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International Corporate Income Tax Reform: Issues and Proposals

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INTERNATIONAL CORPORATE INCOME TAX REFORM: ISSUES AND PROPOSALS

by

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(The views in this paper do not reflect the views of the Congressional Research Service or the Library of Congress.)

While details have changed from time to time, the basic treatment of foreign source income in the United States tax code has remained essentially the same as that in 1918, when the foreign tax credit was introduced.¹ All worldwide income is currently taxed, with a credit for foreign taxes paid, but income of subsidiaries incorporated in foreign jurisdictions is not considered part of that worldwide income until it is repatriated. As a result of a revision in 1962, certain passive income of foreign subsidiaries is subject to current taxation under Subpart F of the Internal Revenue Code. This system produces a number of economic distortions as well as opportunities for tax avoidance. Those continuing issues, along with the increasing integration of the global economy, have led to proposals for reform. These proposals fall roughly into four categories: narrow proposals aimed at tax avoidance concerns, proposals to move the system towards a pure territorial (or source-based) system, proposals to move the system in the opposite direction towards a current world-wide tax system, or proposals to retain the current system but lower the corporate tax rate with revenue offsets.

In evaluating these proposed tax changes, two issues, which are related but nevertheless not identical, should be considered. The first is the real effects of current law and of a revision on economic activity. When investment responds to tax differentials, it affects the allocation of capital which in turn has implications for efficiency and income distribution (the extent to which the tax burden falls on capital versus labor incomes). In a closed economy with a fixed capital stock, the burden of the corporate tax falls on capital income in general.² If the U.S. corporate tax does not apply in the foreign jurisdiction, capital can flow abroad with the result that some of the burden on the tax falls on labor (depending on the mobility of capital).³ Thus, the international tax system has implications for the overall welfare of the United States, and the world, and for the division of that welfare between those with primarily labor income, who tend to have lower incomes, and those with primarily capital income, who tend to have higher incomes.

1. See William P. McClure and Herman B. Bouma, "The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed," *Tax Notes*, Jun. 19, 1989, pp. 1370- 1390 for a discussion of the evolution of the tax system.

2. This outcome is the standard result of the widely accepted Harberger model. See Arnold C. Harberger, "The Incidence of the Corporate Income Tax," *Journal of Political Economy* 70 (Jun. 1962): 215-240.

3. See Gravelle, Jane G. and Kent A. Smetters (2006), "Does the Open Economy Assumption Really Mean That Labor Bears the Burden of a Capital Income Tax?" *Advances in Economic Policy and Analysis* 6 (1): 1-42.

The second issue is revenue. The revenue base can be affected by international capital flows. In addition, without changing economic activity, revenues are affected if firms move the location of their profits. This shift in profits can occur through either avoidance or evasion. I define avoidance as reducing taxes legally, but often in ways not intended by policy-makers; evasion is an illegal activity. Evasion may be more of an issue with individuals and smaller firms rather than large multinationals;⁴ however, the line between the two is often blurred. Tax avoidance, at least, may be facilitated or limited by the fundamental tax regime.

Ideally, a tax system that moves closer to neutrality and economic efficiency as well as limiting the scope for avoidance would be preferable. When the two conflict, it is important to know which might be more serious. For example, if real capital flows are viewed as relatively immobile, and artificial shifting of profits relatively costless, a reform that focuses on avoidance might be preferable to one that focuses on efficiency.

To begin our analysis we first review the major features of the current tax regime and the basic tax reform alternatives. The following sections evaluate the effects on real economic activities and on avoidance issues. The final section concludes with an evaluation of alternatives.

I. THE CURRENT INTERNATIONAL TAX SYSTEM

There are two alternative, conceptually “pure,” principles on which countries could base their tax: residence and territory. Under a residence system, a country taxes its own residents (or domestically chartered “resident” corporations) on their worldwide income, regardless of its geographic source. Under a territorial or source-based system, a country taxes only income that is earned within its own borders.

