exempts 95 percent of foreign dividends from taxation.[119] According to Tadao Yanase, the director of corporate tax policy in Japan's Ministry of Economy, Trade and Industry, the Japanese tax reform was anticipated to ''promote domestic investment in such activities as research and development and further strengthen competitiveness of Japanese companies in overseas markets.''[120]

The new U.K. territorial regime exempts 100 percent of foreign dividends from taxation. Before the regime was enacted, U.K. Treasury Financial Secretary Stephen Timms said he was confident that the dividend exemption (in combination with a worldwide debt cap) and accompanying modernization of the U.K.'s CFC regime would ''enhance UK competitiveness making the UK a more attractive place to do business, and reduce the administrative burden on business, while striking the right balance with mitigating the risk to tax revenues.''[121] HM Revenue & Customs echoed this rationale for the movement toward a territorial regime:

> As a result of globalisation, businesses are becoming more mobile. In this context it is increasingly important that the UK remains an attractive location for businesses to locate and invest. It is therefore important that the tax system continues to be (and is seen to be) internationally competitive, minimising complexity and administration costs, while providing stability and certainty for taxpayers.[122]

As described above, the United States is now one of only seven OECD countries with a worldwide

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[114]Desai and Dhammika Dharmapala, ''Do Strong Fences Make Strong Neighbors?'' 63 *Nat'l Tax J.* 723 (2010).

[115]*Id.*

[116]''Report of the American Bar Association Task Force on International Tax Reform,'' 59 *Tax Law.* 649, 748 (2006).

[117]Although I generally refer to these countries as having territorial tax systems, some may have special rules for passive or other types of income and thus do not have purely territorial systems.

[118]John M. Samuels, ''American Tax Isolationism,'' *Tax Notes*, June 29, 2009, p. 1593, *Doc 2009-14174*, *2009 TNT 122-11*.

[119]Charles Gnaedinger, ''Japanese, U.K. Exemption Systems Could Inform U.S. Tax Reform Decisions,'' *Doc 2010-4363*, *2010 WTD 40-3* (citing statements made by Jonathan Stuart-Smith, partner at Tohmatsu Tax Co. in Tokyo).

[120]''Japan Tax Reform May Help Repatriate Company Funds,'' Reuters (May 9, 2008).

[121]Letter from U.K. Treasury Financial Secretary Stephen Timms to Richard Lambert, director general, Confederation of British Industry (Nov. 24, 2008).

[122]HMRC, ''Taxation of the Foreign Profits of Companies,'' Draft Provisions Discussion Paper (Dec. 9, 2008), *Doc 2009-12298*, *2009 WTD 104-19*. HMRC also stated: ''The policy objective [of the territorial regime] is to enhance the competitiveness of the UK by providing the widest possible exemption. Compared with other developed countries, this dividend exemption is one of the most generous as it is available regardless of the level of shareholding.'' *Id.*

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corporate tax system — only Chile, Ireland, Israel, Mexico, Poland, and South Korea have similar worldwide systems. Each of the other OECD countries that tax corporations on a worldwide basis, however, has significantly lower corporate tax rates.[123]

The United States' continued taxation of U.S. corporations on a worldwide basis, combined with its high statutory corporate tax rate (the second highest such tax rate in the OECD), puts U.S.-based multinationals at a competitive disadvantage. Aligning our international tax rules with those of our major trading partners (and the homes of U.S.-based multinationals' competitors) would allow U.S.-based companies to compete better in today's global economy.

As a result, the time may have come for the United States to join nearly all the other OECD members in exempting dividends paid out of active income.[124] Subpart F and the FTC would be retained for passive income. Active income, however, would be taxed purely on a source basis.[125]

2. Suggested features of a dividend exemption system.

a. Expense allocations. There are compelling arguments that, in principle, deductions allocated to exempt income should be limited. For example, some U.S. domestic tax law provisions deny deductions for expenses relating to tax-exempt income.[126]

Most of our trading partners that exempt dividends from the active income of a CFC, however, do not limit deductions. Austria, Canada,[127] Denmark, Finland, the Netherlands, Russia, Spain, Sweden, and the United Kingdom exempt all foreign business income from home country tax and do not deny deductions for domestic expenses allocable to exempt foreign income tax.[128] Belgium, France, Germany, Italy, Japan, and Norway exempt at least 95 percent of foreign business income from home country tax, subjecting a small portion of foreign income to tax as a proxy for expense allocation.[129] Australia, Hong Kong, and Singapore have territorial tax systems but impose some limitation on deductions of domestic expenses based on foreign investment. Several countries do, however, apply some limitations on deductibility of interest generally, such as the United Kingdom.

