Designing a U.S. Exemption System For Foreign Income When the Treasury is Empty

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DESIGNING A U.S. EXEMPTION SYSTEM FOR FOREIGN INCOME WHEN THE TREASURY IS EMPTY*

by
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I. INTRODUCTION

The U.S. government faces a well-documented long-term revenue shortage that is unlikely to be cured by government expenditure reductions. Thus, it is curious that there is currently considerable pressure for the United States to adopt some type of territorial or exemption system[1] under which

1. Under an exemption system, a residence country will confer a tax exemption on most foreign-source business income earned by its residents. Exemption systems are also frequently referred to as territorial systems because a country employing such a regime will tax only income earned within its own territory, even if the income earner is its resident. This article follows the prevailing rhetorical practice by using "exemption system," "territorial system," and "territoriality" as interchangeable terms, notwithstanding the technical differences in how territorial and exemption systems are implemented in practice by various countries. As noted by some commentators, a true territorial system exempts all foreign-source income from taxation by the residence country, whereas an exemption system exempts only some types of foreign-source income (usually active foreign business income) from taxation by the residence country. *See* Lawrence Lokken & Yoshimi Kitamura, *Credit v. Exemption: A Comparative Study of Double*

most foreign-source active business income earned by U.S. resident corporations would become substantially free of U.S. income tax.

Although we are not fans of territoriality, we recognize that a significant reform of the U.S. international tax system is necessary. In other articles, we have expressed our clear preference for strengthening the U.S. worldwide taxation system[2] by repealing the deferral privilege and instituting a per-country foreign tax credit limitation.[3] However, if such a reform is not

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Tax Relief in the United States and Japan, 30 NW. J. INT'L L. & BUS. 621, 622 (2010) [hereinafter Lokken & Kitamura, *Credit v. Exemption*] (pointing to Singapore as an example of a country with a true territorial system).

Regarding current support for adoption by the United States of a territorial or exemption system, see PRESIDENT'S COUNCIL ON JOBS AND COMPETITIVENESS, ROAD MAP TO RENEWAL 47–48 (2011) [hereinafter JOBS COUNCIL, ROAD MAP] (stating that "[m]any members" of President Obama's business advisory council "believe the United States should move to a territorial system"); THE NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM: THE MOMENT OF TRUTH 33 (2010) [hereinafter DEFICIT COMM'N, MOMENT OF TRUTH] (advocating adoption of an exemption system).

2. Under a pure worldwide system, a residence country taxes its residents on the sum of their domestic-source and foreign-source income but allows a credit for foreign taxes paid by residents on foreign-source income. Because such a system taxes worldwide income, a pure worldwide regime is sometimes referred to as a "full inclusion system." As discussed later in this article in relation to the United States, we recognize, as others have, that no country employs a pure worldwide system just as no country employs a pure exemption system.

3. *See generally* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 TAX NOTES INT'L 547 (Jan. 31, 2000); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 986–94 (1997) [hereinafter Peroni, *Back to the Future*]; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]. For a legislative proposal along these lines, see Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112TH CONG., 1ST. SESS. (2011) (requiring current taxation of the income of controlled foreign corporations).

For other commentaries supporting international tax reform in the form of a full inclusion system, see Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 TAX NOTES 1775 (June 29, 1998); Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?*, 65 TAX L. REV. 323 (2012); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993); Jeffrey M. Kadet, *U.S. International Tax Reform: What Form Should It*

politically feasible, we believe that a properly designed exemption or territorial system could be an improvement over the current U.S. international tax regime, which is badly flawed for multiple reasons.[4] In any event, there is a significant likelihood that Congress will sooner or later be considering legislation to create a U.S territorial or exemption system. Accordingly, it is important for academics and policymakers to thoughtfully discuss the structure of such a system.[5] We hope that this article will contribute to that conversation. Our fundamental point is that because of the U.S. fiscal situation, it is particularly important that a U.S. territorial system not forgo more revenue than is necessary to achieve the system's appropriate ends.

Part II illustrates why nations of the world take ameliorative action to mitigate double income taxation that could chill international trade and leave us with a poorer planet. Part III explains the customary international law solution to the double taxation conundrum. Part IV describes the current U.S. flirtation with territoriality. Part V briefly outlines the long-run U.S. fiscal challenge and argues that any U.S. territorial system should be structured to limit aggravation of the fiscal problem. Part VI describes the dividend exemption element of a properly structured territorial system, and

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Take?, 65 TAX NOTES INT'L 363 (Jan. 30, 2012); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 101, 152-66 (2011) [hereinafter Kleinbard, *Lessons*]; Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547 (Feb. 5, 2007); *see also* Kimberly A. Clausing, *A Challenging Time for International Tax Policy*, 136 TAX NOTES 281 (July 16, 2012) [hereinafter Clausing, *Challenging Time*] (arguing that an unlimited U.S. territorial system "would increase employment in low-tax countries by about 800,000 jobs" and that in the present weak U.S. economy "those new, low-tax-country jobs could displace jobs at home"). For the view that the United States should pursue incremental international tax reform, rather than enact either a full inclusion system or an exemption system for foreign-source income, see David L. Cameron & Philip F. Postlewaite, *Incremental International Tax Reform: A Review of Selected Proposals*, 30 NW. J. INT'L L. & BUS. 565 (2010); Robert H. Dilworth, *President's Economic Recovery Advisory Board: Suggested Considerations in Fundamental Reform of the United States Tax Treatment of Income from Cross Border Trade and Investment*, 30 NW. J. INT'L L. & BUS. 551 (2010); Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, 35 INT'L TAX J. 5 (Sept. 2009).

4. *See generally* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79 (2009) [hereinafter Fleming, Peroni & Shay, *Worse than Exemption*].

5. House Ways and Means Committee Chairman David Camp has published a draft proposal to shift the United States to an exemption system. *See* Ways and Means Discussion Draft and its technical explanation, http://waysandmeans.house.gov/taxreform/. Senator Michael Enzi has introduced a similar, if less ambitious, proposal. *See* United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112TH CONG. 2D SESS. (2012).

Part VII outlines the branch exemption component of such a system. Part VIII deals with certain structural issues. Part IX discusses "competitiveness" concerns and the relevance of tax expenditure analysis. In Part X, we summarize our conclusions.

II. THE DOUBLE TAXATION CONUNDRUM

Every country has a normative claim, based on the ability-to-pay principle, to tax its residents on their foreign-source income,[6] and the exercise of this normative claim is indisputably permitted by customary international law.[7] In addition, every country has a normative claim, based on a benefits-received rationale,[8] to tax income earned by foreigners within its borders, and the exercise of this normative claim is also indisputably permitted by customary international law.[9] Thus, the foreign-source income of a resident of a particular country (the "residence country") is potentially subject to taxation by both the residence country and the foreign country (the "source country") where the income was earned.[10] More than insubstantial

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6. *See* Ilan Benshalom, *The New Poor At Our Gates: Global Justice Implications for International Trade and Tax Law*, 85 N.Y.U. L. REV. 1, 75 (2010); Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 3; ROY ROHATGI, BASIC INTERNATIONAL TAXATION 12 (2002) [hereinafter ROHATGI, BASIC INTERNATIONAL TAXATION]. For a discussion of the connection of source-based taxation and residence-based taxation to the international law concept of sovereignty, see Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155 (2008).

7. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 412(1)(a) (1987); REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 22–27 (2007) [hereinafter AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW]; Michael S. Kirsch, *The Role of Physical Presence in the Taxation of Cross-Border Personal* Services, 51 B.C. L. REV. 993, 999 (2010) [hereinafter Kirsch, *Physical Presence*]; *see also* Kim Brooks, *Global Distributive Justice: The Potential for a Feminist Analysis of International Tax Revenue Allocation*, 21 CAN. J. WOMEN & L. 267, 280 (2009) [hereinafter Brooks, *Global Distributive Justice*].

8. *See* Kirsch, *Physical Presence*, *supra* note 7, at 1040; Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: "What's Source Got to Do with It?" — Source Rules and International Taxation*, 56 TAX L. REV. 81, 88–106 (2002) [hereinafter Shay, Fleming & Peroni, *Source Rules*]; ROHATGI, BASIC INTERNATIONAL TAXATION, *supra* note 6, at 12.

9. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 411–12; AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW, *supra* note 7, at 27; Brooks, *Global Distributive Justice*, *supra* note 7, at 280; Kirsch, *Physical Presence*, *supra* note 7, at 999.

10. *See* CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT

double taxation will discourage growth of international business that advances the welfare of both the residence country and the source country. For example, assume that Domco is incorporated under the laws of Patria, a country that taxes the foreign-source income of its residents (including corporations formed under Patria law) at a 35 percent rate. Further assume that Domco contemplates opening a branch business in Neighborland where the before-tax rate of return would be higher than in Patria. Neighborland taxes business profits at 20 percent. If both countries exercise their normatively justified taxing jurisdictions to the fullest extent, each dollar of profit earned by Domco's Neighborland branch will bear a total income tax burden of 55 percent while the local Neighborland competitors will pay only a 20 percent tax on their profits. Moreover, additional profits produced by expanding Patria operations will bear a tax of only 35 percent. Unless relief action is taken by Patria or Neighborland, or by both countries acting jointly, the double taxation faced by Domco's proposed Neighborland branch will discourage the branch's establishment, even though its establishment would be economically desirable because Domco can earn a higher before-tax rate of return in Neighborland than at home in Patria.[11]

III. THE INTERNATIONAL LAW SOLUTION

Customary international law gives the residence country (Patria in the preceding example) the responsibility for mitigating international double taxation.[12] The principal means for doing so are the worldwide taxation (with credit) method and the exemption system. Under the first of these approaches, the residence country taxes its residents on their worldwide

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AND PROBLEMS 22, 39, 304–06 (4th ed. 2011) [hereinafter GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS].

11. For example, if Domco can earn before-tax returns of 8 percent by expanding its Patria business and of 10 percent by opening a new business in Neighborland, the 35 percent Patria tax will result in an after-tax return in Patria of 5.2 percent, while the 55 percent combined Patria and Neighborland taxes will produce an after-tax return in Neighborland of only 4.5 percent. In this situation, Domco will prefer investing in an expansion of its Patria business instead of in a new Neighborland business even though the latter is the economically superior alternative on a before-tax basis.

12. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 413 cmt. a; Brooks, *Global Distributive Justice*, *supra* note 7, at 281; Kirsch, *Physical Presence*, *supra* note 7, at 1001; Lokken & Kitamura, *Credit vs. Exemption*, *supra* note 1, at 621; *see also* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 265–66, 284–85 (2003) [hereinafter Brauner, *Crystallization*].

incomes while granting a credit for foreign income taxes.[13] This approach permits the residence country to collect a so-called residual tax in cases where the residence country tax on a resident's foreign-source income exceeds the credit for foreign tax on that income.[14] Thus, in the preceding hypothetical, if Patria employed worldwide taxation with a foreign tax credit, it would collect a 15 percent residual tax[15] on income produced by Domco's Neighborland branch.

Under the exemption system, residence countries exempt foreign-source active business income from their income tax regimes.[16] Stated differently, a residence country that takes the exemption approach forgoes collection of any residual tax on the foreign-source active business income of its residents and effectively imposes a zero tax rate on that income.[17]

IV. FLIRTING WITH A FLAWED TERRITORIALITY

Since 1918, the United States has employed worldwide taxation with a foreign tax credit. Recently, however, there has been considerable pressure from some members of the U.S. multinational corporate community,

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13. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 307.

14. *Id.* at 304–05, 307.

15. Thirty-five percent *minus* twenty percent *equals* fifteen percent. This is based on the simplifying assumption that the Neighborland income would be Domco's only foreign-source income. If Domco earned high-taxed income in other countries and if Patria had a loose foreign tax credit limitation such as that currently employed by the United States, then foreign tax imposed by the other countries in excess of the 35 percent Patria rate might reduce or eliminate the 15 percent residual tax. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 407–10, 422.

16. *Id.* at 21–23, 305–06; Brauner, *Crystallization*, *supra* note 12, at 284–85. The residence country's allowance of a deduction for source-country tax is a third approach to solving the international double taxation problem, but it is only partially effective and rarely used. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 23, 304; *cf.* Kimberly Clausing & Daniel Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?*, 64 TAX L. REV. 431, 431-33 (2011) [hereinafter Clausing & Shaviro, *Creditability to Deductibility*] (arguing for superiority from national welfare perspective of deducting rather than crediting foreign taxes).

17. *See* STAFF OF JOINT COMM. ON TAX'N, JCX-22-06, THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES 2 (2006) [hereinafter STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM]; Joann M. Weiner, *Formulary Apportionment: The Way to Tax Profits in the EU*, 47 TAX NOTES INT'L 322, 325 (July 23, 2007).

academia, and the examples of other countries[18] for the United States to transform its taxation of foreign-source active business income from the historic approach to a territorial or exemption approach.[19]

In prior work, we have pointed out that the present U.S. regime for taxing foreign-source income is unacceptable and requires major reform because it allows a zero tax rate to be achieved on certain foreign-source income that is not subject to double taxation, and, in some cases, it even allows a negative rate of tax to be achieved on foreign-source income.[20] We have argued, however, that fairness and efficiency considerations make

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18. Many of the major trading partners of the United States, including most recently Japan and the United Kingdom, have adopted exemption or territorial systems. *See generally* Robin D. Beran, David Hartnett, Anneli Collins & Jonathan Stuart-Smith, *Session 2: Lessons in Reform — Discussion of Recent Tax Reform in Other Countries*, 88 TAXES 37 (June 2010); Jim Carr, Jason Hoerner & Adrian Martinez, *New Foreign Dividend Systems in Japan and the U.K.: Tax Considerations for Distributions from U.S. Subsidiaries*, 38 BNA TAX MGMT. INT'L J. 319 (2009). A number of the cited reasons these countries adopted territorial systems are inapposite to circumstances in the United States and reflect materially different circumstances. For example, the membership of the United Kingdom in the European Union and the relative size and role of the London Stock Exchange in the United Kingdom affected the United Kingdom's tax policy decisions in ways that are not relevant in the United States. Whether the tax policies of other countries should be used as models for the United States is a recurring question that deserves a broader and more substantial analysis. *See* Stephen E. Shay, *Keynote Address*, 88 TAXES 49, 49-51 (June 2010).

19. *See, e.g.*, BUSINESS ROUNDTABLE & BUSINESS COUNCIL, POLICY BURDENS INHIBITING ECONOMIC GROWTH (June 21, 2010) [hereinafter BUSINESS ROUNDTABLE, POLICY BURDENS], http://businessroundtable.org/uploads/hearings-letters/downloads/20100621_Letter_to_OMB_Director_Orszag_from_BRT_and_BC_with_Attachments.pdf; Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004); J.D. Foster & Curtis S. Dubay, *Obama International Tax Plan Would Weaken Global Competitiveness*, THE HERITAGE FOUND. (Apr. 5, 2009), http://www.heritage.org/Research/Reports/2009/05/Obama-International-Tax-Plan-Would-Weaken-Global-Competitiveness. The U.S. multinational corporate business community's historical indifference to territoriality has been due to the fact that the present, highly flawed, U.S. worldwide regime allows U.S. multinational corporations to exceed the limits of a principled exemption system. *See generally* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4; National Foreign Trade Council, Inc., *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L 687 (Aug. 5, 2002) [hereinafter National Foreign Trade Council, Inc., *NFTC Report*].

20. *See generally* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4.

territoriality the wrong solution for the United States.[21] Instead, the defects in the present U.S. regime should be corrected so that it achieves the efficiency and fairness objectives of a principled worldwide system.[22] Nevertheless, the U.S. multinational business community shows signs of abandoning its traditional lack of enthusiasm for territoriality and of moving towards supporting a U.S. exemption system (although the enthusiasm for territoriality definitely varies from industry to industry and from company to company within an industry).[23] Broad multinational business support surely increases the political pressure to adopt territoriality.

The beneficiaries of zero or negative tax rates do not, however, meekly surrender them. Thus, if the U.S. Congress undertakes to craft a territorial or exemption system for foreign-source active business income, the international business community will undoubtedly lobby for a flawed system that preserves aspects of the present regime which are more generous to taxpayers than a properly designed territorial system would be.[24]

In our view, the United States should never adopt a taxation scheme with features that amount to unprincipled transfers of largesse. Adherence to

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21. *See* J. Clifton Fleming, Jr., & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (Dec. 19, 2005) [hereinafter Fleming & Peroni, *Exploring the Contours*]; Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 3; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 3; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide v. Territorial Taxation Debate*, 125 TAX NOTES 1079 (Dec. 7, 2009) [hereinafter Fleming, Peroni & Shay, *Worldwide v. Territorial*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Some Perspectives from the United States on the Worldwide Taxation v. Territorial Taxation Debate*, 3 J. AUSTRALASIAN TAX TEACHERS ASS'N 35 (2008) [hereinafter Fleming, Peroni & Shay, *Perspectives from the United States*]; *see also* Samuel C. Thompson, Jr., *Obama's International Tax Proposal Is Too Timid*, 123 TAX NOTES 738 (May 11, 2009) [hereinafter Thompson, *Obama's International Tax Proposal*].

22. *See generally* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4.

23. *See, e.g.*, *Business Leaders in Support of a Territorial Tax System*, H. COMM. ON WAYS & MEANS, waysandmeans.house.gov/UploadedFiles/Intl_quotes.pdf; Pamela F. Olson, Peter Merrill, Michael Mundaca, Michael Reilly & Jaime Spellings, *Session 6. Staking New Ground: Exploring a Potential Territorial System of Taxation*, 90 TAXES 55, 65-66 (June 2012) [hereinafter Olson, Merrill, Mundaca, Reilly & Spellings, *New Ground*]; Randall Jackson, *International Proposals a Threat to Competitiveness, Panelists Say*, 126 TAX NOTES 1045 (Mar. 1, 2010); BUSINESS ROUNDTABLE, POLICY BURDENS, *supra* note 19, at 17.