In practice, no country uses a pure residence-based tax; historically, virtually all countries tax income foreign investors earn within their borders, although they may grant tax holidays in some cases as an inducement to investment. Some countries, however, do have an exclusively territorial or source-based tax.⁵ Most territorial systems have some anti-abuse provisions for

4. This view was expressed by Larry Langdon, former IRS Commissioner of the Large and Mid-sized Business Division in an interview on Frontline (PBS), Feb. 19, 2003, after several corporate scandals and the passage of Sarbanes Oxley. Interview is posted at: <http://www.pbs.org/wgbh/pages/frontline/shows/tax/interviews/langdon.html>

5. President Bush’s Advisory Panel on Tax Reform published a list of countries that use a territorial system either by statute or treaty. The territorial countries are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Luxembourg, Netherlands, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, and Turkey. The following countries tax foreign-source income at some point and rely on foreign tax credits to relieve double taxation: Czech Republic, Iceland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom,

taxing mobile income, similar to the U.S. Subpart F rules discussed below. The United States uses a system that taxes both income of foreign firms earned within its borders as well as the worldwide income of its U.S.-chartered firms.⁶

Despite these nominal “residence” features, however, U.S. taxes do not apply to the foreign income of U.S.-owned corporations chartered abroad. As a result, a U.S. firm can indefinitely defer U.S. tax on its foreign income if it conducts its foreign operations through a foreign-chartered subsidiary corporation; U.S. taxes do not apply as long as the foreign subsidiary’s income is reinvested overseas. With some exceptions, U.S. taxes apply only when the income is remitted to the U.S.-resident parent as dividends or other intra-firm payments such as interest and royalties. The deferral feature reduces the effective U.S. tax burden on foreign income and imparts an element of territoriality to the system. It also results in a dichotomous structure for taxing overseas business income: deferral in the case of foreign-subsidiary income and current taxation in the case of branches of U.S. chartered corporations. The bulk of active business investment by U.S. firms is through foreign-chartered subsidiaries.⁷

Certain passive income is subject to current tax even if not repatriated under anti-abuse rules; this income is commonly referred to as Subpart F (for the provision of the Internal Revenue Code imposing the rules). Only stockholders owning at least 10% of subsidiary stock and only subsidiaries that are at least 50% owned by 10% U.S. stockholders are subject to Subpart F. Countries that have territorial tax systems generally also have some type of anti-abuse provision to protect their tax base.

Along with deferral, another basic feature of the U.S. system is the foreign tax credit. While the United States taxes worldwide income on either a current or deferred basis, it also allows credits for foreign taxes paid on a dollar-for-dollar basis against U.S. taxes otherwise owed.⁸ This treatment avoids the double-taxation that would otherwise apply and concedes the first right of taxation to the country of source. In effect, the United States gives the foreign host country the first opportunity to tax the income, and collects only what tax is left (up to its own rate) after the foreign host country collects its share.

and the United States. President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (Washington, Nov. 2005), p. 243.

6. A more detailed description of the tax system can be found in Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment*, JCX-55-08, June 25, 2008.

7. According to IRS data for 2004, before-tax earnings and profits of controlled foreign corporations were \$362 billion; branch income was \$97 billion. The data are posted on the IRS website, at [<http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html>].

8. U.S. parent firms are permitted to claim foreign tax credits for foreign taxes paid by their foreign-chartered subsidiaries. Such “indirect” credits can be claimed by the parent when the foreign-source income is remitted as dividends.

When the foreign tax is higher than the U.S. tax, the credit is limited to the U.S. tax that would be due on the foreign income. The purpose of the limit is to protect the U.S. domestic tax base: without it, foreign countries could impose very high taxes without discouraging inbound U.S. investment, because the cost of the higher taxes would be shifted to the U.S. treasury. With the limitation, if foreign taxes exceed the U.S. tax that would be due, the excess foreign taxes cannot be credited. Foreign tax credits that exceed this limitation are termed “excess credits.” Currently, foreign tax credits are allowed on what is sometimes termed an “overall” basis, so that income and tax credits from all countries are combined. This treatment allows for “cross-crediting,” where credits paid in excess of U.S. tax in one country may be used to offset U.S. tax in a country where the foreign tax is lower than the U.S. tax. To prevent abuse, tax credits are divided into “baskets” which separate passive income easily shifted to low-tax countries. Currently, there are two baskets, one for active income and one for passive income. About half of foreign-source active business income is earned by firms with overall excess credits.⁹