Some limitation on the deductibility of expenses relating to tax-exempt income would appear consistent with the treatment of expenses allocated to exempt income under domestic U.S. tax law.[130] A sensible compromise between full deductibility and a cumbersome expense disallowance regime would appear to be to exempt 90 percent of the foreign dividend from U.S. taxation.[131]

Alternatively, policymakers could consider a 95 percent dividend exemption with overall interest disallowance (thin capitalization) rules for U.S. corporations.[132] One approach, which would be similar to the rules adopted by many major U.S. trading partners, would restrict the overall debt-to-equity ratio of U.S. corporations to some acceptable ratio, treating interest in excess of that ratio as nondeductible dividends. This approach is taken by most EU member countries and (as a result of ECJ decisions) applies to interest paid to both domestic and foreign lenders. Expanding our thin capitalization rules to cover U.S. groups could also have the added advantage of discouraging excessive leverage, which some have viewed as particularly problematic in difficult economic conditions.[133]

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[123]China, a non-OECD country, also has a worldwide tax system. Like the other OECD countries that tax on a worldwide basis, however, it has a significantly lower corporate tax rate than the United States: 25 percent compared to 39.21 percent.

[124]For the reasons explained below, I recommend a partial exemption to reflect expenses allocable to exempt income.

[125]This proposed system would treat foreign branches and foreign subsidiaries differently, but taxpayers could avoid the full inclusion of branch income by simply incorporating the branch.

[126]Sections 264-265.

[127]Although the issue was addressed in the recent report of an advisory panel on reforming Canada's international tax system, no changes were recommended even though Canada's dividend exemption was broadened. The principal reason given was to maintain the international competitiveness of Canadian companies. Advisory Panel on International Taxation, "Enhancing Canada's International Tax Advantage" (Dec. 2008), *2008-26028*, *2008 WTD 242-18*.

[128]Samuels, *supra* note 118.

[129]*Id.* Switzerland exempts a variable amount of foreign business income from home country tax and does not deny deductions for domestic expenses allocable to exempt foreign income. *Id.*

[130]Sections 264-265.

[131]The rough justice of a 90 percent exclusion should be measured against the proper amount of deductions that should be disallowed after taking into account that deductible expenses incurred for the direct benefit of a foreign affiliate would be properly chargeable to that affiliate under applicable transfer pricing rules and therefore would be effectively nondeductible before consideration of any limitation on the dividend exclusion.

[132]The earnings stripping rule of section 163(j) currently applies only to interest paid to "tax exempt related parties," *i.e.*, foreign parents of U.S. subsidiaries.

[133]*See, e.g.*, Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu, "Financial Sector Taxation: The IMF's Report to the G-20 and Background Material" (Sept. 2010), *available at* http://www.imf.org/external/np/seminars/eng/2010/paris/pdf/090110.pdf ("Ideally, new measures would address or mitigate existing tax distortions (notably the tax bias in favor of debt), so improving the efficiency of resource allocation and reducing excessive leverage").

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b. Transfer pricing and intangibles. A dividend exemption system could create incentives for multinational corporations to attempt to use transfer pricing to minimize taxable income generated by domestic operations while maximizing income generated by active foreign business operations. These incentives also exist under current law, although some may argue that they could be more significant under a dividend exemption system because the shifting of income could lead to the exemption, rather than the deferral, of U.S. tax.[134] As a result, reform of the transfer pricing rules may be needed.

Compelling arguments have been made for and against a formulary system.[135] For a variety of reasons, however, I assume that any transfer pricing reform would have to be done within the context of the arm's-length standard. The arm's-length standard is the accepted international norm and has been endorsed by every member of the OECD. Also, the arm's-length standard may be viewed as beneficial for the United States because, as applied, it rewards the owner of intangibles, and U.S. companies tend to have more intangibles than companies in other countries.

Intangibles contribute significant profits to modern multinational corporations. Current law, however, creates opportunities for companies to shift profits related to intangibles out of the United States. This phenomenon should be distinguished from profits related to business opportunities overseas, which would not be subject to U.S. tax under a dividend exemption system. Addressing the potential base erosion from the transfer of intangibles is crucial to advancing dividend exemption against the assertion that it would lead to further erosion of the U.S tax base.