24. *See, e.g.*, John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593 (June 29, 2009) [hereinafter Samuels, *American Tax Isolationism*] (vice president and senior tax counsel of General Electric Company arguing that domestic expenses allocable to deferred foreign income should be currently deductible against U.S.-source income even though this magnifies the distortive benefit of deferral).

this standard is particularly important in the context of the current U.S. revenue situation, which we shall briefly describe in the next section.

V. GOING TERRITORIAL IN THE MIDST OF A CURRENT AND LONG-RUN FISCAL CRISIS

A. Dimensions of the Crisis

The U.S. government is experiencing a well-recognized fiscal crisis. This crisis results from a projected deficit spending path that will cause the aggregate federal debt to increase as a percentage of gross domestic product (GDP) and, potentially, to eventually exceed annual GDP. Since a great deal has already been written about the trajectory of the U.S. federal budget and indebtedness,[25] we limit ourselves to two data points in support of our contention that although the United States should never adopt a territorial system with wasteful features, unwarranted revenue loss is particularly objectionable in the context of the current U.S. fiscal predicament. With respect to this predicament, the non-partisan Congressional Budget Office (CBO) has recently concluded that if Congress's taxing and spending behavior continues to follow historical patterns and policies of the past decade, the resulting budget deficits will cause publicly held federal debt to be more than 90 percent of GDP in 2022 and almost 200 percent of GDP by 2037,[26] a debt level that the CBO characterizes as "unsustainable."[27]

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25. *See, e.g.*, CONG. BUDGET OFFICE, THE 2012 LONG-TERM BUDGET OUTLOOK (June 2012) [hereinafter CBO 2012 BUDGET OUTLOOK]; DEFICIT COMMISSION, MOMENT OF TRUTH, *supra* note 1, at 10–11; Alan J. Auerbach & William G. Gale, *Déjà Vu All Over Again:On the Dismal Prospects for the Federal Budget*, 63 NAT'L TAX J. 543 (2010) [hereinafter Auerbach & Gale, *Déjà Vu*]; Alan J. Auerbach & William G. Gale, *The Federal Budget Outlook: No News Is Bad News*, 136 TAX NOTES 1597 (Sept. 24, 2012); Edward D. Kleinbard, *The Role of Tax Reform in Deficit Reduction*, 133 TAX NOTES 1105 (Nov. 28, 2011) [hereinafter Kleinbard, *Deficit Reduction*]; Stephen E. Shay, *Daunting Fiscal and Political Challenges for U.S. International Tax Reform*, BULL. FOR INT'L TAX'N, Apr.–May 2012, at 229; George K. Yin, *Bush Income Tax Cuts Should Not Be Extended*, 123 TAX NOTES 117 (Apr. 6, 2009) [hereinafter Yin, *Bush Tax Cuts*]. For a leading commentator who takes a different view on the issue of whether the United States is in a current fiscal crisis and argues that the current anti-deficit discourse is simplistic and misguided, see Neil H. Buchanan, *Good Deficits: Protecting the Public Interest from Deficit Hysteria*, 31 VA. TAX. REV. 75 (2011) [hereinafter Buchanan, *Good Deficits*].

26. *See* CBO 2012 BUDGET OUTLOOK, *supra* note 25, at 11, 19. The assumption that future taxing and spending policies will mimic historical patterns seems reasonable. *See* Alan J. Auerbach & William G. Gale, *Tempting Fate: The Federal Budget Outlook*, 132 TAX NOTES 375, 376 (July 25, 2011) [hereinafter Gale & Auerbach, *Tempting Fate*] ("A more plausible way to project future outcomes

These projected debt levels are truly extraordinary. U.S. federal indebtedness has exceeded 70 percent of GDP during only one other period, the 1943-1951 era when the United States was carrying the debt load incurred to finance World War II.[28] Thus, the debt levels anticipated by the CBO are unprecedented for a time in which the United States is not engaged in total war. In addition to taking the United States into largely uncharted territory, government debt at these levels of GDP exposes the United States to serious risks. For example, high levels of federal debt increase the likelihood of a U.S. fiscal crisis in which investors are not willing to buy U.S. government debt unless it carries a substantially increased interest rate.[29] This added expense would limit government spending for social welfare and defense and would cause the value of existing U.S. debt to fall, resulting in large losses to pension funds, mutual funds, and other financial institutions.[30] Extraordinary debt levels would reduce the government's ability to respond to recessions and international crises through temporary deficit spending.[31] Most importantly, high levels of government debt and high interest rates would crowd out private borrowing, slow private investment, and depress U.S. economic growth.

The U.S. fiscal challenge is not a new phenomenon, but it has particular urgency at the present time. As two prominent public finance economists have recently explained:

> The unsustainability of federal fiscal policy has been discussed since at the least the 1980s. But the problem has increased in importance and urgency in recent years for several reasons. First, the medium-term projections have deteriorated significantly. Second, the factors driving the long-term projections — the retirement of the baby boomers, the aging of the population, and the resulting pressure on

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may be to assume that future Congresses will act more or less like previous Congresses.").

Currently effective U.S. law provides for automatic tax increases and spending cuts in 2013 that would have a significant restraining effect on the growth of federal debt. However, the CBO anticipates that these increases and cuts would cause a recession and believes that "[f]uture fiscal policy is likely to differ from that embodied in current law." CONG. BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022, 32, 35 (Aug. 2012). This supports the view that the automatic spending cuts and tax increases embedded in current law are unlikely to become effective.

27. CBO 2012 BUDGET OUTLOOK, *supra* note 25, at 5.

28. *See id.* at 19.

29. *See id*. at 43–44.

30. *See id.* at 44.

31. *See id.* at 43.

> Medicare and to some extent Social Security — were several decades away in the 1980s but are now imminent. Third, there are increasing questions about the rest of the world's appetite for U.S. debt, since the United States has changed from a net creditor country in 1980 to a vast net debtor. Fourth, many countries and many U.S. states are also facing daunting fiscal prospects.[32]

Of course, it is arithmetically possible for the United States to reduce its projected deficits and debt amount by leaving tax levels as they are while making major reductions in spending. There is nothing in recent history, however, to suggest that it is politically feasible for Congress to solve the U.S. deficit problem solely by spending cuts.[33]

B. Forfeiting the Residual Tax

If U.S. deficits are to be trimmed to a sustainable level, increased tax revenues are a critical component of a politically plausible solution.[34] The U.S. corporate sector historically accounts for approximately 10 percent of federal revenues. Any congressional actions that would reduce corporate tax revenues should surely be viewed with deep skepticism and concern.[35] Moreover, it will be very difficult, politically, to raise taxes on individual taxpayers while allowing U.S. multinational corporations to escape U.S. tax on their foreign-source business income.

Against the preceding fiscal background, a proposal to replace the U.S. worldwide international income tax system with an exemption or territorial system would seem to be an illogical response to a need for revenue. To see why, return to the Patria example in Part II where Patria

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32. Auerbach & Gale, *Tempting Fate*, *supra* note 26, at 375. *But see* Buchanan, *Good Deficits*, *supra* note 25.

33. *See* Rosanne Altshuler, Katherine Lim & Roberton Williams, *Desperately Seeking Revenue*, 63 NAT'L TAX J. 331, 332 (2010); Martin A. Sullivan, *Taxes Must Rise*, 127 TAX NOTES 369, 370–71 (Apr. 26, 2010); Yin, *Bush Tax Cuts*, *supra* note 25, at 118–19; *see also* Auerbach & Gale, *Déjà Vu*, *supra* note 25, at 554 ("[I]t is simply implausible that cutting health care spending growth alone can solve the long-term fiscal imbalance."); Kleinbard, *Deficit Reduction*, *supra* note 25, at 1110 ("CBO projections demonstrate that the continuation of current revenue and entitlements policies would mean that the federal government would run a deficit in the coming decade even if it were to spend *zero* on all non-defense discretionary spending programs.").

34. *See supra* note 33.

35. *See* Clausing, *Challenging Time*, *supra* note 3, at 283 ("[G]iven today's budget climate, avoiding further erosion of the corporate tax base should be a priority."). *See generally* Yin, *Bush Tax Cuts*, *supra* note 25.

taxes its residents' foreign-source income at a 35 percent rate, and Neighborland taxes business profits at 20 percent. Under a worldwide system, Patria would allow residents who earn Neighborland income a credit for the Neighborland tax but would, nevertheless, collect a 15 percent residual tax on that income (35 percent - 20 percent = 15 percent). If, however, Patria employs an exemption or territorial system, it would waive the 15 percent residual tax and collect no revenue with respect to income earned in Neighborland by Patria residents.

In the U.S. context, this loss of the residual tax has a significant impact on the federal deficit. Although the United States does not currently operate an explicit exemption system, its worldwide system is encumbered with a deferral privilege[36] and other features, which in practice substantially achieve an exemption result.[37] The Staff of the Joint Committee on Taxation has calculated that the U.S. revenue loss from this exemption-like deferral privilege was $21.5 billion for fiscal year 2011 and will total $97.7 billion for the fiscal years 2011-2015 period.[38] In the face of the daunting deficit

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36. In other words, the U.S. tax on foreign-source active business income earned through foreign corporations is deferred until the income is repatriated to the United States through dividends or realized through stock sales.

37. *See* Fleming, Peroni & Shay, *Worse than Exemption*, s*upra* note 4. Assuming the same pre-tax rates of return in the United States and abroad and unchanging tax rates, the benefit of postponing repatriation is not from avoiding the tax on repatriation but from reinvesting the deferred earnings at a higher after-tax return (than if repatriated) so they grow faster (before the U.S. tax is imposed). The benefit of deferring the repatriation tax under these assumptions (separate from foreign tax credit and other issues discussed in *Worse than Exemption*) can exceed in present value terms the U.S. tax on repatriation. An exemption system achieves this same benefit, when repatriation is deferred, *plus* exemption from U.S. tax on repatriation. We thank Professor Alvin Warren for this observation. In practice, companies have utilized strategies that effectively allow deferred earnings to be used in the United States without reporting an income inclusion under section 956. *See* Memorandum from Sen. Carl Levin, Subcommittee Chairman, and Sen. Tom Coburn, Ranking Member, to Members of the Permanent Subcommittee on Investigations of Offshore Profit Shifting and the U.S. Tax Code, 25-27 (Sept. 20, 2012), http://www.hsgac.senate.gov/download/?id=7B9717AF-592F-48BE-815B-FD8D38A71663 (describing Hewlett-Packard short-term loan program intended to circumvent current inclusion); *see also* Paul W. Oosterhuis & Daniel M. McCall, *What's in Order for Assets Crossing the Border?*, 88 TAXES 41, 44–48 (Mar. 2010) (describing patterns of transactions avoiding repatriation tax and IRS responses).

38. STAFF OF JOINT COMM. ON TAX'N, 112TH CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, 32 (Comm. Print 2012) [hereinafter STAFF OF JOINT COMM., ESTIMATES]. Estimates of tax expenditures are not equivalent to revenue estimates since the former do not take into account behavioral responses of taxpayers; however, tax expenditure estimates provide an indication of the magnitude of the amounts involved. *See id.* at 25; STAFF

problems described above, why would the United States replace its worldwide system with an exemption system that may produce an even greater revenue loss? One response is that a switch from the present, highly flawed U.S. worldwide system to a principled exemption or territorial system could actually result in a deficit-reducing revenue gain. We explain how in the next section.

C. Gaining Revenue by Switching to a Zero Rate

In its present form, the U.S. worldwide system, degraded by self-inflicted legislative and regulatory wounds, allows U.S. multinational corporations to exploit tax deferral, defective cost allocation rules, loose transfer pricing rules, cross-crediting, and deduction of overall foreign losses, thereby achieving more favorable U.S. tax results than would be available under a properly designed exemption system.[39] Thus, the U.S. Treasury would likely gain revenue by switching to a principled exemption system.[40] Indeed, in 2005, the Staff of the Joint Committee on Taxation

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OF JOINT COMM. ON TAX'N, JCX-46-11, SUMMARY OF ECONOMIC MODELS AND ESTIMATING PRACTICES OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION 3 (2011).

39. *See* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4. The active finance and active insurance exceptions of section 954(h) and (i), the look-through exception of section 954(c)(6), the regulatory adoption of check-the-box entity classification rules in 1996, the reduction in scope for foreign base company services income in Notice 2007-13, 2007-1 C.B. 410, and the contract manufacturing regulations adopted in 2008 are examples of legislative, regulatory, and administrative developments limiting the scope of the anti-deferral rules of current law.

40. *See* CONG. BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 187 (Mar. 2011) (calculating a $76.2 billion revenue gain for the 2012-2021 period from adoption of a well-designed territorial system); U.S. DEP'T OF THE TREAS., APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 58 (2007) [hereinafter U.S. TREAS. DEP'T, APPROACHES], http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf (supporting the proposition that replacing the current system with an exemption system would increase revenue by approximately $40 billion over 10 years); Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798 (2001) ("[F]or the typical investment in a low-tax country abroad, dividend exemption with expense allocations is likely to increase effective tax rates relative to the current system."); Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J. 811, 816 (2001) [hereinafter Grubert, *Enacting Dividend Exemption*] (calculating static revenue gain of $9.7 billion in 1996 if the United States had used a principled exemption system in that year);

estimated that replacing the highly defective U.S. worldwide system with a proposed exemption system that was principled and theoretically correct would produce a $54.8 billion revenue gain over the fiscal years 2005-2014 period.[41] By contrast, an unprincipled exemption system would lose substantial revenue.[42] In the context of the U.S. financial needs described above, the prospect of a revenue gain from switching to an exemption or territorial system is undeniably attractive.[43]

D. Goodbye to the Revenue Gain

But there will be no significant revenue gain from replacing the current U.S. worldwide system with an exemption or territorial regime unless the latter is correctly structured. An exemption system that perpetuates existing defects would not help the United States climb out of its fiscal hole, and the adoption of a defective system would represent the loss of an opportunity for the United States to make progress towards a sustainable fiscal path. Thus, Congress should resist revenue-losing departures from a principled exemption system, except to the extent that a departure can pass a

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Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 722–23 (2011) [hereinafter Kleinbard, *Stateless Income*] (calculating that if the United States had employed a well-designed territorial system, it would have collected approximately $6.6 billion more revenue in 2004 than it actually collected under the defective U.S. worldwide system).

41. For explanation of the Joint Committee Staff's exemption proposal, see STAFF OF JOINT COMM. ON TAX'N, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 189–96 (2005) [hereinafter STAFF OF JOINT COMM., OPTIONS]. For the revenue estimate, see *id*. at 427.

42. *See* THE PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS 90 (Aug. 2010) ("According to rough estimates from the Treasury, a simplified territorial system without full expense allocation rules would lose approximately $130 billion over the 10-year budget window.").

43. As explained in prior work, we believe that an even better way to increase revenues is to enact legislative reforms that would cure the flaws in the current U.S. worldwide system. *See* Fleming & Peroni, *Exploring the Contours*, *supra* note 21; Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 3; Peroni, Fleming, & Shay, *Getting Serious*, *supra* note 3; Fleming, Peroni & Shay, *Perspectives from the United States*, *supra* note 21; Fleming, Peroni & Shay, *Worldwide vs. Territorial*, *supra* note 21; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4; *see also* 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); Thompson, *Obama's International Tax Proposal*, *supra* note 21. If it is not politically possible to address the flaws of the current system, however, then under the heroic assumption that it were possible to replace the present defective system with a well-designed exemption regime, we would favor it over current law.

cost/benefit test.[44] Given the present fiscal circumstances, the cost/benefit test should be rigorously applied.

E. Principles for Preserving the Revenue Gain

In contemplating the content of a properly designed exemption or territorial system, it is critical to keep in mind that so far as economics and customary international law are concerned, an exemption system's purpose is to avoid a double tax barrier to international business by eliminating residence-country tax on the foreign-source income of residents, thus leaving the source-country tax as the single applicable levy. Neither economics nor international law nor equitable principles require the residence country to go further.[45] Consequently, when a resident's foreign-source income does not bear a significant foreign tax, the economic and international law rationales for exempting that income from residence-country tax vanish, and the income in question is fairly includible in the residence country's tax base pursuant to the ability-to-pay principle that validates the residence country's right to tax the foreign-source income of its residents.[46] Stated differently, a principled exemption system will not grant a zero residence-country tax rate to foreign-source income that has escaped a more-than-de minimis source-country tax.

In addition, a principled territorial system will never create a negative domestic tax rate. To do so would go beyond providing double taxation relief and would amount to an affirmative subsidy for foreign-source income that can be justified only if the subsidy can pass a rigorously applied cost/benefit test.[47]

We now turn to the matter of applying these broad principles to the designing of an exemption or territorial system that would replace the existing U.S. worldwide system in the midst of a national fiscal crisis.

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44. *See* J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 525–28 (2008) [hereinafter Fleming & Peroni, *Reinvigorating*].

45. *See supra* notes 6–17 and accompanying text.

46. *See* Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 3.

47. *See* Fleming & Peroni, *Reinvigorating*, *supra* note 44; *see also* Lokken & Kitamura, *Credit v. Exemption*, *supra* note 1, at 630 ("The purpose of the foreign tax credit is to alleviate double taxation, and this goal is fully achieved by reducing U.S. tax on doubly taxed income to zero . . . . U.S. tax . . . should not be less than zero.").