An alternative to the overall limit is the per country limit. With an effective per country limit, cross-crediting, at least across countries, would no longer occur. In the past, the U.S. has had a per-country limit as either a requirement or option from 1932 to 1976, including a period when the less generous of the two limits applied, as discussed by McClure and Bouma.¹⁰ They note, however, that when the per-country limit applied, companies could still cross-credit by setting up a holding company since income was sourced to the holding company rather than the original country of origin. A per country limit can also have an advantage, because it prevents countries with losses from reducing aggregate foreign source income for purposes of the limit. The debate leading up to the repeal, however, suggests that the motivation for adopting the overall limit was to move closer to an effective territorial system.

Tax deferral results in heightened importance for the system's rules for dividing income between related firms; the more income a firm can assign, for tax purposes, to a foreign subsidiary in a low-tax country, the lower its overall tax burden. There are several methods for doing so, such as altering the prices for inter-company sales (transfer pricing), transferring the ownership of intangibles to low-tax jurisdictions and using contract manufacturing to produce goods in the country of destination, relying more heavily on debt in high-tax jurisdictions than in low-tax ones. More recently, attention has been focused on the use of “hybrid” entities, where the entity is recognized as a corporation in one jurisdiction but not in another. The development of these hybrid entities arises

9. Based on tabulations by Harry Grubert presented at the James A. Baker II Institute for Public Policy conference on tax reform, Apr. 27-28, 2006.

10. See William P. McClure and Herman B. Bouma, “The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed,” *Tax Notes*, Jun. 19, 1989, pp. 1370- 1390. The discussion of foreign tax credit limits is based on their paper.

from “check-the-box” rules that were adopted to simplify the issues of whether a firm is to be taxed as a corporation or partnership, but they have been exploited in an unexpected direction internationally and permit, in many cases, the circumvention of Subpart F. According to Sicular, a temporary provision enacted in 2006 (Section 954(c)(6)) formalizes the “check-the-box” rules, although this provision expires at the end of 2009.¹¹

In sum, the United States taxes its resident corporations on their worldwide income, but permits indefinite deferral of active business income earned through foreign subsidiaries. Where U.S. taxes apply, foreign tax credits alleviate double taxation but are limited to offsetting U.S. tax on foreign income. Subpart F is designed to deny deferral to what is generally passive income but may be circumvented. The overall outcome of this system is that very little U.S. tax is paid on foreign source income. In a 1995 study, Grubert and Mutti found the U.S. tax is only about 3% using BEA data, and the GAO in a 2008 study found a rate of 4% using the new schedule M-3 reconciliation form.¹²

II. ECONOMIC ISSUES AND THE ALLOCATION OF PRODUCTION

The debate over international tax issues has been confused because of the reference to the term “international competitiveness,” which does not have a clear economic meaning. In economic analysis, it is not *countries* that are competitive, it is *companies* that are. A company generally thinks of itself as competitive if it can produce at the same cost as, or a lower cost than, other firms. But a country’s firms cannot be competitive in all areas. Indeed, even if firms in a country are more productive than firms in all other countries in every respect, a country would still tend to produce those goods in which its relative advantage is greatest. The other countries need to produce goods with their resources as well. This notion is called comparative advantage, and it is an important concept in economic theory.¹³ The issue, therefore, is not how to compete in general but how to use limited resources in the best way.

11. See David R. Sicular, “The New Look-Through Rule: W(h)ither Subpart F?” Tax Notes, Apr. 23, 2007, pp. 349-378. The provision originally expired at the end of 2008, but was extended an additional year by the Emergency Economic Stabilization Act of 2008, P.L. 110-343.