The key question is: If intangibles are developed in the United States, when should the income related to them be taxed in the United States? That was Congress's concern when it added the second sentence (the super-royalty or commensurate with income rule) to section 482 in 1986.[136]

Under the cost-sharing regulations as they existed until the recent amendments, it was possible for a U.S.-based multinational to locate most of the profit from an intangible in a CFC solely because the CFC participated in the costs of developing the intangible in the United States. The CFC was not required to participate in the research in any way other than by making a monetary contribution (which could be a capital contribution from the U.S. parent). Under these regulations, it was possible to conduct the development of an intangible, the manufacturing, and the sales in the United States, but to have the majority of the profits treated as arising overseas because the intangible was located there. Valuation of intellectual property for purposes of the buy-in became the crucial determinant of tax liability, but, as recent case law has shown, it is a very inexact science.[137]

Recent amendments to the cost-sharing regulations have tightened the requirements for a CFC to participate in a qualified cost-sharing arrangement.[138] These regulations are likely to be more successful than the former regulations at limiting the ability of U.S.-based multinational corporations to shift profits from intangibles developed in the United States to their foreign subsidiaries. The recent amendments include new methods for valuing the assets each party contributes to the arrangement, as well as additional guidance on the required scope of the cost-sharing activity and the IRS's ability to make adjustments to ensure that the income with respect to the transfer of intangible assets is commensurate with the income attributable to the intangible.

It may make sense, however, to further amend the regulations so that cost sharing would apply only to intangibles developed with substantial participation by a foreign corporation or to intangibles whose costs are shared with foreign affiliates that have actual experience making and selling the goods or services to which the intellectual property relates. If a U.S.-based multinational corporation develops an intangible jointly with its foreign subsidiaries, cost sharing is an appropriate way to allocate the resulting profit between the related parties. A very credible policy argument exists, however, that cost sharing should not be applied to allocate profits to a foreign subsidiary that did not actually participate in developing the intangible or have experience exploiting it.[139]

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[134]Conversely, if a rate reduction is enacted, this incentive may be at least partially counterbalanced.

[135]*See, e.g.*, Reuven Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Fla. Tax Rev*. 497 (2009); Altshuler and Grubert, "Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives?" 63 *Nat'l. Tax J.* 1145 (2010).

[136]Congress considered and rejected more stringent transfer pricing rules that would have applied only to U.S.-based companies. *See* Treasury, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," 387-388 (May 1985).

[137]*Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *Doc 2009-27116*, *2009 TNT 236-17*.

[138]Reg. section 1.482-7T.

[139]Indeed, final cost-sharing regulations released in 1995 required that a cost-sharing participant use covered intangibles in the "active conduct of a trade or business." T.D. 8632, *Doc 95-11248, 95 TNT 247-4* ("A controlled participant must use or reasonably expect to use covered intangibles in the active

(Footnote continued on next page.)

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When a foreign partner is an active participant in the development of the intangible, the arrangement should not raise the same base-erosion concerns that arise in other cases. When an intangible is developed in the United States and a foreign partner is in a better position to manage the intellectual property, the facts could also justify retention of the intangible profit offshore. When, however, an intangible is developed and exploited in the United States with minimal participation by the foreign affiliate, amended cost-sharing rules could allocate the profit back to the United States.

Preexisting cost-sharing agreements could be grandfathered and therefore would not need to meet the new, more restrictive requirements for qualification. However, the tax benefits from preexisting agreements could be cut back, to an extent to be decided by Congress, through the application of special subpart F rules that could be drafted for those grandfathered agreements.

This may, however, not be viewed as a sufficient disincentive to exploit the transfer pricing rules in a dividend exemption environment. If not, consideration could be given to adopting some form of the administration's excess returns proposal. Under that proposal, "if a U.S. person transferred an intangible from the United States to a related [CFC] that is subject to a low foreign effective tax rate in circumstances that evidence excessive income-shifting, then an amount equal to the excessive return would be treated as subpart F income."[140] For purposes of revenue estimating, Treasury economists assumed that subsidiaries with an effective foreign tax rate of less than 10 percent and with intangibles earning a return in excess of 30 percent were subject to the provision.[141] If the proposal is viewed as too blunt an instrument, it could be modified to apply only when triggered by some further metric designed to measure more precisely whether foreign profits are sufficiently tax motivated (such as whether substantial business activities are conducted in the low- or zero-tax jurisdiction).

c. Round-tripping transactions. Another concern with adopting a dividend exemption is that it could encourage U.S.-based companies to close plants in the United States, open plants overseas, and import the goods that were formerly produced domestically. A significant body of economic literature suggests that this is not typically the way U.S. multinational corporations operate.[142] Further, if the dividend exemption were combined with a corporate rate cut, as suggested below, companies would have less of an incentive to incur the significant costs required to close and reopen a plant overseas. However, because this remains a concern,[143] income from these runaway plants could be subject to subpart F under some circumstances if the products are sold into the United States.[144]