VI. A PRINCIPLED DIVIDEND EXEMPTION SYSTEM

The central feature of a territorial system is an exemption from residence country tax for dividends paid by foreign corporations out of the "right kinds of profits" to the "right kind of shareholder."[48] We address the question of the "right kinds of profits" in Part VI.A and the issue of the "right kind of shareholder" in Part VI.B. Part VI.C is a discussion of whether a territorial system's dividend exemption should be expanded to include certain types of non-dividend income. In Part VII, we will discuss application of the exemption approach to foreign income earned directly through an unincorporated foreign branch.

A. Dividends Out of What?

1. Active Income That Does Not Bear a Meaningful Foreign Tax

a. The Need for a Subject-to-Tax Requirement

Assume that USCo is a U.S. domestic corporation that pays U.S. income tax at a 35 percent rate. USCo owns 100 percent of the single class of stock of FS, a corporation formed under the laws of Lowtaxia, a tax haven with no corporate profits tax and no withholding tax on dividends. In Year 1, FS earns a $1 million active business profit, all of which is paid as a dividend to USCo at year end. Because this dividend is paid out of untaxed foreign profits and is free of foreign withholding tax, the United States can tax it in full without causing a double tax result. Moreover, failing to tax the dividend means surrendering up to 35 percentage points of U.S. residual tax. Thus, as explained in Part V.C, the United States would be remiss if it did not impose its corporate tax on USCo's receipt of the dividend.

Does the answer change if the $1 million profit bears a 1 percent Lowtaxia corporate profits tax? Assuming that the United States allows an indirect foreign tax credit under section 902 for the Lowtaxia levy,[49] no

48. As stated by the Staff of the Joint Committee on Taxation: "In theory, exemption could be allowed as income is earned, whether directly or through foreign companies. By contrast, territorial systems of the major U.S. trading partners generally provide exemptions for dividends received by resident companies from foreign companies." STAFF OF JOINT COMM. ON TAX'N, JCX-33-11, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 8 (2011) [hereinafter STAFF OF JOINT COMM., BACKGROUND AND ISSUES].

49. A plausible argument can be made that if foreign-source income is excluded from the benefit of a U.S. exemption system because it bears a rate of foreign tax that is too low to present a meaningful double tax issue, then a U.S.

double tax issue will arise if the United States applies a residual tax on the $1 million dividend paid by FS to USCo, and failure to impose U.S. tax would amount to walking away from as much as 34 percentage points of U.S. residual tax revenue even though doing so is not required by international law.

The preceding analysis leads to the suggestion that a principled exemption system should include a subject-to-tax requirement. That is, the exemption regime should not apply to dividends unless a meaningful foreign tax has been paid in respect of the earnings distributed,[50] or the dividend

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deduction for that foreign tax is adequate — there is no need for the complexity of a direct and indirect foreign tax credit. The international practice, however, is to allow direct and indirect credits for foreign tax imposed on non-exempt income. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8. We have adopted that approach in subsequent portions of this article, and there seems to be no reason to carve out special treatment for one particular class of non-exempt income (i.e., foreign-source income that does not bear a meaningful foreign tax). Indeed, the carve-out would seem to increase complexity with little offsetting benefit.

50. As noted by two commentators: "A dividends exemption is intended to be part of a system for alleviating double taxation, not a means of allowing companies to avoid domestic taxation on repatriations of income that has not been subject to substantial taxation anywhere in the world." Lokken & Kitamura, *Credit v. Exemption*, *supra* note 1, at 646; *see also* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8; STAFF OF JOINT COMM. ON TAX'N, JCX-55-08, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT 38 (2008) [hereinafter STAFF OF JOINT COMM., ANALYSES OF ALTERNATIVE POLICIES]; U.S. DEP'T OF THE TREAS., INTERNATIONAL TAX REFORM: AN INTERIM REPORT 42–43 (1993) [hereinafter U.S. TREAS. DEP'T, INTERIM REP.]; HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 467 (3d ed. 2010) [hereinafter AULT & ARNOLD, COMPARATIVE TAXATION]; Michael J. Graetz, *The David Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 330–31 (2001) [hereinafter Graetz, *Inadequate Principles*]; Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 783 (2001) [hereinafter Graetz & Oosterhuis, *Structuring an Exemption System*]. Existing regulations under the foreign tax credit limitation provide rules for assigning foreign tax to income under U.S. tax principles. *See* Reg. § 1.904-6.

A report by an American Bar Association Section of Taxation task force gave the following example of the problematic results that could arise if there were no requirement that the foreign income be subject to a meaningful foreign tax:

> [A] local [U.S.] manufacturer that has only one line of products and only sells products to U.S. customers [] could benefit from manufacturing the product in Ireland (whether through a CFC or an Irish branch), selling the product back to the United States, paying the Irish corporate tax on the manufacturing earnings at a

payor is a resident in a country with which the United States has a bilateral tax treaty that reciprocally waives the subject-to-tax requirement.[51]

But what if Lowtaxia applied a 35 percent tax to the FS profits from which the $1 million dividend was paid to USCo. Although the U.S. indirect foreign tax credit would alleviate double taxation, there would be no U.S. residual tax revenue to protect because the credit would fully offset the pre-foreign tax credit U.S. levy.[52] This clear difference from the 1 percent foreign tax scenario, where up to 34 percentage points of U.S. residual tax were at stake,[53] means that there would be no compelling reason to treat the dividend as non-exempt.[54]

Clearly, somewhere between a 35 percent Lowtaxia rate and a 1 percent Lowtaxia rate, there is a foreign tax rate benchmark below which the U.S. residual tax is too large to abandon and above which the residual tax is too small to justify the complexity of moving otherwise exempt foreign income into a credit regime. Finding the tipping point at which a subject-to-tax rule should switch on and off is a challenge.

b. The Benchmark

There are multiple candidates, directly or by analogy, for the appropriate benchmark. For example, section 954(b)(4) provides that a foreign-source income item that would otherwise be subject to current U.S. taxation as foreign base company income or insurance income is excused from current U.S. taxation if the item "was subject to an effective rate of

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> 12.5% tax rate and repatriating any unused cash to the U.S. parent as exempt earnings.

ABA Tax'n Sec. Task Force, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 723 (2006) [hereinafter ABA Tax'n Sec., *Task Force Rep.*]; *see also* Fleming & Peroni, *Exploring the Contours*, *supra* note 21, at 1566; George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 118 TAX NOTES 173, 180 (Jan. 7, 2008) (would require exempt income to be subject to tax somewhere).

51. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 467.

52. Thirty-five percent U.S. tentative tax *minus* an indirect credit for the 35 percent Lowtaxia tax *equals* zero U.S. residual tax.

53. In the 1 percent scenario, the U.S. indirect credit for the 1 percent foreign tax leaves up to a 34 percent U.S. residual tax (assuming no cross-crediting).

54. This suggests that in determining whether a foreign tax is so small that it does not count as meaningful, the most important factor is the spread between the U.S. tax rate and the foreign tax rate because that spread determines the U.S. residual tax that will be lost if the U.S. exemption system is allowed to apply. Avoiding double taxation is not the salient issue because income that is ineligible for exemption would qualify for the foreign tax credit regime.

income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11."[55] Under current law, this means a foreign effective rate greater than 31.5 percent.[56] This suggests that dividends should be excluded from a U.S. exemption system unless they are paid out of foreign-source income that has borne a foreign effective tax rate that is greater than 90 percent of the top U.S. corporate rate.

Alternatively, the American Law Institute (ALI) has suggested that if foreign-source income bears foreign effective tax at a rate that is less than 50 percent or perhaps 66 $^{2}/_{3}$ percent "of the U.S. rate paid by the taxpayer," it could appropriately be placed in a "low-tax" basket to limit cross-crediting under the U.S foreign tax credit system.[57] This suggests using a benchmark of 66 $^{2}/_{3}$ percent or 50 percent of the U.S. effective tax rate on the income to identify foreign income that would qualify as the source of exempt dividends. Under current law, this would translate into an effective foreign tax rate condition for exemption of 23 percent or 17.5 percent if the effective U.S. rate equaled the top corporate rate of 35 percent.

Two U.S. scholarly commentators suggested in 2001 that if there is to be a benchmark foreign rate for purposes of identifying foreign-source income that can appropriately support exempt dividends, the benchmark should be set at an effective foreign tax rate greater than 75 percent of the U.S. effective tax rate[58] (resulting in a minimum foreign tax rate of 26 $^{1}/_{4}$ percent under current law if the effective U.S. tax rate equaled the maximum U.S. corporate rate of 35 percent) and, more recently, another commentator has suggested an effective foreign corporate tax rate of at least 20 percent.[59]

Finally, in October 2011, the U.S. House of Representatives Committee on Ways and Means released a discussion draft of a U.S. international tax reform proposal. This proposal includes an exemption or territorial system with an alternative anti-base erosion provision that incorporates a subject-to-tax requirement. Specifically, this provision would disqualify foreign income as the source of exempt dividends unless either the

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55. I.R.C. § 954(b)(4).

56. Thirty-five percent *times* ninety percent *equals* thirty-one point five percent.

57. *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 328–29 (1987) [hereinafter ALI, INTERNATIONAL PROPOSALS]. However, the ALI recommended against a low-tax basket primarily because of the practical problems of calculating the effective foreign tax rate. *See id.* at 329–32. For our discussion of this matter, see *infra* notes 62–70 and accompanying text.

58. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 783.

59. *See* Robert C. Pozen, *A Two-Pronged Approach to Reforming International Corporate Taxes in the U.S.*, 63 TAX NOTES INT'L 951, 952 (Sept. 26, 2011).

effective foreign tax rate on the income was greater than 10 percent or the business activity that produced the foreign income was confined to the dividend payor's country of incorporation.[60]

All of the preceding proposals for identifying the point at which a foreign tax rate is sufficiently consequential seem to be based on rough estimates or hunches, although we note that because the Irish corporate tax rate is 12.5 percent, the 10 percent prong of the Ways and Means proposal may be intended to avoid any impact on many U.S.-owned Irish CFCs that sell their Irish-manufactured products in the United States and other countries besides Ireland.[61] However, as we have discussed above, the

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60. *See* H. COMM. ON WAYS & MEANS, TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME, 33–34 (2011) [hereinafter WAYS & MEANS TECHNICAL EXPLANATION], http://waysandmeans.house.gov/uploadedfiles/final_te_--_ways_and_means_participation_exemption_discussion_draft.pdf. The technical explanation of the discussion draft says, "at least 10 percent." However, the draft legislative language sets the requirement "in excess of 10 percent." H. COMM. ON WAYS & MEANS, DISCUSSION DRAFT § 331B (2011) [hereinafter WAYS & MEANS DISCUSSION DRAFT], http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf; *see also* Philip D. Morrison, *Chairman Camp's Territorial Proposal and the Potential Expansion of Subpart F*, 41 TAX MGMT. INT'L J. 90, 90 (2012) (The low-taxed income disqualification would require "all income of a CFC to be currently taxed in the United States if the income is derived outside the CFC's country of incorporation and it is subject to a foreign effective tax rate of 10% or less."); David G. Noren, *The Ways and Means Committee International Tax Reform Discussion Draft: Key Design Issues*, 41 TAX MGMT. INT'L J. 167, 173 (2012) ("[U]nless a CFC is essentially selling into its own home-country market, an effective rate of 10% or less will lead to the treatment of the CFC's income as Subpart F income . . . ."). Senator Mike Enzi has introduced a bill proposing dividend exemption that would disqualify income from exemption if the effective foreign tax rate was less than 50 percent of the highest U.S. corporate tax rate (17.5 percent under current law, i.e., 50 percent of 35 percent = 17.5 percent). *See* S. 2091, 112th Cong., 2d Sess. (2012).

61. In fact, multinational corporations are able to and do achieve effective tax rates in Ireland and other countries well below 12.5 percent or even 10 percent. *See* Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.21. For example, Microsoft was reported to pay tax for its 2011 fiscal year at an effective tax rate for financial statement purposes of approximately 4 percent on an aggregate of $15 billion of earnings before tax in Puerto Rico, Ireland, and Singapore. *See* Testimony of Stephen E. Shay Before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs Hearing on Offshore Profit Shifting and the U.S. Tax Code (Sept. 20, 2012), http://www.hsgac.senate.gov.subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code.

objective in choosing the appropriate foreign effective tax rate is to identify the point below which the U.S. residual tax is too significant to surrender by conferring an exemption. Resolving that conundrum is beyond the scope of this article because it requires a calculation and consideration of revenue gains and losses from other features of a U.S. exemption system as well as a consideration of the U.S. government's overall revenue needs. Thus, the issue of the appropriate benchmark involves data and modeling that is beyond the scope of this article. Clearly, however, in the context of current U.S. revenue needs, any U.S. territorial system that is ultimately adopted should avoid conferring exemption on dividends paid out of foreign income that has not borne a material foreign income tax. Such income does not present a meaningful double taxation case but instead creates the prospect of a U.S. residual tax that is too large to give away.

There is, nevertheless, strong opposition to this conclusion. The following statement accurately captures the opposition argument:

> In particular, a system based on a minimum effective rate of tax in a foreign jurisdiction would be fundamentally flawed. Effective tax rates vary substantially from year to year based largely on differing rules in different countries affecting the timing of income and expenses. Accelerated depreciation and the deduction of various liability reserves are but two examples of how foreign effective tax rates can be substantially lower in some years and substantially higher in other years than comparable U.S. rates on income as measured for U.S. tax purposes. A minimum effective tax rate requirement set at higher than a *de minimis* level would inevitably result in situations where income from the same country, including countries with relatively high statutory rates, would be exempt in some years but taxable in others. The uncertainty and complexity of such a rule for both taxpayers and tax administrators make it clearly anti-competitive.[62]

In fact, however, the U.S. international tax regime has found a way to respond to these objections in an analogous situation. Section 954(b)(4) provides that for purposes of computing the Subpart F income of a controlled foreign corporation (CFC):

> [F]oreign base company income and insurance income shall not include any item of income received by a

62. *See* National Foreign Trade Council, Inc., *NFTC Report*, *supra* note 19, at 702; *see also* ALI, INTERNATIONAL PROPOSALS, *supra* note 57, at 329–32.

> controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.[63]

This provision requires essentially the same computation that would be necessary if a subject-to-tax requirement were included in a U.S. territorial or exemption system. While the section 954(b)(4) computation is not simple, and there is uncertainty in marginal cases, regulations have made it workable,[64] and the same approach could be taken with respect to the subject-to-tax requirement of a U.S. exemption system.

c. The Cliff Effect

Structuring a subject-to-tax requirement in terms of a minimum foreign effective rate does, however, create a cliff effect that raises two theoretical possibilities. First, low-tax foreign countries might respond by raising their tax rates to a point just above the U.S. minimum rate threshold so that U.S. corporate taxpayers earning income in those countries would be beneficiaries of a U.S. tax exemption rather than a credit for foreign tax payments.[65] The U.S. Treasury would be a loser in this scenario. Second, U.S. corporations might forgo opportunities to increase their pre-tax profits through strategies that would drop their effective tax rate in a particular country from above the U.S. minimum rate threshold to a point below it.[66] World welfare would decrease in this scenario. The phenomenon of international tax competition[67] will surely act as a restraint on the first of these scenarios, and both scenarios could be mitigated by attaching a phase-in to the U.S. minimum rate threshold. For example, the United States might give a one-third exemption to income subject to at least a 10 percent foreign effective tax rate, a two-thirds exemption where the foreign effective tax rate

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63. I.R.C. § 954(b)(4).

64. *See* 3 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 74.39.3 (4th ed. 2006) [hereinafter ISENBERGH, INTERNATIONAL TAXATION]. The current section 954(b)(4) regulations do not include foreign dividend withholding taxes in the effective tax rate computation. This omission would have to be corrected.

65. *See* Olson, Merrill, Mundaca, Reilly & Spellings, *New Ground*, *supra* note 23, at 63.

66. *See id*.

67. *See generally* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000); Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555 (2009).

is at least 15 percent, and a complete exemption at the 20 percent or above level.[68] This approach would require low-tax countries to make larger, and less likely, tax rate increases that would have to affect investors from all countries (not just the United States) in order to secure a full U.S. exemption with respect to income earned within their borders. It would also mean that foreign tax minimization would be less likely to result in loss of the entire U.S. exemption.

d. The Listed Country Approach

Alternatively, Congress could give the Treasury the authority to designate a list of countries whose tax systems are sufficiently robust so that, on average, they will impose a substantial source tax on U.S. multinational corporations even if they fail to do so in some cases. Income sourced in those countries would automatically have subject-to-tax status. Income derived from unlisted countries would fail the subject-to-tax requirement and be disqualified as a source for exempt dividends.[69] While this alternative would not have the taxpayer-specific precision of the section 954(b)(4) approach, it would avoid creating a cliff effect, and it would increase certainty and reduce compliance costs. If the creation of the list was insulated from political pressure so that low-tax countries that allow themselves to be used as tax havens, such as Switzerland, Ireland, Luxembourg, Singapore, and Hong Kong (to name a few), were excluded from the approved list, the list approach could serve as an acceptable compromise in light of the fact that

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68. For example, the effective rate test in Option A of Chairman Camp's discussion draft is phased in. *See* WAYS & MEANS DISCUSSION DRAFT, *supra* note 60, § 331A (adding new I.R.C. § 954(f)(2)). Under current U.S. tax law, if a foreign country applies a higher than normal tax rate to income earned within its borders by U.S. residents in order to take full advantage of the U.S. foreign tax credit, the foreign tax credit is available only for the normal portion of the foreign tax. The excess is a non-creditable "soak-up" tax. *See* Reg. § 1.901-2(c). Presumably a similar rule would apply for purposes of determining whether a foreign tax is sufficient to satisfy the subject-to-tax requirement.