12. Harry Grubert and John Mutti, “Taxing Multinationals in a world with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?” International Tax and Public Finance, vol. 2 (Nov. 1995): 439-57. Government Accountability Office, U.S. Multinational Corporations: Effective Tax Rates are Correlated With Where Income is Reported, GAO-08-950, Aug. 2008.

13. Comparative advantage is not a technical or unfamiliar concept; it is a common, everyday occurrence. A lawyer may be able to do his or her paralegal employee’s work more efficiently, but that activity is not the best use of his or her time. A lawyer has an absolute advantage in both law practice and paralegal work, but a comparative advantage in practicing law.

Economic analysis does sometimes discuss the competition of countries for capital, an issue that relates to inbound investment, not the outbound investment that the international competitiveness argument is frequently applied to. This issue is discussed below in the consideration of optimal taxation.

Economists tend to discuss tax policies in terms of efficiency and optimality. Consider efficiency first. If a tax system is to be designed to be efficient, then, barring the need to correct for externalities and other market imperfections, it should also be neutral. A capital income tax should not alter the allocation of capital, so that the share of a fixed capital stock should be the same as it would be in the absence of tax. This efficiency can be achieved under many types of rules if all countries have the same tax rate, but only under one regime if tax rates differ. That regime is referred to as capital export neutrality, and it means that investments owned by the citizens of any one country will face the same tax rate regardless of the location. Investors will still be earning the same return after tax in each jurisdiction, and will have no incentive to shift the location of investment. Given competitive markets, this rule will maximize worldwide output, that is, be optimal from the standpoint of overall worldwide welfare.

Note that there is no need to have equal tax rates in a particular location, a condition that is often identified with “competitiveness.” It is also referred to as capital import neutrality. If the pre-tax rate of return is 10% and one country imposes a 50% tax rate and another imposes a 25% tax rate, investors resident in the first country will earn a 10% return before tax and a 5% return after tax on their domestic investments and on any foreign investments. Residents of the second country will earn the same pretax return but their after-tax return will be 7.5% in both jurisdictions, or in any other jurisdiction. This difference in after-tax return does not interfere with the ability of each country’s firms to compete in any jurisdiction since they are still earning the same pre-tax return and the price of the products produced is driven by pre-tax, not post-tax, return; that is, cost includes the required return after tax to the investor and the tax.

While no country imposes a pure residence-based tax, such a system could also be obtained with worldwide taxation and unlimited foreign tax credits as long as investment abroad is direct (made by corporations) as it typically was in the past. Even if foreign tax credits are limited, the world wide system, without deferral, and perhaps with an effective per-country foreign tax credit limit, might be a fairly good approximation of a neutral system, especially when tax rates tend to be in similar ranges. Only investments in countries with higher tax rates would be affected, as those investments would be discouraged relative to other investments.

Another perspective about tax policy of a particular country is that of optimality – what U.S. tax policy maximizes the welfare of U.S. citizens. This policy for outbound investment is to equate the return earned to the U.S. in

foreign investments to that earned domestically,¹⁴ a rule sometimes referred to as national neutrality. (This policy only holds when the actions of the investing country cannot affect the return earned abroad.) Since foreign taxes are not received by U.S. citizens either privately or for their use in funding public goods, the optimal prescription is to allow only a deduction, not a credit, for foreign taxes. As investors equate their after-tax returns, they will also equate returns before foreign taxes to domestic returns. The tax rate should be even higher for a large country which can influence with its on outbound capital the rate of return in the rest of the world.

Optimal taxation of returns on inbound investment is not necessarily related to the tax rate on domestic investment. It depends on how responsive that investment is to taxes: if it is very responsive, tax rates should be lower and if it is not very responsive tax rates should be higher.¹⁵ If the country of origin imposes a tax with a credit, then the tax rate should be at least as high as that rate. Indeed, that is a reason that worldwide developed country tax regimes with a foreign tax credit may be helpful to developing countries in establishing a needed tax base: a foreign firm's income can be taxed by the host country without actually increasing the firm's tax burden, and if the country has a limited domestic tax base, it would be desirable to impose a corporate tax.