Recent proposed legislation, however, illustrates some of the difficulty in drafting that legislation. For example, the American Jobs and Ending Offshoring Act proposed to disallow deductions for some items incurred in moving American jobs offshore, and it would have created a new category of subpart F income for income directly or indirectly derived from the operation of a trade or business that was started or expanded outside the United States as part of an American jobs offshoring transaction.[145] The proposed legislation would have defined an "American jobs offshoring transaction" as "any transaction (or series of transactions) in which the taxpayer reduces or eliminates the operation of a trade or business (or line of business) within the United States in connection with the start up or expansion of such trade or business (or such line of business) by the taxpayer outside of the United States."

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conduct of a trade or business. Thus, an entity that chiefly provides services (e.g., as a contract researcher) may not be a controlled participant."). This rule was eliminated in 1996. T.D. 8670, *Doc 96-13943*, *96 TNT 93-8*.

[140]Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," 43 (Feb. 2010), *Doc 2010-2363*, *2010 TNT 21-20* (Treasury green book).

[141]*See* Kristen A. Parillo, "Intangible Asset Proposal Will Not Displace Transfer Pricing," *Tax Notes*, Mar. 1, 2010, p. 1028, *Doc 2010-4055*, or *2010 TNT 37-3*. Treasury estimated a revenue gain of $15.5 billion over 10 years. Treasury green book, *supra* note 140, at 43. The JCT estimated a revenue gain of $10.2 billion over 10 years. *See* JCT, "Estimated Budget Effects of the Revenue Provisions Contained in The President's Fiscal Year 2011 Budget Proposal," JCX-7-10R (Mar. 15, 2010), *Doc 2010-5625*, *2010 TNT 50-13*.

[142]The research is summarized in Desai, "Securing Jobs or the New Protectionism?" *Tax Notes*, Apr. 20, 2009, p. 315, *Doc 2009-6392*, or *2009 TNT 74-11*. The supply chain of U.S.-based companies is typically greater than 75 percent in the United States, while more than 50 percent of their sales are overseas. These findings also support the conclusion that foreign growth spurs U.S. economic activity.

[143]*See, e.g.*, S. 3816; S. 260; Export Products Not Jobs Act, S. 96.

[144]The trigger for inclusion could be if a Worker Adjustment and Retraining Notification Act notification is given to the employees of a plant that is about to be closed. 29 U.S.C. sections 2101 to 2109. Also, the U.S.-based multinational could be permitted to enter into a 10-year gain recognition agreement in which it commits not to sell goods produced by the foreign plant into the United States. *Cf.* section 367(a) regulations. In those circumstances, the shift would be viewed as not primarily tax motivated and thus not subject to a subpart F inclusion.

[145]S. 3816.

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Determining whether the reduction or elimination of a U.S. business is ''in connection with'' the commencement of that business outside the United States may be difficult as a factual matter. Further, even if the ending of U.S. business and commencement of a foreign business are clearly related, there may be valid nontax business reasons for the change in operation, and it is unclear why those business-motivated transactions should be subject to current taxation. In a statement opposing the Creating American Jobs and Ending Offshoring Act, then-Finance Committee ranking minority member Charles E. Grassley, R-Iowa, provided several examples of nontax reasons, including when there is only a small demand for the product in the United States compared with its overseas markets, when some items are not found in appreciable quantities in the United States, or when a U.S. company acquires a foreign company that imports into the United States.[146] Grassley also argued that the bill could decrease employment in the United States by encouraging American companies to sell their foreign subsidiaries or further expatriating manufacturing jobs.

As opposed to the general ''in connection'' language used in several recent legislative proposals, a rule taxing income from runaway plants if the products of the plant are sold into the United States could require a specific nexus between the plant closure and the product sale into the United States. In other words, the subpart F inclusion would be limited to round-tripped goods rather than generally to all goods sold into the United States after a combination of a U.S. closure and foreign expansion.

d. Transition issues. Although I do not fully consider these issues here, transition rules would need to be considered if the United States enacted a dividend exemption system.[147] Without transition rules, U.S. corporations with foreign subsidiaries, and their shareholders, would gain a transition benefit because corporate earnings that previously would be available only at the cost of U.S. tax would now be accessible with no tax cost. As commentators have recognized, however, ''perfection is unlikely to be attainable'' when designing a transition system, and there will be a need to balance many considerations. These include the taxes U.S. multinationals would have paid if the current system had remained in place, the tax planning costs they would have incurred in minimizing that tax, administrative and compliance complexity, and the creation of undesirable incentives.[148] Potential transition regimes include a one-time transition tax imposed on foreign subsidiaries' accumulated earnings and profits (even if not repatriated) or imposing a reduced tax on actual and deemed distributions to U.S. parents until an amount equal to pre-enactment foreign E&P had been paid out.