69. *See generally* H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525 (2001) [hereinafter Rosenbloom, *From the Bottom Up*] (making such a proposal); STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 8–9; U.S. TREAS. DEP'T, INTERIM REP., *supra*, note 50, at 42–43; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 783. Australia and Spain apply versions of this approach. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 16, 35. The presence of a treaty alone is not sufficient to assure that income will be subject to more than a de minimis amount of tax. *See, e.g.*, Tom Bergin, *Special Report - Amazon's billion-dollar tax shield*, REUTERS, Dec. 6, 2012, http://uk.reuters.com/article/2012/12/06/uk-tax-amazon-idUKBRE8B50AT20121206 (describing use of Luxembourg companies to avoid tax).

the United States faces a severe revenue constraint and, therefore, should avoid waiving residual tax on income of U.S. residents that is not significantly taxed anywhere else in the world. In this context, the relative weights given to precision and to revenue generation should be shifted somewhat towards the latter in the policy-making process.

e. Locational Distortion

Finally, it seems clear that in comparison with a U.S. worldwide system that has been reformed to cure its considerable defects,[70] a U.S. exemption system would erode the beleaguered U.S. tax base by encouraging U.S. resident corporations to locate new or expanded business activity in low-tax foreign countries instead of in the United States.[71] This phenomenon would be considerably magnified if the U.S. exemption system were to permit the foreign location to be one where no meaningful local tax has to be paid as a cost of carrying on business there.[72] This is not a good policy outcome, and it is particularly objectionable in the present U.S. revenue context.

f. Implicit Taxes

Return now to the earlier example of USCo, a U.S. resident corporation paying U.S. income tax at a 35 percent rate, and its wholly owned, active business subsidiary, FS, which is incorporated in Lowtaxia, a country without a corporate profits tax or a dividend withholding tax.[73] Assume that the United States and Lowtaxia are the world's only countries, that U.S. corporations like USCo can earn a 10 percent pre-tax return on investments in U.S. business activities, and that the United States provides a tax exemption for all dividends from foreign subsidiaries regardless of whether the subsidiaries have paid any foreign tax. The theory of tax capitalization suggests that because the after-tax return to U.S. corporations on their U.S. investments is 6.5 percent,[74] U.S. corporations will be willing to pay a purchase price for tax-free investments in Lowtaxia businesses that

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70. *See* JOBS COUNCIL, ROAD MAP, *supra* note 1, at 47–48; Daniel E. Kwak, *America's Refusal to 'Race to the Bottom': Worldwide vs. Territorial Taxation*, 65 TAX NOTES INT'L 387, 393–94 (Jan. 30, 2012). *See generally* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 3.

71. *See generally* Fleming, Peroni & Shay, *Worldwide vs. Territorial*, *supra* note 21.

72. *See* ABA Tax'n Sec., *Task Force Rep.*, *supra* note 50, at 730; STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 5.

73. *See supra* notes 49–51 and accompanying text.

74. 10 percent – (10 percent × 35 percent) = 6.5 percent.

will result in a 6.5 percent rate of return.[75] U.S. corporations that do so are said to bear a 35 percent implicit tax[76] because their 6.5 percent rate of return in Lowtaxia is 35 percent less than the 10 percent pre-tax rate of return available in the United States.[77] These U.S. corporations are then regarded as bearing the same rate of tax, 35 percent, on their Lowtaxia investments as on their U.S. investments.[78] Does this suggest that the dividends FS pays to USCo should be regarded as having come from income that bore a 35 percent foreign tax, a level of taxation that is surely sufficient to satisfy the demands of any subject-to-tax requirement? Stated more broadly, if the explicit source tax on foreign income and the implicit tax on that income sum up to a meaningful levy, does the implicit tax concept obviate the need for including a subject-to-tax requirement in a U.S. exemption system? With respect to this inquiry, Professor Kleinbard has pointed out, "Implicit taxes are not collected by a government, but instead are reflected in an investor's yield."[79] In addition, Professor Weisbach has observed that "[i]mplicit taxes are misnamed. Implicit taxes are not taxes in the sense of the confiscation of resources by the government. They are simply asset price adjustments in response to a tax benefit or detriment."[80]

It may be that the term "implicit tax" has rhetorical utility in some settings. In the context of the USCo hypothetical, however, Professors Kleinbard and Weisbach remind us that although USCo suffered an implicit tax, it did not actually pay any tax to Lowtaxia. Instead, USCo paid a price for a Lowtaxia investment that was higher than otherwise because of applicable U.S. and Lowtaxia tax exemptions. Consequently, USCo experienced a lower pre-tax rate of return than if it had made a taxable investment in the United States. But earning less is not the same as paying a meaningful tax to both a residence country and a source country on the same income, thereby triggering the residence country's international law obligation to provide double taxation relief.

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75. *See* Kleinbard, *Lessons*, *supra* note 3, at 118.

76. For general explanations of the implicit tax concept, see MYRON S. SCHOLES, MARK A. WOLFSON, MERLE ERICKSON, EDWARD L. MAYDEW & TERRY SHEVLIN, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 121–22, 125–27 (3d ed. 2005); Harry Watson, *Implicit Taxes*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 185 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005).

77. 6.5 percent = 10 percent – (10 percent × 35 percent).

78. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 78 (4th ed. 2008). Professor Kelinbard has recently provided a thorough analysis of why this full 35 percent implicit tax would be unlikely to occur in the real world. *See* Kleinbard, *Lessons*, *supra* note 3, at 118–29.

79. Kleinbard, *Lessons*, *supra* note 3, at 118.

80. David A. Weisbach, *Implications of Implicit Taxes*, 52 SMU L. REV. 373, 374 (1999).

In the context of designing a U.S. exemption system,[81] this means that we must recognize that the purpose of such a system is to mitigate international double taxation levied by governments.[82] The purpose is not to rescue U.S. corporations from low pre-tax rates of return resulting from having paid a price to a private party that was increased by the market to reflect tax exemptions. Thus, USCo's implicit tax does not create a case for double taxation relief, and a U.S. exemption regime should not apply to dividends paid by FS out of Lowtaxia income.

A territoriality proponent might, however, argue that the preceding analysis is bogged down in legal formalisms and that the real purpose of a territorial or exemption system is to apply the economic theory of capital import neutrality (CIN).[83] That theory asserts that worldwide economic efficiency will be maximized if countries refrain from taxing the foreign-source incomes of their residents so that only source-country tax applies, even if the source-country tax is zero.[84] Therefore, so the argument goes, a territorial or exemption system is the optimum regime because source-country taxation is the only form of taxation allowed under such a system.[85]

We agree that territorial or exemption systems are often associated with CIN,[86] and under an extreme version of CIN, dividends received by USCo from FS should be exempt from U.S. tax even if the FS profits that supported the dividends bore zero foreign tax.[87] However, no major commercial nation employs an exemption system that adopts the extreme version of CIN.[88] They all recognize that exemption systems must strike a balance between double taxation relief and protection of residence country

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81. *See id.* at 377 ("[W]e care about implicit taxes, but it is difficult to make general statements about which way they cut. . . . [O]ne must think about them in a given context, but each case will be different.").

82. *See* AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 446–47; Lokken & Kitamura, *Credit vs. Exemption*, *supra* note 1, at 646.

83. For an explanation of CIN, see GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 21.

84. *See* STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 2, 5, 57–59; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 41–42.

85. *See* STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 5.

86. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 186; *see also* STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 5, 59; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 41–42.

87. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8; STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 2; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 41–42.

88. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8.

tax bases from excessive erosion.[89] For example, they generally exclude from exemption passive income generated by cross-border investments, and several of them have subject-to-tax requirements.[90] Thus, the better view is that an exemption or territorial system is a method for mitigating double taxation levied by governments. From that standpoint, it is critical that although investments in low-tax countries like Lowtaxia suffer pre-tax rate of return reductions that are often called implicit taxes, there is no double taxation because the implicit tax represents forgone income rather than a duplicative payment to a government. Therefore, the implicit taxes that result from low explicit foreign taxes should be irrelevant with respect to the double taxation conundrum. Their existence does not make out a case for rejecting a subject-to-tax requirement in an exemption system.

At this point, many pro-exemption advocates would argue that the preceding analysis is irrelevant because the purpose of exemption systems is to make U.S. multinational corporations more competitive in low-tax foreign markets and that an exemption system that does nothing more than alleviate international double taxation is deficient per se.[91] This is actually a demand for a competition subsidy delivered through the tax system, and we will discuss this aspect of territoriality in Part IX.

g. Applying the Subject-to-Tax Rule to a Dividend Exemption System

In theory, a subject-to-tax requirement could be applied by requiring each foreign subsidiary of a U.S. corporation to create an accounting pool of income that was disqualified from exemption by the subject-to-tax requirement and a separate accounting pool for income that was not disqualified. Dividends paid by the foreign subsidiary to a U.S. parent could then be treated as drawn proportionately from each pool or as coming initially from only one of the pools and then from the other when the first was exhausted.[92] Dividends would be taxable to the extent they were allocable to the disqualified income pool under the applicable ordering rule.

This approach to the subject-to-tax requirement would, however, confer a problematic deferral benefit on the disqualified low-tax income, and

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89. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 2, 4–5, 8–10; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 41–42; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 447, 474–75.

90. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8–10; STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 2, 4; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 476–85.

91. *See supra* note 23.

92. *Cf.* I.R.C. § 959(c).

it would be unusual. Countries that disqualify certain types of income from serving as the source of exempt dividends usually do so indirectly and in a way that avoids deferral. They typically allow a full exemption for the dividend (or a fraction thereof that reflects an adjustment for expenses allocable to foreign income),[93] but at the same time they maintain CFC regimes[94] that, speaking in simplified terms, require the disqualified portion of the foreign subsidiary's income to be currently included in the income of the domestic parent. In this way, disqualified income is indirectly barred from both exemption treatment and deferral.[95]

Consistent with this pattern, countries that impose subject-to-tax requirements generally do so by treating low-taxed foreign income as disqualified income that is subject to current inclusion under the CFC regime.[96] This is the approach taken in the October 2011 Ways and Means discussion draft, which would generally retain Subpart F and treat certain low-taxed foreign income as Subpart F income.[97] It has the advantage of utilizing a familiar regime that has been in place since 1962, although it is out of date and badly in need of reform. Consequently, the approach of implementing a subject-to-tax requirement by treating low-taxed foreign income as Subpart F income strikes us as satisfactory. Assuming that Subpart F is retained, with some modification, and that some income is subject to current taxation, foreign tax credits should be available under section 960 with respect to taxable Subpart F income.

h. Tiered Structures

Recall the example of USCo, a U.S. resident corporation paying U.S. tax at a 35 percent rate, and its wholly owned, active business subsidiary, FS, which is incorporated in Lowtaxia, a country without a corporate profits tax

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93. *See infra* notes 178–79 and accompanying text.

94. The U.S. CFC regime, familiarly known as Subpart F, is contained in I.R.C. §§ 951–965 and is the subject of a vast body of literature. For a detailed survey of the Subpart F provisions, see 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ch. B3 (1992) [hereinafter KUNTZ & PERONI, U.S. INTERNATIONAL TAXATION].

95. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 3–4, 8–10; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 476–77; Kleinbard, *Lessons*, supra note 3, at 144–45.

96. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8–10.

97. *See* WAYS & MEANS TECHNICAL EXPLANATION, *supra* note 60, at 33–34. Strangely, the Ways and Means Discussion Draft allows an additional tax to be imposed upon distribution of previously taxed Subpart F income by exempting only 95 percent of the previously taxed amount. We believe that this is not the appropriate approach to this issue. *See infra* notes 99, 107, and accompanying text.

or a dividend withholding tax. We have argued that dividends from FS to USCo should not qualify for a U.S. exemption because they are not paid out of income that has incurred a meaningful foreign tax. Conversely, the FS dividends should be exempt if the FS business income incurred a meaningful foreign tax. Should that conclusion be any different if the Lowtaxia active business is conducted by FS's wholly owned Lowtaxia subsidiary, FS2, and FS's income consists of dividends from FS2? Clearly not. A U.S. exemption system should effectively look through the dividends received by USCo from FS to their ultimate source and should allow an exemption to the extent that a meaningful foreign tax was borne as the income travelled through one or more corporate layers to USCo.[98] A practical way to achieve this end is to treat any low-taxed income of FS2 as Subpart F income, apply the hop-scotch rules in sections 951(a)(1) and 958(a)(2), and exempt the dividend distributions of FS2's previously taxed earnings.[99]

2. Passive Income

The preceding sections have dealt with structuring a U.S. tax exemption for dividends paid out of the foreign active business income of a foreign subsidiary. We have argued that the exemption should not be available unless the active business income has borne a meaningful foreign tax. Perhaps surprisingly, however, it seems that passive income should never be exempt even if it has been subject to a substantial foreign tax.

The common explanation for this apparent incongruity is that the capital that produces passive income is so highly mobile and so independent of particular markets and national economies that it can be shifted to low-tax jurisdictions much more easily than the capital that yields active business income.[100] Accordingly, if exempt dividends could be paid out of a foreign subsidiary's passive income, there would be a massive migration of passive income-producing capital to low-tax jurisdictions that would dwarf the similar taxpayer behavior regarding the transfer of active business capital to low-tax jurisdictions like Ireland.[101] Thus, so the argument goes, it is all a

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98. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 190.

99. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 530–31. This mechanism would address the issue identified earlier in this Article. *See supra* note 97.

100. *See, e.g.*, STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 4–5; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 41–42; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 475; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 774–75; Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771, 783 n.49 (2010).

101. *See supra* note 100.

matter of degree, and the source of exempt dividends must be limited to active business income.

Regardless of whether one is impressed by the dubious logical force of this argument, the major commercial nations that employ territorial systems are overwhelmingly united in excluding passive income as a source of exempt dividends.[102] Thus, as two of us said in an earlier article, "[b]ecause the principal argument in favor of a U.S. exemption regime [in comparison to a worldwide taxation system] is to make U.S. multinationals more competitive with exemption country multinationals in the markets of low-tax foreign countries, there is no need for the United States to outdo the competition by exceeding the generosity of other exemption countries."[103] If a U.S. exemption system provided a tax exemption for foreign-source passive income, it would be giving away revenue that no other significant exemption system country has chosen to surrender, which would be particularly objectionable in the context of the current U.S. fiscal situation. Passive income should not qualify as a source for exempt dividends and should continue to be treated as currently taxable Subpart F income.

The preceding analysis means that a U.S. exemption system must make a distinction between active and passive income and provide rules for currently taxing the latter. Both the 2005 Joint Committee Staff exemption proposal and the 2011 Ways and Means discussion draft exemption proposal use the Subpart F income definition and the Subpart F regime for these purposes.[104] That is a convenient solution because it relies on a well-developed body of law (albeit one that needs substantial revision).[105]

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102. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 8; STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 4; STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 187; AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 475; *see also* Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 856 (2000) [hereinafter Chorvat, *Ending Foreign Business Tax*] (recommending that passive income not be treated as exempt income in an exemption system).

103. Fleming & Peroni, *Exploring the Contours*, *supra* note 21, at 1563 (footnote omitted).

104. With respect to the Joint Committee Staff proposal, see STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 191. With respect to the Ways and Means discussion draft, see WAYS & MEANS TECHNICAL EXPLANATION, *supra* note 60, at 18.

105. We leave for another day an analysis of whether the section 954(h) exclusion of active banking and financing income from Subpart F income is appropriate and whether there are practical ways to make Subpart F more effective. *See, e.g.*, ABA Tax'n Sec., *Task Force Rep.*, *supra* note 50, at 777–812. We also defer a discussion of our preference for replacing Subpart F with a pass-through regime, a topic on which we have extensively written. *See* Peroni, Fleming & Shay, *Getting Serious*, *supra* note 3, at 507–19.

Granted, the Subpart F income definition reaches certain sales and services income that is not truly passive. This sales and services income does, however, have the same potential to be shifted to low-tax jurisdictions as income that is literally passive,[106] and so it is appropriate to treat it as if it were passive.

Assuming that Subpart F is retained, foreign tax credits with respect to taxable Subpart F income would be available under section 960 and previously taxed earnings should be exempt when distributed.[107]

B. Who Qualifies?

1. Corporate Shareholders

With respect to corporate shareholders owning stock in a foreign corporation, two principal issues arise under a properly designed exemption system. First, what is the requisite amount of stock that a domestic corporation must own in the foreign corporation for dividends paid to it to qualify for exemption? Second, will the exemption system apply to dividends paid to a domestic corporation owning the requisite percentage of stock in a foreign corporation that is not a CFC.

With respect to the first issue, most exemption systems limit the applicability of the dividend exemption to domestic corporations owning at least 10 percent of the foreign corporation's stock. Domestic corporations having a less than 10 percent interest generally do not qualify for exemption.[108] In our view, a U.S. exemption system should adopt this approach. For this purpose, stock ownership should probably include not only actual ownership but also indirect and constructive ownership, as is true under the Subpart F regime of current law. The logic for this 10 percent threshold approach is simplicity and administrability. In order to be able to report income under the exemption system, a shareholder needs to be able to obtain information about the foreign corporation's income and expenses.[109] Corporate shareholders with a less than 10 percent interest are less likely to be in a position to obtain that information. Moreover, the 10 percent

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106. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 775; *see also* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 189–91 (effectively treating "highly mobile income" as passive income).

107. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 498.

108. *See, e.g.*, STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 190; PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSAL TO FIX AMERICA'S TAX SYSTEM 134 (2005) [hereinafter PRESIDENT'S TAX REFORM ADVISORY PANEL].

109. *See, e.g.*, Peroni, Fleming & Shay, *Getting Serious*, *supra* note 3, at 511.

threshold is a common dividing line in the international tax rules for separating corporate stock interests that are viewed as direct investments (which qualify for tax benefits such as the indirect credit in section 902) versus those that are viewed as portfolio investments (the income with respect to which is passive investment income).[110]

With respect to the second issue, three possible approaches could be taken. One approach would be to limit the exemption system to foreign corporations that are CFCs. This would considerably narrow the possible scope of the exemption system and require retention of all of the current international tax rules relating to so-called noncontrolled 10/50 foreign corporations. If the deferral principle were retained with respect to such corporations, as would likely be the case, this approach would also create planning opportunities to avoid the exemption system rules with respect to foreign corporations owning large amounts of income not eligible for the exemption regime.

A second approach would be to apply the exemption system to a domestic corporation's 10 percent or greater stock interest in a noncontrolled foreign corporation only if the domestic corporation so elects. The major argument in favor of this approach is that it allows a U.S. shareholder to avoid application of the exemption system in situations where it is unable to obtain the necessary information concerning the nature of the income earned by the foreign corporation in order the apply the rules of the exemption system. However, taxpayer elections are a one-way ratchet — they only work to the detriment of the fisc and create tax-planning opportunities for well-advised taxpayers. Moreover, this approach would also require retention of all of the current international tax rules relating to noncontrolled 10/50 foreign corporations. One way to reduce the scope of the election is to limit it to 10 percent or more U.S. shareholders in non-publicly traded foreign corporations that are not CFCs.

The third approach would be to apply the exemption system to any domestic corporate stock interest in a foreign corporation that equals or exceeds the 10 percent threshold, regardless of whether the foreign corporation involved is a CFC, on a non-elective basis. On balance, we think that this is the best approach because there seems to be little logic to limiting the exemption system only to foreign corporations meeting the definition of a CFC, and mandating application of the exemption system will permit simplification of the current international tax rules relating to noncontrolled 10/50 foreign corporations and reduce tax-planning opportunities that undermine the U.S. tax base.

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110. *See, e.g.*, GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 494–95.

2. *Individual Shareholders*

The major focus of proponents of territorial taxation is on domestic corporate investment in foreign corporations; little attention has been paid to how foreign-source income earned by individuals should be treated under such a system.[111] However, the question arises as to whether a properly designed territorial system should apply to individuals, either with respect to the dividends they receive from a foreign corporation or with respect to foreign income that they earn directly as individual business proprietors or investors. With respect to dividends, we would not apply the same rules to 10 percent or more individual shareholders of foreign corporations as those that apply to domestic corporate shareholders meeting the 10 percent ownership threshold. Under the U.S. corporate system of classical corporate taxation, earnings are taxed once at the corporate level and after-tax earnings are taxed again at the level of the shareholder. There is no risk of double corporate-level taxation where a foreign corporation is owned directly by a non-C corporation shareholder. Moreover, the U.S. classical corporate tax system assumes that dividends between members of a corporate group should be tax-free or bear very little tax.[112] This assumption, however, does not apply to dividends received by individual shareholders. In addition, if a U.S. exemption system provided a tax exemption for dividends received by non-C corporation shareholders, it would be giving away revenue that no other significant exemption system country has chosen to surrender, and in a situation where any international double taxation arising from a foreign withholding tax on the dividend income is ameliorated by a direct foreign tax credit under section 901. Thus, we would continue to apply current law to non-C corporation shareholders.

One related matter bears mention here. If an individual taxpayer earns foreign-source business income directly, rather than through a foreign corporation, one could argue that logic and horizontal equity considerations support applying the territorial system to such income earned by an individual, but only with respect to the types of income that would qualify for exemption if earned by a foreign corporation or by a branch of a foreign corporation. However, the comparison is not apt as the individual is not subject to a separate additional level of taxation of this income and the individual is protected against double taxation on foreign business income by the availability of a foreign tax credit. Moreover, no other significant exemption country has chosen to take this approach, thereby surrendering the

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111. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 780.

112. *See, e.g.*, I.R.C. §§ 243, 1501.

residual tax on such income.[113] Thus, we do not favor extension of the exemption system to foreign business income earned directly by individuals.

C. Should Royalty, Interest, and Services Payments from Foreign Corporations Qualify for Exemption?

1. Royalties

Foreign-source royalties received by U.S. residents typically bear no foreign income tax because the foreign payors are allowed to deduct the royalty payments when computing foreign taxable income and the payments are frequently exempted from foreign withholding tax by an applicable income tax treaty. Thus, there is usually no international double taxation with respect to the foreign-source royalty receipts of U.S. taxpayers and, therefore, no reason to provide double taxation relief. Surprisingly, however, the U.S. international income tax regime effectively ignores this point with regard to foreign-source royalties paid by a CFC to its U.S. parent corporation.

This is the case because look-through rules in section 904(d)(3) of current law provide that low- or zero-taxed foreign-source royalties received by a U.S. parent corporation from a subsidiary that is a CFC go into the general category foreign tax credit limitation basket. That basket also includes both high-foreign-taxed dividends paid to the U.S. parent corporation by other CFCs and any directly-earned active foreign business income of the parent that bears a high foreign tax.[114] Foreign taxes on this

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113. Some countries provide an exemption for foreign-source personal service income earned by resident individuals. *See* AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 468–69. The U.S. version of this exemption is found in section 911. The present discussion deals only with the question of whether the exemption system should be extended to foreign business activities of U.S. resident individuals when the activities do not consist primarily of the individuals' performance of personal services. We postpone to a subsequent article a discussion of whether section 911 should be repealed or modified. For policy discussions regarding the section 911 exclusion, see GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 454–57; KUNTZ & PERONI, U.S. INTERNATIONAL TAXATION, *supra* note 94, at ¶ B1.04[1]; Charles I. Kingson, *A Somewhat Different View*, 34 TAX LAW. 737 (1981); John D. Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 TAX LAW. 691 (1981); Renée Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101 (1985).

114. *See, e.g.*, Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less than Enthusiastic About the Idea (And Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 764–67 (2006) [hereinafter Lokken, *Territorial Taxation*].

income that exceed the U.S. tax thereon are then offset against the U.S. tax on the foreign-source royalties — a process known as "cross-crediting." This can substantially diminish the U.S. tax on the royalties or reduce it to zero even though the royalties do not suffer any significant double taxation.[115] The following example illustrates this dynamic.

Example 1

> USCo, a U.S. multinational corporation with a 35 percent U.S. marginal effective income tax rate, owns all the stock of Subco, a CFC operating in the foreign country of Lowtaxia. Lowtaxia has an income tax treaty with the United States that exempts royalties paid to a U.S. resident from Lowtaxia income tax unless the royalties are attributable to a permanent establishment maintained by the U.S. resident in Lowtaxia. USCo licenses a Lowtaxia patent to Subco for use in its Lowtaxia manufacturing business. For the current year, Subco pays USCo royalties of $100,000 under its license for the Lowtaxia patent, which is treated as foreign-source income under section 862(a)(4). Lowtaxia allows Subco to deduct these royalties in computing its taxable income. USCo is exempt from Lowtaxia withholding tax on the royalties by reason of the income tax treaty with the United States. Under the look-through rules in section 904(d)(3), USCo's royalty income falls within the general category income limitation basket, which also contains other foreign income of USCo bearing taxes that exceed the U.S. tax thereon by $35,000. USCo is allowed to cross credit these excess foreign taxes against the $35,000 of U.S. tax on the zero-foreign-taxed Lowtaxia royalty income, thus eliminating the entire U.S. tax on that income. This means that the $100,000 of royalty income is completely tax-exempt, having borne no tax in either the United States or Lowtaxia.

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115. *See* STAFF OF JOINT COMM., ANALYSES OF ALTERNATIVE POLICIES, *supra* note 50, at 8 ("According to one study, almost two-thirds of royalties were sheltered by excess foreign tax credits in 2000."); STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 188; HARRY GRUBERT & JOHN MUTTI, TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM 35 (2001) [hereinafter GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME] ("In 1994, this flow of excess credit royalties reduced the U.S. tax liabilities of U.S. parents by $2.7 billion, of which $2.0 billion was in manufacturing."); Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 774; Grubert, *Enacting Dividend Exemption*, *supra* note 40, at 812.

To repeat a now familiar theme, the international law obligation of the United States to mitigate international double taxation of foreign-source income does not extend to foreign-source income that is largely or entirely free of foreign tax and, therefore, largely or entirely free of double taxation. Moreover, there is no equitable imperative that requires a zero U.S. tax rate for such income. Thus, the U.S. practice, illustrated in *Example 1*, of effectively imposing a zero tax rate on foreign-source royalty income goes beyond the international law and equitable obligations of the United States. Nevertheless, the euphoria of a zero tax rate is hard to give up and it is highly likely that U.S. multinational corporations will press to have their foreign-source royalty receipts included within the income items that are exempted from U.S. income tax by a U.S. exemption system.[116] This pressure should be resisted with respect to foreign-source royalties that do not bear a meaningful foreign tax[117] because conferring an exemption on such royalties would exceed the double tax relief purpose of a territorial system[118] and would, therefore, amount to a tax expenditure subsidy for developing and exploiting foreign intellectual property.[119] This point will be elaborated on in Part IX. In addition, foreign-source royalties that are not significantly taxed in a foreign jurisdiction can be taxed by the United States without having to face the problem of the cliff effect described in Part VI.A.1.c.

It might be argued that if a U.S. territorial system does not exempt foreign-source royalties, U.S. parent corporations will move their research and development activities to CFCs resident in low-tax countries; the U.S. parent corporations will have those subsidiaries develop all of the new

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116. *See Group Comments on JCT Report on Compliance, Tax Expenditure Reform*, 2005 TAX NOTES TODAY 49-36 (Mar. 15, 2005) [hereinafter *Group Comments*] (business group objects to exemption system that would tax foreign-source royalties); *see also* U.S. TREAS. DEP'T, APPROACHES, *supra* note 40, at 59–63 (report by Bush administration Treasury Department giving support to an exemption system that would not tax foreign-source royalties).

117. *But see* Chorvat, *Ending Foreign Business Tax*, *supra* note 102, at 856 (arguing that the foreign-source royalties paid to a U.S. corporation by a CFC affiliate corporation should not be subject to U.S. tax).

118. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 191; PRESIDENT'S TAX REFORM ADVISORY PANEL, *supra* note 108, at 134; *see also* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 189, 195; GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME, *supra* note 115, at 36; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 774 n.4, 776 (concluding that an exemption system should not apply to foreign-source royalties received by a U.S. corporate parent payee that are deductible by the foreign corporate payor and not subject to substantial foreign withholding taxes); Grubert, *Enacting Dividend Exemption*, *supra* note 40, at 813, 815–16.

119. We do not discuss in this article proposals for lower rates of tax for foreign royalty income. These tax expenditures should be assessed like any other — under a rigorous cost/benefit analysis.

technology for the U.S. parents' corporate groups and earn the royalty income that results from licensing the new technology; and the subsidiaries will then pay the royalties to the U.S. parents in the form of exempt dividends.[120] From this standpoint, the United States will have driven U.S. research and development work to foreign locations without having gained tax revenue. However, if section 954(c)(2)(A) and (c)(3)(A)(ii) is repealed with respect to royalties that do not bear a meaningful foreign tax, so that such royalties are included in Subpart F income even when derived in the active conduct of a business or from a related corporation, the royalties in this hypothetical situation would be currently taxable as explained in Part VI.A.1.g. If this approach is taken, denying exemption treatment to foreign-source royalties received by a U.S. parent corporation from a controlled foreign subsidiary should create little incentive to move technology development operations to low-tax foreign countries.

The suggestion has been made that if foreign-source royalties are not treated as exempt by a U.S. territorial system, foreign subsidiaries will pay inflated exempt dividends and artificially low taxable royalties to their U.S. parent corporations.[121] This strategy will undoubtedly be attempted and the problematic tool of transfer pricing enforcement appears to be the only answer. Nevertheless, this less than ideal answer seems better than giving an unprincipled exemption to all foreign-source royalty income received from foreign subsidiaries, particularly in light of the revenue needs of the United States.

Finally, a U.S. exemption system should prevent, through foreign tax credit limit basketing or a per-country limitation, the cross-crediting of high foreign taxes against the U.S. tax on foreign-source royalty income. Otherwise, the revenue from denying exemption treatment to royalties will be compromised.

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120. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 11; Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman & Martijn van Kessel, *Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience*, 111 TAX NOTES 799, 811 (May 15, 2006); David G. Noren, *Designing a Territorial Tax System for the United States*, 40 TAX MGM'T INT'L J. 643, 648 (2011).

121. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 11; ABA Tax'n Sec., *Task Force Rep.*, *supra* note 50, at 723.

2. *Other Untaxed Foreign Income*

The current U.S. international income tax system treats certain income items as having a foreign source even though they are typically subject to little or no foreign tax.[122] Examples include certain transportation income attributable to transportation that begins or ends in the United States, certain income derived from a space or ocean activity, international communications income, and shipping income, which the current statute and regulations treat (in whole or in part) as foreign-source income.[123] Another example would be a U.S. person's income from services that are performed outside the United States[124] but which are not attributable to an office or other fixed base in any foreign country and, thus, unlikely to be taxed by any foreign country.[125] Such income is often effectively exempt from U.S. income tax under the current U.S. international tax system because of the cross-crediting opportunities provided by the current U.S. tax law.[126] As explained in connection with the preceding discussion of royalties, this zero tax treatment exceeds the international law and equity-based obligations of the United States; accordingly, the case for including such income within the reach of the exemption system is exceedingly weak. Nevertheless, the beneficiaries can be expected to insist that these income items be included in the income that is exempted from U.S. taxation by a U.S. territorial system.

3. *Export Sales*

Inventory sales income is sourced to the place of sale under sections 861(a)(6), 862(a)(6), and 865(b), and under the regulations[127] and case

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122. *See* Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 145; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 776.

123. *See, e.g.*, I.R.C. § 863(c), (d), (e); Reg. §§ 1.863-4, -8, -9.

124. Such personal service income would be treated as foreign-source income under the place-of-performance rule in sections 861(a)(3) and 862(a)(3) of current law.

125. *See supra* note 122.

126. *See* Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 145; Shay, Fleming & Peroni, *Source Rules*, *supra* note 8, at 152–53.

127. *See* Reg. § 1.861-7(c). The regulations, however, have long had a tax-avoidance exception to the title passage rule, which provides that the place where the substance of the sale occurred, instead of the place where title passed, will be treated as the place of sale if the "sales transaction is arranged in a particular manner for the primary purpose of tax avoidance." *Id.* This tax-avoidance exception has had little practical effect in preventing manipulation of the inventory source rules because the government has been generally unsuccessful when litigating its application. *See* 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 73–42 to 73–43 (rev. 3d ed. 2005) [hereinafter BITTKER & LOKKEN,

law,[128] the place of sale of inventory is defined as the location where the seller's rights, title, and interest in the inventory pass to the buyer.[129] If the U.S. seller is also the inventory's manufacturer, the "export sales source rule" arbitrarily treats the resulting income as 50 percent production income and 50 percent sales proceeds,[130] with the production component sourced to the location of the production assets[131] and the sales portion generally sourced to the location of the sale as identified by the title passage test.[132] Thus, the 50 percent notional sales income component usually will be characterized as foreign-source if title to the inventory passes to the purchaser outside the United States.[133] Stated differently, the export sales source rule of current law does not attempt to actually relate the source of export sales income to the economic activity that generated the income.[134] Instead, this rule arbitrarily allows no less than 50 percent of the U.S. manufacturer's income from an export sale to be treated as having a foreign source even when the income bears no material foreign tax and even if most of the taxpayer's economic activity giving rise to the income (i.e., producing and arranging for sale of the goods) takes place within the United States.[135]

TAXATION OF INCOME, ESTATES, AND GIFTS]; GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 100; 1 PHILIP F. POSTLEWAITE & SAMUEL A. DONALDSON, INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL 46 (4th ed. 2003). Consequently, the title passage test is the governing rule for determining the place of sale for inventory property, with few exceptions. *See, e.g.*, I.R.C. § 865(e)(2).

128. *See, e.g.*, Liggett Group, Inc. v. Commissioner, 58 T.C. Memo (CCH) 1167 (1990); A.P. Green Exp. Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960).

129. This rule is often referred to as the "title passage test."

130. *See* I.R.C. §§ 863(b), 865(b); Reg. § 1.863-3(a), (b).

131. *See* Reg. § 1.863-3(c)(1).

132. *See* I.R.C. §§ 861(a)(6), 862(a)(6), 863(b), 865(b); Reg. §§ 1.863-3(c)(2), 1.861-7(c).

133. *See* Reg. § 1.863-3(b)(1). Under a second alternative, a taxpayer may elect to determine the amount of production income by using the so-called "independent factory or production price" if the taxpayer can establish that such an independent factory or production price exists. *See* Reg. § 1.863-3(b)(2). Under a third, rarely used alternative, a taxpayer may allocate the income from export sales between the production and sales function based on the taxpayer's books of account, but only if the taxpayer has received the IRS District Director's advance permission and if certain other requirements in the regulations are met. *See* Reg. § 1.863-3(b)(3).