In general, this concept of optimizing a single country's welfare has not been a very important philosophy in the United States, perhaps because of fear of retaliation, perhaps because of the notion that the U.S. should be a good citizen of the world rather than adopting a "beggar thy neighbor" policy. The analysis of optimality does, however, suggest that the flaw in a practical world-wide system with a foreign tax credit limit, if it tended toward imperfection with respect to high-tax countries, would simply move towards an optimal tax system.¹⁶

14. This optimal rule is derived from the maximization of domestic income, $F(K)+r(1-t_f)K$, where K is outbound investment, r is the foreign pre-tax return, and t_f is the foreign tax rate. The result, differentiating with respect to K and setting the result equal to zero is that the pre-tax return in the domestic economy equals the return after foreign tax in the foreign jurisdiction. This outcome would be different if the outbound investment could affect the pre-tax return in the foreign jurisdiction: in this case, the tax rate should be higher to discourage outbound investment and increase the pre-tax return earned in the foreign jurisdiction.

15. Using a demand elasticity, the optimal tax is $1/(1+e)$ where e is the elasticity of inbound investment with respect to the after-tax return. Maximizing $F(K) - r(1-t)K$ with respect to t , and recognizing that r and K are functions of t , and r is the marginal product of capital yields this result. When inbound capital is very elastic, the tax rate is close to zero while as it becomes very inelastic, the tax rate rises towards 100%.

16. Note that in almost all of the discussion about international tax issues, little attention has been directed toward the effects of risk. In a standard analysis of risk, if taxes are proportional and full loss offset is allowed, and if the riskless rate is zero, there is no burden of the tax at all and the investor can restore the original risk and variance by expanding the share of risky assets. Indeed, a high tax rate can be beneficial as it shifts risk and return to the government, which is able to spread risk more efficiently

In neither the efficient nor the optimal system is there a justification for territorial, or source-based taxes. A territorial system does not achieve efficiency because after-tax returns are initially higher in low-tax countries. In the example above, and supposing a third 0% tax country were added, all companies would earn a 5% return in the 50% tax rate country, a 7.5% return in the 25% tax rate country, and a 10% return in the 0% country. This discrepancy would cause capital to flow out of the high-tax (50%) jurisdiction and into the 0% low-tax jurisdiction (with the effect on the 25% jurisdiction unclear). Capital would be mis-allocated and production would be inefficient. Despite the term applied to such a system, capital import neutrality, there is no neutrality in this system, but rather a distortion in the allocation of capital.

Why then, in light of these observations, is there much support for a territorial system? Virtually every country (and every one with a sophisticated tax system) either has such a system, or has a close approximation to it through a deferral and credit system that leads to little tax collected on foreign income. The simplest explanation is that the original rules were formulated based on legal concepts of what income was appropriate to tax, and that inertia, the political influence of multinational corporations and the simplifications of a territorial tax (if abuses are not vigorously monitored) led to the system common around the world today. Indeed even today, there is pressure to move to a territorial tax.¹⁷

Kleinbard discusses three reasons that are advanced for moving to a territorial system: to improve international competitiveness, to encourage repatriation, and to simplify.¹⁸ The first reason, as demonstrated above, is the result of a (perhaps willful in some cases) misunderstanding of the basics of economics. The second reason is possibly a legitimate reason, but the disincentive to repatriate could also be eliminated by moving in the opposite direction, ending deferral, which appears more consistent with both economic efficiency and optimality. Kleinbard disagrees particularly with the argument that tax administration and compliance would be simplified, as there are increased

(especially across generations). Since corporate taxes tend to be proportional, risk premiums are large relative to risky returns, and there is scope for offsetting losses (through diversification and loss carrybacks and carryforwards) an argument can be made that the burden of the tax is limited and that the main effect of the tax is to reallocate risk. See Roger H. Gordon, (1985), 'Taxation of Corporate Capital Income: Tax Revenues Versus Tax Distortions,' *Quarterly Journal of Economics* 100 (Feb. 1985): 1-27. In an international context, incorporating risk still suggests capital export neutrality in order to allocate private risk efficiently.