e. Revenue impact. Revenue estimates for dividend exemption tax systems have varied significantly. A 2007 Treasury study estimated that switching to a dividend exemption system would raise $40 billion over 10 years. According to Treasury, ''this revenue gain arises primarily from the elimination of foreign tax credits that, in effect, shield a considerable portion of low-taxed nondividend foreign source income, such as certain royalties, from U.S. tax.''[149] The recent PERAB report said that a territorial system without full expense allocation rules would lose approximately $130 billion over 10 years, but also said that ''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.''[150]

C. Corporate Tax Reform

1. Lowering the rate. After TRA 1986, the U.S. corporate tax rate was among the lowest in the OECD. However, while other OECD countries have gradually lowered their rates, the United States has actually increased the top marginal corporate rate by one percentage point. As a result, the United States will soon have the second-highest corporate tax rate in the OECD.

Having a corporate tax rate that exceeds those of our trading partners may have significant implications for the location of investment. As described above, economic literature has shown that the nominal corporate tax rate is correlated with the location of multinational investment. Also, a high tax rate exacerbates the incentives to shift profits out of the United States via transfer pricing, thin capitalization, and other plans to avoid U.S. tax.

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[146]Grassley Floor Speech, ''Creating American Jobs and Ending Offshoring Act'' (Sept. 27, 2010).

[147]It should be noted, however, that Japan and the United Kingdom did not enact transition rules when they each recently switched to dividend exemption systems.

[148]*See* Shaviro, ''The Rising Tax-Electivity of U.S. Corporate Residence,'' *supra* note 113.

[149]Treasury, *supra* note 90, at 58; *see also* Grubert and Mutti, ''Taxing International Business Income: Dividend Exemption Versus the Current System'' (2001), *available at* http://www.aei.org/docLib/20021130_71546.pdf (using 1994 data, estimating that an exemption system would generate $7.7 billion annually in additional revenue).

[150]PERAB, *supra* note 13, at 90.

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2. Broadening the base. To make the tax reform suggested herein revenue neutral or revenue positive, it may be possible to broaden the corporate tax base by eliminating or revising various corporate tax expenditures. Also, given the significant growth of flow-through businesses in recent years, Congress may want to consider some measures to equalize the treatment of large businesses, whether flow-through or not.

Further, a VAT should be on the table as a revenue raiser in the coming years. However, policymakers must be willing to put a VAT on a menu of revenue-raising provisions to be considered in any upcoming fundamental tax reform.

a. Reconsidering corporate tax expenditures. As the Bowles-Simpson commission wrote in its December 2010 report:

> In the quarter century since the last comprehensive tax reform, Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax earmarks — amounting to $1.1 trillion a year of spending in the tax code — not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth and competitiveness, our current code drives up health care costs and provides special treatment to special interests. The code presents individuals and businesses with perverse economic incentives instead of a level playing field.[151]

It is debatable whether the corporate tax expenditures are an effective and efficient means of carrying out their intended objectives (for example, encouraging specific types of investments) or, further, whether those intended objectives come at too high a cost (for example, distorting investment decisions). As Donald Lubick and Ward Hussey state:

> It is usually less efficient to use the tax system than to pay a direct subsidiary to the activity involved. Use of the tax system imparts a degree of permanence that preserves the subsidy long past the period of its need, complicates and undermines efficient enforcement of the revenue laws generally, introduces government intervention through revenue officials who are not equipped to police the qualifications of those subsidized, and, most important perhaps, is inefficient because of the inflexibility inherent in defining the proper objects of the subsidy in tax law terms. Such tax preferences inevitably direct government resources in large measure to unintended beneficiaries. They distort market influence on efficient allocation of resources.[152]

In its recent report, "Tax Policy Reform and Economic Growth," the OECD recognized that "in many cases, base-broadening is a growth-oriented tax reform strategy."[153] The OECD highlighted four main efficiency and cost-related arguments in favor of a broad base: (1) increased efficiency (minimization of distortions and deadweight losses arising from different rules applying to similar types of taxpayers or activities); (2) reduction in administrative, enforcement, and compliance costs; (3) increased tax compliance (with opportunities for tax arbitrage reduced); and (4) the potential to lower rates, which can lead to efficiency gains and reductions in tax avoidance and evasion incentives.[154]

There are more than 75 corporate tax expenditures and 30 general business tax credits in the code.[155] Although I recognize that decisions regarding tax expenditures are highly political, policymakers *and* businesses must be willing to sacrifice a few sacred cows to broaden the corporate tax base to lower the corporate tax rates. Congress ultimately may decide to keep some tax expenditures, but businesses should recognize that the continuation of specific corporate tax expenditures, which tend to benefit only certain types of businesses, comes at the expense of a lower corporate rate, which tends to benefit all corporations.