134. *See* U.S. DEP'T OF THE TREAS., THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 22 (2000); U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 31, 32 (concluding that the export sales source rule of current law "can reach results that depart significantly from the 'economic nexus' principle"); 1 ISENBERGH, INTERNATIONAL TAXATION, *supra* note 64, at ¶ 19:29.

135. 2 U.S. DEP'T OF THE TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 365–67 (1984) [hereinafter U.S. TREAS. DEP'T, TAX

Consequently, a U.S. taxpayer/manufacturer can treat 50 percent of its income from the export sale of inventory manufactured entirely within the United States as foreign-source income even if the U.S. manufacturer makes the sale entirely from a U.S. office and even though no foreign country is likely to impose any tax on the sales income because the U.S. exporter does not maintain a foreign sales office.[136] In fact, a U.S. manufacturer's income from export sales of inventory usually bears little or no foreign income tax,[137] unless the U.S. manufacturer/exporter has a sales office or other fixed place of business or sales employees in the foreign country of sale.[138] This means that if a U.S. inventory manufacturer sells to a foreign customer and passes title to the goods abroad, the result is zero-foreign-taxed income, half of which is characterized as foreign-source sales income for U.S. foreign tax credit purposes.[139] As noted above, this result often occurs even though most, if not all, of the income producing activity occurred in the United States.

The zero-foreign-taxed income result explained in the preceding paragraph is important because of cross-crediting. To be specific, a U.S. manufacturer/exporter that has incurred foreign income tax in excess of the

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REFORM]; U.S. DEP'T OF THE TREAS., THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 399 (1985) [hereinafter U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS].

136. *See* Reg. § 1.863-3(b)(1); U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50 at 32; ALI, INTERNATIONAL PROPOSALS, *supra* note 57, at 32; Lokken, *Territorial Taxation*, *supra* note 114, at 768–69.

137. Most foreign countries would not tax income from the sale of inventory property merely because title to the inventory property sold passes within the country. U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 135, at 399; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 32; ALI, INTERNATIONAL PROPOSALS, *supra* note 57, at 354. Thus, under current law, the title passage test for determining the source of the sales portion of the income from the export sale effectively facilitates a U.S. taxpayer artificially creating zero-taxed foreign-source sales income to expand the taxpayer's foreign tax credit limitation and increase the opportunities for cross-crediting. *See* U.S. TREAS. DEP'T, TAX REFORM, *supra* note 135, at 365; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 135, at 350–51, 399–400; ALI, INTERNATIONAL PROPOSALS, *supra* note 57, at 354. This enhances the opportunities for a taxpayer to achieve tax results that are more harmful to the U.S. fisc than those that would obtain under a properly designed exemption system. *Cf.* Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 139; Shay; Fleming & Peroni, *Source Rules*, *supra* note 8, at 153.

138. *See, e.g.*, U.S. DEP'T OF THE TREAS., REPORT TO THE CONGRESS ON THE SALES SOURCE RULES 1 (1993); *see also, e.g.*, U.S. TREAS. DEP'T, TAX REFORM, *supra* note 135, at 365–67; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 135, at 399.

139. *See, e.g.*, Donald J. Rousslang, *The Sales Source Rules for U.S. Exports: How Much Do They Cost?*, 62 TAX NOTES 1047 (Feb. 21, 1994).

U.S. tax on other active foreign business income, such as income from services performed abroad, can use the excess credits to absorb the U.S. tax otherwise payable on the low-foreign-taxed export sales income that was artificially characterized as foreign-source by the export sales source rule.[140] The result under the present U.S. regime is a zero U.S. tax on foreign-source export sales income that bears little or no foreign tax.[141] Under a properly designed exemption system, a U.S. manufacturer's income from low or zero foreign taxed export sales would not qualify for exemption because it would not suffer any meaningful double taxation.[142] Thus, such income would be subject to the full U.S. income tax. Nevertheless, the beneficiaries of the current export sales source rule can be expected to press for its inclusion in a U.S. exemption system because benefits once enjoyed are hard to surrender. This pressure should be resisted.[143] Conferring a zero tax rate on export sales income that bears little or no foreign tax would both lack any equitable basis and exceed the double tax relief purpose of an exemption system, and, therefore, would amount to a tax expenditure subsidy for manufacturer/exporters that would be unlikely to satisfy an appropriately rigorous cost/benefit analysis. This point will be discussed further in Part VIII.A.

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140. *See* U.S. TREAS. DEP'T, INTERIM REP., *supra* note 50, at 32; Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 139–40; Peroni, *Back to the Future*, *supra* note 3, at 1007; *see also* U.S. DEP'T OF THE TREAS., BACKGROUND PAPER, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 48 (2007). The Joint Committee Staff's estimate of the cost of the export sales source rule for 2011–2015 is $31 billion. *See* STAFF OF JOINT COMM., ESTIMATES, *supra* note 38, at 32.

141. *See*, *e.g*., ABA Tax'n Sec., *Task Force Rep.*, *supra* note 50, at 703–05; Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 139; Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1, 20–22 (1991); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 118 (Oct. 6, 2003).

142. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 776 (concluding that "income from export sales not attributable to an active foreign business" should not qualify for exemption under a properly designed exemption system); *see also* GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME, *supra* note 115, at 10; Grubert, *Enacting Dividend Exemption*, *supra* note 40, at 814.

143. It is noteworthy that Senator Enzi's bill, S. 2091, would treat export sales income as U.S.-source income for purposes of the foreign tax credit limitation. *See* S. 2091, § 213, 112th Cong., 2D SESS. § 213 (Feb. 9, 2012).

4. Indifference to Foreign Taxes

Opponents of the positions taken in this article will likely argue that if a U.S. exemption system is made inapplicable to foreign-source income that does not bear a meaningful foreign tax, U.S. multinationals will lack any motivation to reduce their foreign taxes below the "meaningful" threshold because doing so would create residual U.S. tax liability.[144] However, the most egregious failures to reduce foreign taxes could be limited by incorporating the "compulsory payment" requirements of the regulations for creditability of foreign taxes.[145] In addition, taxpayers will wish to minimize a foreign tax below the meaningfulness threshold if there are doubts about the creditability of the tax for U.S. tax purposes. Taxpayers will also wish to minimize foreign taxes for time value of money reasons if there is a timing gap between the time the foreign tax is paid and the time it is accruable for U.S. foreign tax credit purposes. Finally, in many cases, there will be no minimization opportunities with respect to a foreign tax and, with tax havens, there will be little or no foreign tax to minimize. It would not be appropriate to let the income in those cases escape a U.S. residual tax because of a concern that U.S. residents will not minimize foreign taxes in other cases.

D. Gain (or Loss) from the Sale of the Stock of a CFC

Another issue that arises regarding the proper scope of a territorial system concerns the proper treatment of gain or loss from the sale of the stock of a CFC under such a system. Taxation of 100 percent of the stock sale gains would conflict with the basic premise of a territorial system; accordingly, exemption to some extent is appropriate. There are several possible approaches to this issue, all of which have some problems.

One approach to the treatment of gains from the sale of stock of a CFC would be to exempt gain only to the extent of the stock's allocable share of exempt but undistributed earnings of the CFC.[146] We support this approach because it allows exemption only to the extent of the stock gain

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144. *See, e.g.*, Clausing & Shaviro, *Creditability to Deductibility*, *supra* note 16, (criticizing the availability of a U.S. foreign tax credit for making U.S. residents indifferent to the amount of creditable foreign tax they incur so long as the foreign tax liability does not exceed the U.S. federal income tax liability); Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65 (2011) (same).

145. *See* Reg. § 1.901-2(e)(5).

146. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 191; *see also* STAFF OF JOINT COMM. ON TAX'N, JCX-42-11, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME 91 (2011) [hereinafter STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME]; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 776.

that is attributable to earnings that actually have been meaningfully taxed at the corporate level. Stock gain in excess of that amount is not usually taxed by the source country and therefore should be taxed by the residence country and not exempted. This approach is consistent with our thesis throughout this article of understanding exemption as a means to avoid double corporate taxation but not to exempt from taxation income that is not taxed by another country. This approach also has some intuitive appeal because it is relatively simple to administer.[147]

A second possible approach would be to exempt all gain from the sale of CFC stock (or the percentage of gain that corresponds to the percentage of dividends that are exempt, as explained in Part VIII.B) on the theory that the gain is attributable to the present value of the expected future income from appreciated corporate assets that will give rise to income qualifying for exemption under the territorial system.[148] This is a taxpayer-favorable approach and is the simplest method for dealing with this issue. However, it would be overly inclusive to the extent that the CFC's assets are the kind of assets that produce non-exempt income, and it would distort corporate behavior by encouraging foreign corporations to retain, rather than distribute, their earnings that do not qualify for exemption. Thus, it would create an end-run around the rules limiting the types of corporate income that qualify for exemption under a properly designed territorial system. Accordingly, we view this approach as the least acceptable of the three possibilities discussed here.

A third possible approach would be to require the selling U.S. shareholder to look through the stock of the CFC to the underlying assets of the corporation. Under this approach, the selling U.S. shareholder would have to allocate the gain from the sale of the CFC stock between the unrealized appreciation attributable to corporate assets that produce income qualifying for exemption and those corporate assets that produce income not qualifying for exemption.[149] Only the portion of the stock sale gain attributable to appreciation in the assets producing exempt income would itself be exempt from tax. This approach is more precise and theoretically correct than exempting all stock sale gain. It is also the most complex

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147. However, this approach has been criticized by some commentators as conceptually flawed because it does not properly take into account the gain attributable to the present value of the expected future income from appreciated corporate assets giving rise to income qualifying for exemption under the territorial system. *See* STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME, *supra* note 146, at 91.

148. *See id*.

149. *See* STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME, *supra* note 146, at 91; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 776.

approach and would involve difficult allocation and valuation issues (always a source of practical problems in the tax system).

With respect to losses, there are the same three possible alternative approaches, each with its advantages and disadvantages. However, if any loss deduction is going to be allowed under either the first or third approach above, thought must be given to the possibility of tax-motivated loss-generating transactions by taxpayers and what that means regarding the need for anti-abuse rules relating to losses. Those anti-abuse rules, of course, would create additional complexity and might undermine the administrability of an exemption system. This has led some proponents of territorial taxation to propose complete disallowance of any deduction for losses from the sale of CFC stock, regardless of whether all or some portion of gain from the sale of CFC stock is subject to taxation.[150] This asymmetrical treatment of losses from the sale of CFC stock has the virtue of protecting revenue as well as simplicity and administrative convenience, but lacks a consistent conceptual foundation. On balance, we favor symmetrical treatment of gains and losses from the sale of CFC stock, which means that we probably would disallow CFC stock sale losses only to the extent that they arise from an activity giving rise to exempt foreign-source income.

VII. BRANCH EXEMPTION

In Part VI, we described the structure and limits of a principled dividend exemption system in the context of USCo, a U.S. domestic corporation that owns all the stock of FS, a corporation formed under the laws of Lowtaxia and carrying on an active business there. We concluded that under a U.S. territorial or exemption system, dividends distributed by FS to USCo should be exempt from U.S. income tax but only to the extent that they are paid out of active foreign-source income that has borne a meaningful foreign tax.

Should similar conclusions apply if FS is USCo's unincorporated branch in Lowtaxia? The case for a positive answer seems compelling. If foreign active income merits a U.S. exemption when it is realized by a U.S. corporation indirectly in the form of dividends from a foreign subsidiary, then there is strong intuitive appeal for treating the same income as exempt

150. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 191; *see also* STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME, *supra* note 146, at 92. Several countries with territorial systems use this complete loss disallowance approach, including Germany and the Netherlands. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 26, 33.

when it is earned directly through the U.S. corporation's foreign branch operations.[151]

However, foreign-source branch losses should not be deductible against a U.S. corporation's U.S.-source income.[152] We will develop that point fully in Part VIII.C., so at this point we will simply say that there should be no deduction of foreign branch losses against U.S. income because allowance of the deduction would confer an unwarranted and distortive subsidy on the foreign operations. In addition, for reasons given in Part VI, the U.S. exemption system should not apply to passive branch income or to branch income that has not borne a meaningful foreign tax. Thus, while foreign branch operations should be included in a U.S. exemption system, they should be included in a way that quarantines and disallows the deduction of foreign branch losses as well as excludes from exemption treatment both foreign branch income that does not bear a meaningful foreign tax and foreign passive branch income. The question is how to accomplish these ends. None of the answers are simple.

One approach is to structure the U.S. exemption system so that it treats a branch as if it were a wholly owned foreign subsidiary to which Subpart F applies. This is the path recommended in the 2011 Ways and Means discussion draft,[153] the Bush Tax Reform Advisory Panel Report,[154] and in the 2005 Joint Committee Staff proposal.[155] Taking this path would automatically block branch losses from being deducted against U.S.-source income[156] and it would also prevent the U.S. exemption from applying to passive foreign income and low-taxed foreign income, assuming that Subpart F income is defined to include the latter.

The controlled subsidiary approach would make explicit the transfer pricing issues that exist between parent corporations and "real" subsidiaries but which create substantial practical difficulties in practice in dealings with a branch. Treating the branch as a controlled foreign corporation brings the outbound asset transfer rules of section 367 into play and in practice may make it easier to apply section 482 to assure that the United States receives its fair share of income. Particularly with respect to use of an intangible in

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151. *See* JANE G. GRAVELLE, CONG. RESEARCH SERV. R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 35 (2012) [hereinafter GRAVELLE, OPTIONS AND CHALLENGES]; Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 774.

152. *See* AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 473.

153. *See* WAYS & MEANS TECHNICAL EXPLANATION, *supra* note 60, at 22.

154. *See* PRESIDENT'S TAX REFORM ADVISORY PANEL, *supra* note 108, at 106.

155. *See* STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 191.

156. This assumes that section 904(f)(5), which allows overall foreign losses to be deducted against U.S. source income, is repealed.

the sale of property, separating the branch essentially transforms what would be a sale by the branch with an embedded intangible into a sale with a royalty back to the home office. Cash transfers from the branch to corporate headquarters will have to be characterized as exempt distributions, taxable rents, royalties, or service fees.[157] The effort to conform transfer pricing with a branch to that with a subsidiary is consistent with the OECD's effort to achieve that result.[158]

What if USCo forms a wholly owned U.S. subsidiary, DS, and then forms a partnership to operate the Lowtaxia branch with USCo having a 99 percent interest in the partnership and DS holding the other 1 percent?[159] Should a taxpayer be allowed to use this self-help to achieve pass-through treatment instead of foreign subsidiary treatment? The U.S. exemption system could be structured to deny its benefit to the U.S. partners' share of foreign passive income and low-taxed foreign income and to prohibit overall foreign losses from being deducted against the U.S. partners' domestic income.[160] In addition, the existence of a partnership would require the identification of rents, royalties, or service fees, achieving part of the objective of the deemed CFC rule. Moreover, in an exemption system, it will be necessary to apply section 367-type principles (including the section 367(d) rules for intangibles) with respect to transfers to a domestic or foreign partnership that has a foreign trade or business. If these protections are present, a taxpayer should be permitted to use "self-help" to cause a branch to be held by a partnership.[161]

The second approach to proper treatment of a foreign branch is to characterize it as a disregarded entity,[162] but deny the U.S. exemption to the branch's foreign-source passive and low-taxed income, and prohibit deduction of the branch's overall foreign losses against USCo's U.S.-source

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157. *See* GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 151, at 35–36. The Bush Tax Reform Advisory Panel Report noted that under its exemption proposal, royalty income would have to be imputed to foreign branches. PRESIDENT'S TAX REFORM ADVISORY PANEL, *supra* note 108, at 240.

158. *See* OECD, MODEL TAX CONVENTION ON INCOME AND CAPITAL, ART. 7, § 2 (2010).

159. *See, e.g.*, GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 151, at 35.

160. The Ways and Means discussion draft delegates these issues to Treasury to solve in regulations, WAYS & MEANS TECHNICAL EXPLANATION, *supra* note 60, at 22, but it seems to us that many of these questions need to be resolved by Congress in the statute itself.

161. This approach possibly could be extended to a foreign legal entity that is treated as a disregarded entity under the U.S. check-the-box entity classification regulations, provided that the disregarded entity is treated in the same way described in the text above for a partnership.

162. *See* Reg. § 301.7701-2(a).

income.[163] This approach, however, would require that costs be allocated between USCo's headquarters and the branch, and that the branch's share of the costs then be allocated between income qualifying for exemption and disqualified income. Similar allocations have to be made under current U.S. law for foreign tax credit purposes.[164] More importantly, there would usually be a treaty between the U.S. and the country where the branch was located and the branch would usually be a permanent establishment for treaty purposes.[165] Consequently, allocations between headquarters and the branch would typically be governed by established principles of treaty law.[166] Thus, the disregarded entity approach to structuring an exemption system may not be worse for taxpayers than current law regarding cost allocations but it certainly will not be simple. Indeed, the disregarded entity approach would be better for taxpayers if they are allowed to make sales through the branch using a home office intangible without charging a royalty to the home office. Embedding the intangible return in the cost of the product opens the door to avoiding U.S. tax on the return to the intangible held in the United States and is one reason we prefer the deemed CFC approach or the use of a regarded partnership.

Regardless of whether USCo's Lowtaxia branch is regarded as a wholly owned foreign subsidiary or as a disregarded entity, the United States would have to decide whether its exemption system would treat asset transfers by USCo to the branch as taxable events or as nonrecognition transfers. The current scope of taxable transfers should be expanded to take account of the fact that in an exemption system there is no second bite at the tax apple as there is in the deferral system of current law.[167] These are complex technical issues that are beyond the scope of this article and that warrant substantial focus.