17. For example, the President's Advisory Panel proposed moving to a territorial tax. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, Nov. 2005).

18. Edward D. Kleinbard, "Throw Territorial Tax From the Train," *Tax Notes*, Feb. 5, 2007, pp. 547-564.

pressures (as discussed below) to shift income under a territorial system. A similar position is taken by Paul McDaniel.¹⁹

One argument that might be made and might appear persuasive is that the U.S. cannot achieve efficiency in isolation. Suppose, in the example above, that the 25% tax rate (low-tax) country taxes on a source basis and the 50% (high-tax) country on a current basis with a foreign tax credit. More of the 25% tax rate country's investment would flow to the 0% tax rate country than would the high-tax country's investment. There would be a higher relative concentration of the high-tax country's investment domestically than in the case of a residence-based tax or even with both countries with limited foreign tax credits. However, there is no reason to see this system as undermining the welfare of the high-tax country. Investments at home are still earning higher domestic returns (including the taxes collected) than investments abroad. And the effect on worldwide efficiency cannot be worse than the case with both countries having a territorial tax (at the extreme, with perfect substitutability of capital, all the investment in the 0% tax rate country will be owned by the 25% country and the allocation of capital the same as if both countries had a territorial tax).

Another argument which has been used inappropriately is the argument that savings is responsive to the rate of return and therefore lowering the tax on outbound investment would not displace domestic investment because it is new savings. Aside from considerable uncertainty as to whether lowering tax rates increases or decreases savings,²⁰ this argument suffers from a fundamental fallacy: the assumption that the domestic tax rate is not reduced to allow for a revenue neutral change. That is, if the revenue from an increase in the tax rate on outbound investment is used to decrease the overall tax rate, there is no overall change in the savings incentive.²¹

But are there any other economic reasons? For most of the history of the tax system there seem to be none. However, the growth in portfolio investments (investments by U.S. individuals of stock in foreign companies) has given rise to new arguments for source-based taxation and a new concept of neutrality. The term capital ownership neutrality (CON) is closely associated with Desai and Hines, professors, respectively, of business at Harvard and economics at the University of Michigan.²² The term itself, however, appears to have been coined

19. Paul R. McDaniel, "Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?" *Florida Tax Review*, Vol. 8, No. 3, 2007.

20. Because of income and substitution effects, the theoretical outcome is not clear. In dynamic life cycle models, the result depends on what type of tax substitutions for lower capital income taxes. See, for example, Alan J. Auerbach and Laurence J. Kotlikoff, *Dynamic Fiscal Policy*, New York, Cambridge University Press, (1987) where the capital stock changes negligibly with a substitution of a wage tax.

21. For a review of this argument, see Donald J. Roussslang, "Deferral and the Optimal Taxation of International Investment Income," *National Tax Journal*, vol. 53, (Sep. 2000): 589-600.

22. Mihir Desai and James Hines, *Evaluating International Tax Reform*, National

by Michael Devereux,²³ a British economist. The underlying justification for the new standard's development, the growth of portfolio investment, was also discussed independently about the same time in a paper by Frisch.²⁴ Essentially, capital ownership neutrality is the same as capital import neutrality in that, under certain very restrictive assumptions, it is achieved by source-based taxation, and some of the earlier discussions viewed it as a resurrection of capital import neutrality.²⁵

The issue of ownership neutrality developed because international investment markets changed. At the time the previous notions of neutral international tax systems were first developed – generally, the early 1960s – virtually all U.S. investment abroad was carried out through foreign direct investment by U.S. firms.²⁶ U.S. portfolio investors held almost no stock in foreign firms. In 1976, portfolio holdings of stock were only 4% of the total of direct investment and portfolio holdings; in 2007, it was 61%. Until the mid-1980s, the share of foreign stocks in U.S. residents' stock portfolios was less than 1%,²⁷ and thus it was reasonable to assume, as in the discussion above, that there was no substitution across the nationality of firms, but rather only across locations – that is, U.S. investors could not substitute investment abroad through foreign firms for investment in U.S. firms with foreign operations.