Although I do not make specific recommendations here on which specific tax expenditures should be preserved or eliminated, Table 2 lists some of the largest business tax expenditures that policymakers may wish to examine.

b. Thinking beyond corporate taxation. I recognize that any proposal to change the boundaries between corporate and noncorporate taxation of business entities is likely to encounter significant debate. Given the increased growth of flow-through entities and thus the continued narrowing of the

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[151]National Commission on Fiscal Responsibility and Reform, *supra* note 74, at 24.

[152]Ward M. Hussey and Donald C. Lubick, *Basic World Tax Code and Commentary* 7-8 (1996).

[153]OECD, *supra* note 2, at 86. The OECD report observes that the retention of tax expenditures might be justified when the costs of broadening the base exceed the corresponding efficiency gains; when the expenditure is intended to serve as a social benefit and the tax system is an efficient mechanism for delivering that benefit; and when expenditures operate as tax incentives that correct for market failures or provide incentives to internalize positive external effects. *Id.* at 85-86.

[154]*Id.* at 84.

[155]*Id.* at 29.

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Table 2			
	Revenue, 2008-2017 (Fiscal Year, $ in billions)		
Major Special Business Tax Provisions	**Corporate**	**Non-corporate**	**Total**
Accelerated depreciation/expensing provisions	356	306	662
Deduction for U.S. production/manufacturing activities	210	48	258
Research and experimentation (research credit)	132	1	133
Low-income housing tax credit	55	6	61
Exclusion of interest on life insurance savings	30	0	30
Inventory property sales source rules	29	0	29
Deductibility of charitable contributions	28	0	28
Special employee stock ownership plan rules	23	4	27
Exemption of credit union income	19	0	19
New technology credit	8	1	9
Blue Cross/Blue Shield deduction	8	0	8
Expense of percentage over cost depletion, fuels	7	0	7
Other business preferences	27	28	66
Total	**$932**	**$394**	**$1,326**
Source: PERAB report, Table 9, at 77 (citing Department of the Treasury, Office of Tax Analysis data).			

corporate tax base, however, these boundaries should be subject to reconsideration in any tax reform debate.

Flow-through entities now earn nearly half of all U.S. business income. Further, there is a compelling policy argument that businesses of similar sizes and engaged in similar activities should face similar tax regimes and rates. Policymakers may wish to consider measures to promote neutrality of business entity taxation, many of which could raise revenue. These measures could be targeted, such as subjecting profits earned by shareholders in businesses (other than those currently taxed as corporations under the section 7701 regulations) to payroll taxes, or broad, such as requiring firms with specified corporate characteristics (for example, publicly traded businesses or businesses with certain income or assets thresholds) to pay the corporate income tax.[156]

c. Considering a VAT. It appears that opposition to a VAT is one of the few things lawmakers of all political persuasions can agree on these days. Rep. Barney Frank, D-Mass., has said a VAT is ''dead as a doornail,''[157] while House Majority Leader Eric Cantor, R-Va., has said, ''I don't think any of us want to go the direction of the social welfare states around the world.''[158] In April 2010 the Senate voted 85-13 to pass a (nonbinding) resolution declaring a VAT a ''massive tax increase that will cripple families on fixed income and only further push back America's economic recovery.''[159]

A VAT should be on the table as our nation considers the best ways to tackle its deficit. The advantages and disadvantages of a VAT have been addressed extensively elsewhere, and I will not repeat them at length here.[160] Rather, I submit that policymakers must be willing to consider whether the nation's interests can be served by enacting a VAT.[161]

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[156]PERAB, *supra* note 13, at 75.

[157]*See* Michael O'Brien, ''Barney Frank: 'Zero chance' of Congress Approving a Value-Added tax,'' TheHill.com (July 29, 2010) (quoting Frank).

[158]*See* Damian Paletta, ''Another Deficit Plan Targets Taxes,'' *The Wall Street Journal*, Nov. 17, 2010 (quoting Cantor).