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163. In general, this is the approach taken by the Australian exemption regime. *See* AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 468–69, 474; *see also* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 16.

164. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 691–93.

165. *See* U.S. MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, ART. 5, § 2 [hereinafter U.S. MODEL TREATY].

166. *See* U.S. MODEL TREATY, *supra* note 165, at ART. 7; U.S. MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 22–25 (2006).

167. There is a divergence of views regarding this issue. *See, e.g.*, AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 488–91; Rosenbloom, *From the Bottom Up*, *supra* note 69, at 1552–53. Addressing the outbound transfer issues goes hand-in-hand with developing revised transfer pricing rules adequate to handle the increased pressures that would result from shifting to an exemption system.

In short, the case for including qualified foreign branch income in a U.S. exemption system seems compelling. The problems are solvable and the complexities are probably no worse than those that currently exist under the U.S. worldwide system with a limited foreign tax credit.

But handling branches within an exemption system is clearly not easy, so one can understand Japan's decision to exclude foreign branches from its recently adopted exemption system.[168] However, if that approach were taken by the United States, it would leave U.S. multinational corporations free to elect, to the detriment of the fisc, between (1) a controlled subsidiary that can pay exempt dividends, but not exempt royalties, interest, and services fees, and (2) a branch whose transfers to corporate headquarters are generally not subject to U.S. tax regardless of how they are characterized, but that lacks the separate legal personality required to participate in transfer pricing tax-minimization strategies. This would have the undesirable and economically inefficient effect of making tax planning, rather than business considerations and economics, the fundamental driver of the choice between a foreign controlled subsidiary and a foreign branch.[169] On balance, it clearly seems better to include branches in a U.S. exemption system.

VIII. CERTAIN STRUCTURAL ISSUES

For international law purposes, the role of an exemption system is to prevent international double taxation of foreign-source income by reducing the residence country tax on that income to zero. Nothing in this rationale suggests that the residence country should dip below zero by conferring a negative rate of tax and no normative principle supports negative taxation.[170] Stated differently, a principled exemption system stops at zero.

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168. *See generally* Lokken & Kitamura, *Credit v. Exemption*, *supra* note 1, at 629.

169. *See also* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 10.

170. A negative rate of tax arises when an inappropriate tax saving effectively causes the tax rate on a particular income item to fall below zero. For example, assume that individual A borrows $100 at 10 percent per annum interest to purchase a $100 tax-exempt municipal bond that pays 10 percent per annum interest. From a before-tax standpoint, this makes no sense because the 10 percent interest charge on the loan offsets the 10 percent interest received on the bond so that the bond investment produces an economic return of $0 even though the bond interest is tax exempt. If, however, A also earns salary income taxable at a marginal rate of 35 percent and the tax system allows her to deduct the loan interest expense against her salary, the deduction will save $3.50 in tax. Since the loan was incurred to acquire the bond, not to earn salary, deduction of the loan interest expense against salary income is inappropriate. The interest expense should be deducted against the bond

The present U.S. international income tax regime goes beyond this zero limit by effectively conferring a negative U.S. tax rate in certain situations. Below, we explain how those scenarios arise under current U.S. law and why Congress should resist beneficiary pressure to make them part of a U.S. exemption system.

A. Export Sales Redux

Part VI.B.3 has explained how the export sales source rule causes the present U.S. international tax system to confer a zero tax on income that bears little or no foreign tax. That, however, is not the end of the rule's mischief. The rule can also create a negative tax on export sales income within the present U.S. regime. *Example 2* illustrates this point.

Example 2

> Assume that USCo, a U.S. multinational corporation, has a marginal effective U.S. income tax rate of 35 percent and a marginal effective tax rate of 45 percent on its active foreign business income earned in Hightaxia, a foreign country. During the current year, USCo has total worldwide pre-tax income of $1,000,000, $500,000 of which is U.S.-source income from transactions occurring entirely within the United States. USCo earns $300,000 of pre-tax foreign-source business income in Hightaxia and pays $135,000 of foreign income tax to that country. USCo also produces inventory in the United States and sells the inventory to independent foreign distributors in Otherland. Title to the inventory passes from USCo to the foreign distributors at the time that the distributors receive the inventory in Otherland. USCo has $200,000 of pre-tax income from these inventory sales during the current year.

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interest where it will produce no tax saving because the bond interest is tax exempt. For this reason, the inappropriate $3.50 tax saving produced by incorrectly deducting the loan expense from A's salary income is commonly referred to as a $3.50 negative tax on the bond interest that increases the return on the bond from $0 to $3.50 per annum. (An alternative explanation is that the deduction reduces the after-tax cost of the $10 interest expense to $6.50 so that the $10 interest receipt produces $3.50 of net income.) Because the $3.50 return is entirely a product of manipulating the tax system and does not involve any real economic gain, Congress concluded that the result in the foregoing example was unacceptable and blocked it by enacting the disallowance provisions of section 265. This provision prevents interest on a loan incurred to finance a tax-exempt bond investment from being deducted against taxable income.

> None of that income is taxed by Otherland because USCo has no office or fixed place of business there. Under the current U.S. export sales source rule, USCo may treat one-half (i.e., $100,000) of this inventory sales income as foreign-source income even though it is not subject to tax in any foreign country and, in terms of economic connection, should be characterized as entirely U.S.-source income. Thus, USCo has total pre-tax foreign-source income of $400,000, consisting of $300,000 earned in Hightaxia and $100,000 artificially created by the export sales source rule with respect to transactions with Otherland distributors. Under current U.S. law, this latter $100,000 of foreign-source income falls within the general category income limitation basket, where the high foreign taxes on USCo's active foreign business income in Hightaxia can be cross credited against the zero-foreign-taxed $100,000 of export sales income. USCo's foreign tax credit limitation for the general category income limitation basket is $140,000 (i.e., $400,000/$1,000,000 × $350,000 = $140,000), so all $135,000 of the foreign taxes paid by USCo can be credited in the current year. In effect, USCo's total "real" foreign-source income for the current year of $300,000 (excluding the $100,000 of export sales income that is improperly treated as foreign-source income under current law) effectively bears a negative U.S. tax. This is because the U.S. credit for the $135,000 of tax paid to Hightaxia eliminates the entire $105,000 of U.S. tax on the $300,000 of properly characterized foreign-source income ($300,000 × .35 = $105,000) and also reduces the 35 percent U.S. tax on the $100,000 of artificially characterized foreign-source income from $35,000 to $5,000. Thus, $30,000 of U.S. tax is saved with respect to $100,000 of income that is, in substance, U.S.-source income that should not produce a foreign tax credit. This inappropriate saving amounts to a 10 percent negative tax on the $300,000 of "real" foreign-source income (i.e., $30,000 / $300,000 = .10).

This negative tax result exceeds the double tax relief purpose of an exemption system. Nevertheless, it seems likely that the benefit of a negative tax will be even harder to surrender than the benefit of a zero tax. Consequently, taxpayers presently enjoying the effects of the export sales source rule in the U.S. system can be expected to press for inclusion of the rule, and its negative tax consequence, in a U.S. exemption system. As explained earlier, however, nothing in international law requires an

exemption system to go below zero and no equitable norm requires a sub-zero result. Thus, a negative tax rate in a U.S. exemption system would be a tax expenditure that should be subjected to rigorous cost/benefit analysis.

B. Misallocated Expenses

A general principle of the U.S. income tax is that expenses allocable to exempt income should not be allowed as income tax deductions[171] unless Congress deliberately chooses to increase the exempt activity's tax advantage by reducing the effective U.S. tax rate below zero.[172] Nevertheless, the current U.S. international income tax system allows certain deductions that effectively create a negative U.S. tax even though there is no evidence that Congress intended to confer such a benefit. *Example 3* illustrates this phenomenon.

Example 3

> USCo, a U.S. multinational corporation is taxed on its U.S.-source income at 35 percent. USCo owns all the stock of Subco, a Lowtaxia corporation actively engaged in manufacturing operations. Lowtaxia is a tax haven that has no income tax and no withholding tax on dividends. Under current U.S. income tax law, U.S. tax on Subco's Lowtaxia income is deferred until that income is distributed to USCo as dividends.[173] USCo incurs $100,000 of expense at its U.S. headquarters solely for its own benefit to monitor Subco's management and operations. Because the United States defers the U.S. tax on Subco's income until Subco pays dividends to USCo, USCo should be required to defer a U.S. deduction for the $100,000 expense until Subco pays the related income to USCo. Nevertheless, under current law, USCo is allowed to deduct the $100,000 expense at the time it is incurred.[174] Failure to defer the deduction means that during the period that Subco holds the related income offshore, USCo effectively enjoys an interest-free loan from the U.S. government equal to the $35,000 U.S. tax saving

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171. *See, e.g.*, I.R.C. § 265.

172. *See supra* note 170.

173. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 24–26, 485–86. The exceptions to this rule do not apply to manufacturing income.

174. *See generally* Reg. § 1.861-8(g) Ex. 18; Priv. Ltr. Rul. 88-06-002 (Sept. 24, 1987); Priv. Ltr. Rul. 79-28-006 (Mar. 29, 1979).

> produced by immediate deduction of the $100,000 expense.[175] The value of this $35,000 interest-free loan is effectively a negative U.S. tax on the Subco income. This negative tax is a subsidy that distorts taxpayer choice between domestic and foreign investment because the subsidy is available only with respect to foreign investments.

The benefit to USCo would be even more dramatic if the United States were operating an exemption system. In that case, the Subco income would never be taxed by the United States and USCo would enjoy a $35,000 benefit forever; not just the benefit of a $35,000 interest-free loan during the period that U.S. tax on Subco's income is deferred. In other words, an exemption system allowing USCo to deduct $100,000 of administrative expense against its U.S.-source income, even though the expense is economically allocable to Subco's exempt income, would produce a permanent, but inappropriate, $35,000 net tax saving to USCo that would effectively be a negative U.S. tax on the Subco income.

For reasons previously given, neither the double tax relief rationale of an exemption system nor equitable considerations require that an exemption system provide the negative tax benefit that results from allowing a deduction against taxable income for a parent corporation's headquarters expenses that are related to exempt foreign income earned by a foreign subsidiary. Nevertheless, taxpayers that enjoy approximately that benefit under the present U.S. system, as illustrated in *Example 3*, will surely push for a U.S. exemption system that allows such expenses to be deducted against taxable U.S. income. In doing so, they will likely point out that several major commercial nations allow their resident corporations to deduct costs that support the earning of exempt or deferred foreign-source income if the costs are incurred within the residence country.[176] Therefore, U.S.

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175. When dividends are ultimately paid to USCo, the $100,000 expense deduction will not be allowed against those dividends because it was already claimed in an earlier year. Thus, USCo will have $100,000 more income at the time of the dividend distribution than if the expense deduction had been delayed. This will give the U.S. Treasury $35,000 more tax on the dividends than otherwise and will amount to a "recapture" of USCo's earlier $35,000 tax saving, but the Treasury will not collect any interest on the $35,000 because this tax was not due until USCo received the extra $100,000 of dividends. Consequently, the $35,000 tax saving in the earlier year that is recovered without interest in the later year is equivalent to a $35,000 interest-free loan from the Treasury to USCo.

176. *See* James R. Hines, Jr., *Foreign Income and Domestic Deductions*, 61 NAT'L TAX J. 461, 463 (2008); Samuels, *American Tax Isolationism*, *supra* note 24, at 1594–95; T. Timothy Tuerff, Manal Corwin, Paul Oosterhuis, John M. Samuels & David Walker, *Keynote Panel Session 1: Tax Reform—In Search of a 21st Century U.S. Tax System*, 88 TAXES 19, 22 (June 2010); *Group Comments*, *supra* note 116;

taxpayers will argue that U.S. resident corporations should not be barred from deducting such costs against their U.S.-source income because to do so would make them less competitive in foreign markets.[177] This is, of course, nothing more than a reiteration of the competitiveness argument that fails for the reasons discussed below in Part IX.

A closely related argument is that if the costs incurred in the United States are allocated to exempt foreign-source income and made deductible only against that income, it is highly likely that the relevant foreign countries will reject the U.S. position and will not allow the allocated expenses to be deducted for purposes of computing source-country tax on the foreign-source income. If so, there will be no current deduction in either the United States or the foreign country for the affected costs in spite of the fact that the costs have actually been incurred.[178]

In other words, U.S. opponents of cost allocation implicitly insist that tax competition will not force foreign countries to respect the U.S. allocation and that the inability of U.S. multinationals to deduct the allocated costs in the respective foreign countries will render these multinationals less competitive in foreign markets.[179] We are not convinced that all source countries are so resistant to tax competition, but even if they are, this line of argument is nothing more than a tailored version of the competitiveness rationale that is examined in Part IX and found wanting.

Finally, even if U.S. multinational corporations are made less competitive by a U.S. exemption system that bars deducting costs against taxable U.S.-source income when the costs are economically connected to exempt foreign-source income, *Example 3* indicates that allowing a U.S.

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see also STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 9 ("Most jurisdictions with territorial systems permit deductions for resident companies' expenses for generating exempt foreign income.").

177. *See* U.S. TREAS. DEP'T, APPROACHES, *supra* note 40, at 61–62; Michael J. McIntyre, *A Program for International Tax Reform*, 122 TAX NOTES 1021 (Feb. 23, 2009); Samuels, *American Tax Isolationism*, *supra* note 24, at 1594–95; *see also* ADVISORY PANEL ON CANADA'S SYSTEM OF INTERNATIONAL TAXATION, FINAL REPORT: ENHANCING CANADA'S INTERNATIONAL TAX ADVANTAGE 53 (2008) http://www.apcsit-gcrcfi.ca/07/cp-dc/pdf/finalReport_eng.dpf (making the competitiveness argument to justify allowing deductions against Canadian domestic income for interest expenses that support foreign investment). *But see* Martin A. Sullivan, *The Effects of Interest Allocation Rules in a Territorial System*, 136 TAX NOTES 1098, 1102 (Sept. 3, 2012) (arguing that allocating interest expense to exempt foreign-source income does not harm the international competitiveness of U.S. multinational corporations).

178. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 782; Martin A. Sullivan, *Obama Chooses a Clumsy Way to Limit Deferral*, 123 TAX NOTES 1163, 1164–65 (June 8, 2009).

179. *See* sources cited *supra* note 177.

deduction for such costs is a tax expenditure subsidy that must undergo a rigorous cost/benefit analysis to see if it can compete with other important uses for U.S. federal revenue. This is particularly so in light of the current U.S. fiscal situation.

One last issue merits discussion here. A number of countries employing exemption systems reduce the percentage of income qualifying for exemption by some stated percentage (e.g., 5 percent) as an alternative to disallowing a domestic corporation's expenses relating to earning exempt dividend income from its foreign corporate holdings.[180] Thus, under those systems, no expense allocation or apportionment rules apply to disallow any portion of a domestic corporation's expenses that may be properly allocable to the tax-exempt dividend income. This approach reduces complexity by eliminating the time-consuming and costly disputes that arise under the deduction allocation and apportionment rules. However, by using an arbitrary percentage in place of a fact-based allocation and apportionment deduction disallowance approach, this approach will result in the overtaxation of some dividend income paid by foreign corporations (to the extent that the domestic corporation's expenses that would properly be allocable to the exempt dividend income and disallowed, expressed as a percentage of the dividend income paid by the foreign corporation, are less than the arbitrary percentage used in place of expense disallowance rules) and the undertaxation of other such dividend income (to the extent that the domestic corporation's expenses that would properly be allocable to the exempt dividend income and disallowed, expressed as a percentage of the dividend income paid by the foreign corporation, are greater than the arbitrary percentage used in place of expense disallowance rules). For this reason, we believe that a properly designed exemption system should not use this approach; instead it should use properly constructed expense allocation and apportionment rules.[181] Alternatively, if this percentage haircut approach

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180. This rule is sometimes referred to as an expense "haircut." Countries using some variation of this approach include France, Germany, Japan, and Switzerland. *See* STAFF OF JOINT COMM., BACKGROUND AND ISSUES, *supra* note 48, at 23, 25, 28, 40.

181. The exemption proposals of both the Bush Tax Reform Commission and the Staff of the Joint Committee on Taxation would retain the allocation and apportionment rules to determine which deductions are properly allocable to exempt dividend income and, thus, are nondeductible. *See* PRESIDENT'S TAX REFORM ADVISORY PANEL, *supra* note 108, at 134; STAFF OF JOINT COMM., OPTIONS, *supra* note 41, at 190; *see also* STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME, *supra* note 146, at 83–84. Commentators Graetz and Oosterhuis also favored retaining allocation and apportionment rules for deductions in their exemption system proposal, although they argued that "stewardship expenses" should be narrowly defined in such a system because any such expenses allocable to exempt income would not be deductible in any jurisdiction — an inappropriate

is to be adopted in place of allocation and apportionment of deduction rules, we believe that it makes sense for the percentage haircut to vary by industry group so that industry groups with higher expenses allocable to tax-exempt foreign income on average would have a higher percentage haircut, and those with lower expenses allocable to such income on average would have a smaller percentage haircut. These percentages could be developed by Treasury and IRS studies as has been done to determine the class lives of assets for depreciation purposes.