To make the argument that capital ownership neutrality (and therefore source-based taxation) should be the guiding principle for an efficient and neutral tax system, three requirements are needed. First, firms are assumed not to substitute operations in one location for those in another – capital is completely immobile across locations. Second, firms must differ in their productivity – that is, some firms are more efficient than others – and there must be substitution across portfolios that results in firms being shut out of lines-of-business that they could run more efficiently. Third, there must be no mechanisms available to

Tax Journal, vol. 56, (Sep. 2003): 487-502.

23. Michael P. Devereux, "Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality, and All That," Unpublished Paper, Jun. 11, 1990.

24. Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," Tax Notes, Apr. 30, 1990, pp. 581-591.

25. Frisch, in "The Economics of International Tax Policy: Some Old and New Approaches," states, "In short, a major element of the CIN view would seem to possess a grain of truth," (p. 590) referring to the capital import neutrality framework. Devereux, in "Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality, and All That," indicated that he originally attempted to redefine capital import neutrality to cover the capital ownership neutrality concept.

26. The concepts were first developed by Peggy Musgrave. See, for example, her *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge MA: Harvard Law School, 1969), pp. 108-121.

27. Jane G. Gravelle, *Reform of International Taxation: Alternatives*, Congressional Research Service Report RL34115, Library of Congress, Washington, D.C. 2008.

obtain the benefits of productive efficiency – short of owning the productive capital assets. For example, relatively inefficient firms cannot rent efficient technologies or hire efficient managers away from efficient firms.

If only the first requirement is met (immobility across locations), any system of taxing investment abroad would be neutral because the particular distortion – allocation of investment across locations – is simply assumed away. It does not matter if overseas operations are taxed higher or lower than domestic investment, because investment has no reason to move. Residence taxation would be efficient as well as source-based taxation, because the national affiliation of firms would not matter to productivity (although residence taxation would not be optimal for the high-tax country which would have no revenues).²⁸

If the two remaining assumptions also apply – productivity differs and no mechanisms exist to boost efficiency – residence-based taxation is inefficient while source-based taxation produces efficiency. With residence-based taxation, the after-tax return of the high-tax country's productive firms in the above example, would still not be enough to sell shares of stock in some cases. For example, in the earlier two-country illustration, if the pre-tax return were 12%, the after tax return of 6% in the high-tax country would not be enough for these firms to operate given the return of at least 7.5% for investments of corporations of the low-tax country with a pre-tax return of 10%. If the only way to realize the higher return is to own the capital, the higher pre-tax yields of these more efficient firms would not be realized. With source-based taxation, the efficient firms in each country would operate and displace the less efficient ones.

In the more realistic tax systems where countries also tax capital income in their own location, the high-tax country's especially productive firms would still operate in their own country. That is, by taxing income within its borders, a high-tax country that is attempting to practice capital export neutrality with a worldwide tax still faces neutral ground in its home country. Thus, any distortion arising in practice from the current system would involve foreign firms and the solution of exempting foreign-source income from tax is the solution consistent with capital ownership neutrality.

Consider each of the restrictions in turn. The first is the assumption that capital is immobile across locations; yet, there is a large body of evidence that suggests that the location of capital does respond to taxes, although the response is not large, and the empirical estimates vary across studies.²⁹ So, at best, it

28. This optimality issue has also been addressed with the notion of national ownership neutrality, which indicates that it is both efficient and optimal to have source-based taxation.

29. This literature is reviewed in Organization for Economic Development and Cooperation (OECD), *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, OECD Tax Policy Studies, No. 17, 2007. The mean of all elasticities (p.12) is 0.75, although the elasticity estimates vary considerably and are statistically significant only about half the time. This elasticity is quite small, although the elasticities appear to be rising over time.

would be a question of picking which type of distortion is worse. As long as capital is mobile across jurisdictions, “capital ownership neutrality” is not neutral. At most, the model shows that there is no way to achieve neutrality with a corporate tax and that one is in a second-best world.