[159]S. Amdt. 3724 to S. Amdt. 3721 to H.R. 3851.

[160]Proponents of a VAT argue that it could serve as an efficient revenue-raising mechanism in a time of increasing revenue needs. *See, e.g.*, Gale and Harris, *supra* note 44. Opponents of a VAT argue that the federal government will grow as federal lawmakers continually increase the VAT rate to pay for spending. *See* Curtis S. Dubay, ''The Value-Added Tax Is Wrong for the United States'' (Dec. 21, 2010), *Doc 2010-27158*, *2010 TNT 245-29*. Opponents also argue that a VAT will slow economic growth. *Id.* Some have also made the point that there should be a high burden of persuasion before adopting an entirely new tax, requiring an entirely new (or at least significantly adapted) administrative infrastructure.

[161]In general, a VAT is a tax on sales to consumers that is collected at the different stages of the production process. There are two general types of VATs: credit invoice and subtraction method. Under a credit-invoice VAT, which is used in Australia, Canada, Europe, and New Zealand, all business sales are taxable but sellers pass on invoices to registered business taxpayers who purchase goods and services from them. These purchasers then claim a credit for the taxes paid on their purchases. The result is that there are no net taxes on sales between registered VAT businesses. Rather, the end consumer bears the full tax. Under a subtraction-method VAT, all businesses pay VAT on the difference between the value of their sales and the value of their purchases from other businesses. The sum of all amounts subject to the VAT (assuming no exemptions) equals the value of sales to end consumers. For interesting discussions of how a U.S. add-on VAT might be

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One reason a VAT should be on the table is that it is unclear whether ''politically feasible tax increases within the current tax structure can generate sufficient revenues to bring federal budget deficits under control.'' Economists Altshuler, Katherine Lim, and Roberton Williams have examined the extent to which individual tax rates would need to rise to reduce the average deficit over the 2015-2019 period to 2 percent of GDP, a level at which deficits could be sustainable in a growing economy.[162] Assuming the 2001 and 2003 tax cuts had sunset in 2011 as scheduled, revenue would need to increase by an average of $239 billion per year to meet this target. However, if the tax cuts are assumed to have been permanently extended, revenues would need to rise an average of $775 billion annually over the 2015-2019 period to meet the same goal.

Altshuler, Lim, and Williams examined five options for meeting the 2 percent deficit target: (1) raising all individual income tax rates proportionally; (2) raising the top three tax rates proportionally; (3) raising tax rates proportionately on single taxpayers with income exceeding $200,000 and married couples filing jointly with income greater than $250,000 (that is, the taxpayers targeted for tax increases by President Obama during the 2008 presidential election); (4) eliminating itemized deductions; and (5) limiting the value of itemized deductions to 15 percent.

Under option 1, Altshuler, Lim, and Williams found that all tax rates would need to rise significantly to meet the 2 percent of GDP deficit target. Assuming the 2001 and 2003 tax cuts continue beyond their sunset date, the bottom 10 percent rate would become almost 15 percent and the top rate would increase from 35 to 52 percent. If those tax cuts did not continue, the bottom 15 percent rate would rise to 17 percent and the top rate would rise from 39.6 to 45.5 percent. Under option 2, in which rates for taxpayers in the lowest tax brackets would remain the same, the top three tax rates would rise from 28 to 60.8 percent, from 33 to 71.7 percent, and 35 to 76.1 percent, assuming the 2001 and 2003 tax cuts had been extended. If the 2001 and 2003 tax cuts had not been extended, the top three tax rates would rise from 31 to 41.1 percent, from 36 to 47.7 percent, and 39.6 to 52.5 percent. Under option 3, the top rate would need to rise to nearly 91 percent assuming the 2001 and 2003 tax cuts were extended and 56.4 percent if the 2001 and 2003 tax cuts were not extended. Altshuler, Lim, and Williams found that options 4 and 5, which would limit itemized deductions, would not raise enough revenue to meet the 2 percent of GDP target if the 2001 and 2003 tax cuts were continued.

Altshuler, Lim, and Williams concluded:

> None of the options we have examined would provide a realistic approach to reducing the deficit over the coming decade. . . . We do not rule out corporate tax increases (either through corporate tax increases (through either statutory rate increases or base broadening), but we feel that raising significant revenues through the corporate tax is not a viable strategy. We need a different approach. . . . Reducing the federal budget deficit to a level that is sustainable over the long run will likely require either more comprehensive tax reform or tapping a new source of revenue, such as a value-added tax.