C. Foreign Losses

Since 1913, U.S. federal income tax law has provided that U.S. residents are generally taxable on both their U.S.-source and foreign-source income at the time it is earned. As mentioned earlier, a major exception to this general rule is the so-called "deferral principle" or "deferral privilege" under which U.S. residents are allowed to conduct profitable overseas business activities through a CFC without paying U.S. tax on the resulting income until the foreign corporation makes dividend distributions or the U.S. residents sell the CFC's stock at a price that reflects its accumulated earnings. In the interim, payment of U.S. income tax on the foreign corporation's earnings is deferred without incurring an interest charge.[182] Thus, because there is no interest charge, the effect of this deferral privilege is to shrink the U.S. tax on the foreign-source income. This shrinkage increases with the passage of time and causes the tax's present value to approach zero if the period between the earning of the income and the dividend distribution (the deferral period) is sufficiently long.[183] Consequently, the effective U.S. tax rate on foreign-source income earned by a foreign corporation that pays a low foreign tax is less — often dramatically less — than the effective U.S. tax rate on income from U.S. operations, and this tax preference is a distortive incentive for U.S. residents to locate their business operations in low-tax foreign countries. Because income from foreign operations is lightly taxed as a result of the deferral privilege, losses from foreign operations ought not to be deductible against more heavily taxed U.S.-source income. To allow the deduction would boost the deferral

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result, in their opinion, for expenses incurred to earn business income. *See* Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 50, at 781–82. We take a different view. *See supra* text accompanying notes 178–80.

182. *See* GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 24–26, 485–86. The exceptions to this rule are readily avoidable. *See, e.g.*, Peroni, Fleming & Shay, *Getting Serious*, *supra* note 3, at 459–64. This discussion and *Example 4* assume that the necessary avoidance criteria are satisfied.

183. *See* Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 4, at 96–104.

privilege's bias towards establishing business and investment activities in low-tax foreign countries. This point is illustrated by the following example:

Example 4

> Assume that USCo, a U.S. multinational corporation that pays U.S. federal income tax at a marginal effective tax rate of 35 percent, is deciding between building a factory in the United States or in Lowtaxia, a tax haven that has no business profits tax, no withholding tax, and no branch profits tax. Also, assume that the effective rate of U.S. federal income tax on the profits of a Lowtaxia factory operated through Subco, USCo's Lowtaxia CFC, will be only 5 percent because Subco will not pay dividends for many years, and, under current federal income tax law, there will be no U.S. tax on Subco's profits until dividend payments are made or USCo sells Subco stock. (The Lowtaxia tax rate will, of course, be zero.) Clearly, the U.S. system biases USCo in favor of locating the new facility in Lowtaxia. Now assume that USCo expects the new factory to produce losses during a multi-year start-up period regardless of where it is located. If USCo builds the factory in Lowtaxia, operates the factory as an unincorporated branch during the start-up period, and is allowed to deduct the initial losses against U.S.-source income, thirty-five cents of U.S. tax saving on U.S.-source income will result from each dollar of branch loss even though the Lowtaxia branch generates no U.S.-source income. This outcome is effectively a negative U.S. tax on the Lowtaxia branch during the start-up years that will magnify the incentive for USCo to locate the new factory in Lowtaxia initially as a branch operation[184] that will later be transferred to Subco to gain the benefit of deferral when the factory becomes profitable.

Congress responded to this problem by providing that a taxpayer can deduct foreign-source branch losses against U.S.-source income only to the extent that the losses exceed the taxpayer's positive foreign-source income, if any, from other operations.[185] If, however, a taxpayer has an overall foreign-

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184. *See generally* STAFF OF JOINT COMM., ANALYSIS OF ALTERNATIVE POLICIES, *supra* note 50, at 60.

185. *See* I.R.C. § 904(f)(5); GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 679–80.

source loss, the overall loss is deductible against U.S.-source income, thus producing the incentive enhancement illustrated in *Example 4*.[186] This is highly significant. Under the U.S. income tax regime, deductible losses of a foreign branch are immediately taken into account on the owner's U.S. income tax return whereas profits earned by a CFC are generally not subject to U.S. tax until paid out as dividends or until a stock sale occurs. Thus, overall foreign-source branch losses are quite likely to occur because the preceding factors will cause U.S. taxpayers to (1) bunch loss activities in foreign branches, so the losses will be immediately available to the U.S. owner and (2) move the activities to CFCs when they become profitable in order to defer U.S. tax on the foreign-source income.

The U.S. tax system weakly addresses this strategy with the so-called "branch loss recapture rules," which require that a foreign branch's prior losses must be added to the U.S. owner's income when the branch's assets are transferred to a CFC.[187] However, because the resulting tax increase occurs in a year subsequent to the years when tax savings were realized from the branch loss deductions, the time value of money concept[188] establishes that the strategy of operating through a foreign branch during the start-up loss period and then switching to a CFC operation when profits begin to flow remains an attractive move and an additional incentive to locate business operations in low-tax foreign countries.

The relationship of the preceding discussion to a possible U.S. exemption system lies in the fact that as a general rule, only domestic business losses are deductible under an exemption system. This is because the tax base is limited to net domestic business income and foreign losses are

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186. *See* BITTKER & LOKKEN, TAXATION OF INCOME, ESTATES, AND GIFTS, *supra* note 127, at 71–27 to 71–29. Granted, the overall foreign-source loss is "recaptured" by recharacterizing an appropriate amount of foreign-source income as U.S.-source income in later years for foreign tax credit limitation purposes, *see* I.R.C. § 904(f)(1), but because of the time value of money, this recharacterization does not eliminate the advantage of deducting an overall foreign loss against U.S.-source income.

187. *See* I.R.C. § 367(a)(3)(C); Reg. § 1.367(a)-6T; BITTKER & LOKKEN, TAXATION OF INCOME, ESTATES, AND GIFTS, *supra* note 127, at 71–27 to 71–29; GUSTAFSON, PERONI & PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS, *supra* note 10, at 855–59; ISENBERGH, INTERNATIONAL TAXATION, *supra* note 64, at ¶ 92.10; KUNTZ & PERONI, U.S. INTERNATIONAL TAXATION, *supra* note 94, at ¶ B2.04[4][g][ix]; *see also* Fleming, Peroni & Shay, *Worse than Exemption*, *supr*a note 4, at 148.

188. *See generally* JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & ROBERT J. PERONI, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 145–47 (4th ed. 2012).

irrelevant in calculating that amount.[189] Allowing a deduction for foreign losses against domestic income would magnify the exemption system's distortive effect on the decision whether to locate business operations in the taxpayer's residence country or in a low-tax foreign country. This point is illustrated by the following example:

Example 5

> Forco is a corporation resident in Foreignlandia, an exemption system country that uses the Foreignlandia dollar as its currency. Forco is debating whether to build a new manufacturing facility in Foreignlandia or in Lowtaxia, which has no business profits tax, no withholding tax, and no branch profits tax. Foreignlandia imposes a tax on domestic corporate profits at an effective rate of 30 percent. When Forco considers the positive prospects of its new facility — i.e., potential profits — it will conclude that Foreignlandia's exemption system encourages location of the facility in Lowtaxia to shelter those profits from the 30 percent Foreignlandia tax. When Forco then considers the risks — loss years in the start-up phase — Forco will recognize that if Foreignlandia allows Lowtaxia losses to be deducted from Forco's Foreignlandia income, each dollar of Lowtaxia loss will save thirty cents of tax on Foreignlandia domestic income even though the Foreignlandia income is not generated by the Lowtaxia operation. Thus, these tax savings would amount to a negative Foreignlandia tax on the Lowtaxia operation during loss years and will enhance the exemption system's bias in favor of Forco building the new facility in Lowtaxia.

Consequently, exemption systems typically prohibit the deduction of foreign losses. But to repeat a familiar point, it is painful for the beneficiaries of negative taxes to let them go. Thus, if the United States adopts an exemption system, the beneficiaries of the negative taxes produced by the current U.S. federal income tax treatment of overall foreign losses illustrated in *Example 4* can be expected to argue that the United States should depart from the international consensus and allow losses from exempt foreign activities to be deducted against U.S.-source income. This argument should be rejected because it has no basis in international law and, for the reasons

189. *See* AULT & ARNOLD, COMPARATIVE TAXATION, *supra* note 50, at 476–77.

given above, would magnify the distortive effects of a U.S. exemption system.

IX. COMPETITIVENESS VS. REVENUE

In earlier parts of this article we have explained that a properly designed U.S. exemption system will fully satisfy the international law obligation of the United States to relieve double taxation and that if an exemption system goes beyond double taxation relief, it is, to that extent, a subsidy regime that effectively spends U.S. revenue for a limited set of beneficiaries at a time when there is not nearly enough money in the Treasury to fund pressing public needs. However, many of the proponents for replacing the current U.S. international income tax regime with a territorial system have not been significantly concerned with the nature and extent of the U.S. international law obligation to ameliorate double taxation. Instead, the advocacy in favor of territoriality has centered on securing a competitiveness subsidy[190] through the tax system for the foreign activities of U.S. multinational corporations.[191]

In an earlier work, we argued that this competiveness plea has numerous flaws.[192] First, it misdefines competitiveness as improvement in the after-tax profitability of already successful U.S. multinational corporations instead of more broadly as improvement in the living standard of Americans.[193] And even if competitiveness was defined in terms of the

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190. *See, e.g.*, STAFF OF JOINT COMM., IMPACT OF INTERNATIONAL TAX REFORM, *supra* note 17, at 5; R. Glenn Hubbard, *Tax Policy and International Competitiveness*, 82 TAXES 213 (Mar. 2004); Olson, Merrill, Mundaca, Reilly & Spellings, *New Ground*, *supra* note 23, at 60, 64–66; Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025, 1040 (Feb. 28, 2011). For a commentator who supports adoption of an exemption system on the grounds that it would increase worldwide economic efficiency, rather than competitiveness grounds, see Chorvat, *Ending Foreign Business Tax*, *supra* note 102.

191. For an explanation of the subsidy effect of an exemption system, see Fleming, Peroni & Shay, *Worldwide v. Territorial*, *supra* note 21, at 1091. As Professor Kleinbard has observed, the competitiveness argument in favor of territoriality "is indistinguishable from a call for export subsidies, on the grounds that other countries offer export subsidies." Kleinbard, *Lessons*, *supra* note 3, at 129.

192. *See* Fleming, Peroni & Shay, *Worldwide v. Territorial*, *supra* note 21, at 1085–86.

193. The World Economic Forum defines competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of a country." WORLD ECONOMIC FORUM, THE GLOBAL COMPETITIVENESS REPORT: 2012-2013, at 4 (Klaus Schwab ed., 2012), http://reports.weforum.org/global-competitiveness-report-2012-2013/. The World Economic Forum's Report focuses on various factors in defining competitiveness, including institutions, infrastructure,

financial interests of U.S. multinational corporations, the need for that kind of competitiveness subsidy has never been convincingly established. Isolated anecdotes of U.S. corporations responding predictably to tax-reduction opportunities have been brought forward[194] but there has never been a systematic demonstration that a comprehensive subsidy, such as a broadly applicable territorial regime, is required to make the general population of U.S. multinational corporations competitive in foreign markets. Indeed, a recent study by a leading public finance economist has concluded that "[t]he importance of low tax burdens on foreign income for U.S. worldwide 'competitiveness' does not seem to have much empirical support."[195] The same study finds an absence of strong empirical support for the contention that low U.S. tax burdens on the foreign income of U.S. multinational corporations increases U.S. domestic investment.[196] More generally, the competitiveness argument conflicts with orthodox economic theory as explained by another prominent public finance economist:

> [T]he argument that because most other countries do not tax their foreign subsidiaries, the United States also should not do so in order to allow its firms to compete abroad does not stand up to economic analysis. A country does not compete in the manner that a firm does, because its resources (labor and savings provided by its citizens) do not disappear if another firm undercuts prices; they are simply used in a different way. That is, a country does not compete with the rest of the world, it trades with them, both its products and its capital. It can generally be shown that the United States would still be better off, or at least no worse

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macroeconomic environment, health and primary education, higher education and training, goods and labor markets efficiency, innovation, and market size. Using this approach to measuring competitiveness, the United States was ranked first overall in the World Economic Forum's Global Competitiveness Report in 2007-2008 and 2008-2009, second overall in 2009-2010, fourth overall in 2010-2011, fifth overall in 2011-2012, and seventh overall in 2012-2013. *Id.* at 359 (for U.S. rankings after the 2010-2011 report); WORLD ECONOMIC FORUM, THE GLOBAL COMPETITIVENESS REPORT: 2009-2010, at 320 (Klaus Schwab ed., 2009) (for U.S. rankings prior to the 2010-2011 report); *see also* STAFF OF JOINT COMM., TAXATION OF CROSS-BORDER INCOME, *supra* note 146, at 88.

194. *See, e.g.*, Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345 (June 21, 2010).

195. Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247, 268 (2012) [hereinafter Grubert, *Foreign Taxes*].

196. *Id.* at 257.

> off, if it taxes foreign and domestic investments by its firms at the same rate, even if other countries do not.[197]

Finally, even if there was a convincing demonstration that U.S. multinational corporations needed a publicly funded subsidy, this need should be required to undergo a cost/benefit analysis in which it competes against other salutary uses for the currently inadequate U.S. revenue stream. This has never happened.

X. CONCLUSION

The thrust of this article has been to argue that if the United States decides to replace its current crippled international income tax regime with an exemption or territorial system, then the policy discussion needs to be fundamentally reframed. To be specific, in preceding portions of this article we have pointed out that the United States is in a serious revenue bind and that replacing the badly flawed U.S. international income tax system with an exemption or territorial system would likely gain much-needed revenue for the Treasury if the replacement system were properly structured. We have also identified the following design characteristics that the replacement system must have in order to fulfill its revenue potential:

> 1. A robust subject-to-tax requirement and continued current taxation of passive and mobile income under an updated Subpart F regime;
> 2. Disqualification from exemption for royalties, interest, services payments, and other foreign-source items that do not bear a significant foreign tax;
> 3. Elimination of the current tax exemption for 50 percent of the income from U.S. export sales;
> 4. Allocation of domestic expenses to foreign-source exempt income in a more realistic way than an inadequate 5 percent "haircut;" and
> 5. A prohibition against deducting foreign losses from U.S.-source income.

As we have explained in earlier parts of this article, a territorial system that lacks these features would exceed the international law obligation of the United States to alleviate international double taxation suffered by U.S. residents, and to that extent the United States would simply

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197. GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 151, at 17; *see also* Eric Toder, *International Competitiveness: Who Competes Against Whom and for What?*, 65 TAX L. REV. 505, 507–08, 532–34 (2012).

be engaging in the transfer of scarce revenue to the U.S. multinational community. The response of territoriality advocates is that providing relief from double taxation is only an incidental consideration with respect to adoption of a U.S. exemption system, that the primary purpose of such a system is to deliver a competitive assistance subsidy to U.S. multinationals, and that design features that would raise revenue are ipso facto objectionable because they would curtail the competitiveness subsidy effect of a U.S. exemption system.[198] This response is supplemented by the argument that even if an exemption system lacking these five critical design features would exceed the requirements of international law, represent bad tax policy, and lose badly needed revenue, the United States must, nevertheless, take that path because other commercially important countries have done so. Thus, the United States must mimic those countries and engage in a race to the bottom so that its multinationals can compete on a level playing field.[199]

This narrower use of the competitiveness argument has the same flaws as its application to the more general question of whether a territorial system should be adopted as a replacement for the current U.S. international taxation regime. But even if one were to credit the competitiveness argument in this more limited context, it must be recognized that the game has changed. The United States is in a revenue crisis, and a correctly designed territorial system would have the twin virtues of helping to ease that crisis while ensuring that the United States satisfies its international law obligation. By contrast, a U.S. territorial system that lacks the five critical design features described in this article would amount to a tax expenditure that diverts scarce revenue to the benefit of a narrow subset of U.S. taxpayers.[200]

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198. *See, e.g.*, Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, *The U.S. International Tax System at a Crossroads*, 127 TAX NOTES 45, 59 (Apr. 5, 2010) (generally objecting to a subject-to-tax requirement); Olson, Merrill, Mundaca, Reilly & Spellings, *New Ground*, *supra* note 23, at 65 (same and also generally objecting to a territorial regime that raises revenue); *see also* Martin A. Sullivan, *Let's Promote the Competitiveness of All American Businesses*, 133 TAX NOTES 1175, 1179 (Dec. 5, 2011) [hereinafter Sullivan, *Promote Competitiveness of All*] ("U.S. multinationals are not interested in territorial systems . . . [that effect] an overall tax increase. Nor do U.S. multinationals want a territorial system that is revenue neutral relative to current law. They want a territorial system that reduces their taxes.").

199. *But see* GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 151, at 17 ("[M]oving to a territorial system because other countries have generally done so does not mean such a system is desirable either for them or for the United States.").

200. This point is roughly illustrated by the fact that approximately 2,040,000 C corporation returns were filed for 2004. *See* STAFF OF JOINT COMM. ON TAX'N, JCX-66-12, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY 5 (2012). However, about 80 percent of the foreign income earned that year by U.S. multinational corporations was earned by fewer than 900 corporations. Grubert,

In the best of times, that kind of tax expenditure should be required to undergo a rigorous cost/benefit analysis and be ranked against other meritorious revenue uses. In the currently difficult times from a U.S. revenue standpoint, those requirements merit extra attention.

Foreign Taxes, *supra* note 195, at 251; *see also* Sullivan, *Promote Competitiveness of All*, *supra* note 198, at 1175, 1178–79 (noting that tax system features that promote the competitiveness of U.S. multinationals harm U.S. businesses that focus on the domestic market and/or on exporting from the United States).