A VAT could raise significant revenue. Eric Toder and Joseph Rosenberg have estimated that imposing a 5 percent VAT on a broad base in 2012 would raise about $355 billion and, when partially offset by accompanying reductions in individual, corporate, and payroll tax liabilities, would result in net revenue increase of $258.6 billion (for one year).[163] The broad-base VAT would include all domestic consumption, except education, government-financed healthcare, services by charitable organizations, and services performed by subnational governments. Sales and local sales taxes, the imputed value of financial services, and interest on consumer debt would also be exempt. A narrow-base VAT (that is, one that has the same exemptions as the broad base but also exempts housing consumption, food consumed at home, and private medical expenses such as out-of-pocket expenses and insurance premiums) would raise about $221 billion and, when offset by reduced individual,

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structured and analysis of the international experience in implementing VATs, see Symposium (Part I), ''Designing a Federal VAT,'' 63 *Tax. L. Rev*. 285 (2010), and Symposium (Part II), ''Designing a Federal VAT,'' 63 *Tax. L. Rev*. 517 (2010).

[162]Altshuler, et al., ''Desperately Seeking Revenue,'' *supra* note 12. The paper also considers the options necessary to reduce the debt to 3 percent of GDP, which is a target that former OMB Director Peter Orszag deemed sustainable.

[163]Toder and Joseph Rosenberg, ''Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes,'' *supra* note 12. Toder and Rosenberg's revenue estimate follows the estimating convention used by Treasury and the JCT, which uses a fixed GDP. According to Toder and Rosenberg:

> with nominal GDP (and prices) fixed, a consumption tax must lower factor incomes. Effectively, the sales tax paid by the business is deductible from profits that the business reports and reduces the taxable wages it pays. Treasury and JCT thus apply an offset in reduced individual income, corporate income, and payroll tax revenues when sales taxes are imposed or increased.

Id.

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corporate, and payroll tax liabilities, would raise approximately $161 billion.[164]

Further, although many charge that a VAT would be a regressive tax that would raise tax burdens proportionately more on low-income taxpayers, a VAT itself is not necessarily regressive[165] and may be structured to promote progressivity while still raising significant revenue.[166] For example, revenue from the VAT could be used to reduce payroll taxes. Toder and Rosenberg have found that using revenues from a broad-based VAT to replace part of the payroll tax would actually raise after-tax income for the bottom 95 percent of the population (while lowering after-tax income for the top 5 percent).[167] A VAT combined with a refundable credit of $436.88 per adult and $218.44 per dependent child could be ''very progressive,'' especially if coupled with a payroll tax deduction.[168]

Some have suggested enacting a VAT in combination with fundamental individual income tax reform, which, although I do not specifically discuss IT herein, may be of interest to policymakers. For example, Michael J. Graetz has proposed a tax plan that would, in sum, enact a VAT with a broad base and a rate between 10 and 14 percent, exempt all income less than $100,000 for married couples and $50,000 for single persons (indexed for inflation), impose a low rate of tax (20 to 25 percent) on the taxable income of high-income individuals, and lower the corporate tax rate to 15 or 20 percent.[169]

IV. Conclusion

The current U.S. corporate and international tax rules put U.S. multinationals in a disadvantageous position while raising relatively little revenue compared to the total U.S. tax revenue and less revenue than would be expected when compared to the revenue collected by other countries with lower corporate tax rates. U.S.-based companies often do not repatriate profits in the absence of complex and contentious tax planning transactions. Foreign businesses often find the United States inhospitable from a tax perspective.

The time has come for a pragmatic and centrist reform of the U.S. corporate and international tax rules. Such a reform could involve reducing the corporate rate to the OECD average and exempting active foreign dividends from income. At the same time, it could involve limiting indirectly the deductibility of expenses allocated to exempt dividends by partially taxing the dividends, further restricting the ability of U.S.-based companies to artificially shift profits out of the United States or to engage in round-tripping transactions, reconsidering a variety of corporate tax expenditures, and introducing a VAT.

There may be other pragmatic, centrist, and revenue neutral reform ideas that could be integrated into this proposal or that are better alternatives. The question is whether a serious discussion is possible. The answer is yes, and the time is now.

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[164] *Id.* at 13.

[165] *Id.* at 23 (finding that ''the burden of a broad-based VAT is roughly proportional throughout the income distribution, except at the very top''). Toder and Rosenberg observed that a narrow-based VAT would likely be more progressive than the broad-based VAT.

[166] *See generally id.*

[167] *Id.* at 24.

[168] *Id.* at 26.

[169] Graetz, *100 Million Unnecessary Returns*, *supra* note 28.

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