The second restriction requires a high, perhaps perfect, degree of substitution in portfolios of different types of stocks that would lead to the exclusion of stock of high-tax countries. The fact that the portfolio share has grown does not, in itself, provide evidence of a significant elasticity; rather, it may reflect a variety of technical and institutional changes that make holding foreign stocks more feasible. (The shares can also fluctuate with stock market values).

There is considerable evidence to suggest that such perfect substitution is not the case. If it were, investors around the world would tend to hold shares of different country’s firm’s stocks in proportions reflecting their share of total worldwide value. It has long been known, however, that there is a significant home bias in the holding of both portfolio and direct assets, and this bias continues to hold. At the end of 2007, worldwide stock values were \$60.8 trillion while the U.S. accounted for \$19.9 trillion, or about a third of the total, using U.S. located stock exchange values as a proxy for the domestic equity share.³⁰ According to BEA, holdings of foreign portfolio stock investments (investments with ownership of less than 10% of the firm) by U.S. residents were \$5.2 trillion, while portfolio holdings of U.S. stock by foreign investors was U.S. \$2.8 trillion.³¹ Thus U.S. residents had 23% of their stock portfolios in foreign investment.³² However, if there were no home bias they would be expected to hold two thirds in foreign stocks, or \$15.4 trillion, about three times as much. Similarly, the remainder of the U.S. stocks, \$12.6 trillion, should be held by foreign investors, almost six times the amount actually held.

Moreover, the portfolio shares are consistent with the notion that the holdings that do exist are not so much due to tax differences but to a general desire to diversify assets across countries to reduce cyclical risk. Two-thirds of investment is in other countries with similar tax rates. At the end of 2005, the two largest shares were for the U.K. (16%) and Japan (15%). While the U.K., with a 30% corporate rate, has a lower statutory rate than the U.S. (39% including state taxes), Japan has a rate of 41%. The next two largest claimants with 7% and 6% have rates of 35%.³³ There are significant shares in two tax

30. World Federation of Exchanges: [<http://www.world-exchanges.org/WFE/home.asp?menu=436&document=4822>].

31. [<http://www.bea.gov/international/index.htm#iip>].

32. This ratio is based on the share of foreign portfolios of \$5.2 trillion of total portfolios which is the U.S. equity value of \$19.9 trillion minus the amount held by foreigners of \$2.4 trillion plus the \$5.2 trillion of foreign portfolios.

33. Data are from tax rates cited in Congressional Budget Office, *Corporate Tax Rates: International Comparisons*, Nov. 2005, and portfolio share data are from U.S. Department of Treasury Report on U.S. Portfolio Holdings of Foreign Securities.

havens, Bermuda (5%) and the Cayman Islands (3%). According to the Department of Treasury, however, the Bermuda investments are largely former U.S. firms that have moved their location to avoid U.S. tax (a phenomenon called inversion, which was subsequently addressed with legislative restrictions), and the Cayman Islands investments are in offshore financial centers (again likely a tax avoidance issue rather than direct production issue).³⁴ Unlike studies of foreign direct investment, which are numerous, the empirical estimates of portfolio substitution are just beginning and should be treated with caution. Those to date have found varying effects, which suggest far from perfect substitutability.³⁵

An imperfect portfolio substitution elasticity also suggests that the phenomenon of eliminating efficient firms is less likely to happen. Firms that are especially productive and efficient will earn higher returns than other firms in similar circumstances of nationality and location, and they would be expected to be retained in both domestic and foreign investors' portfolios. Any firms whose size is contracted by portfolio shifts due to tax rates are more likely to be the marginal firms that have a normal level of productivity.

Finally, this model assumes that there are no other ways to enjoy the additional productivity of more efficient firms. In effect, the model begins with the assumption of productive advantages without defining in formal terms – so that the effects can be modeled – the source of the productivity. For example, if the greater productivity of the firm is due to the employment of managers with greater skills, then that productivity arises at a cost, and these management skills embodied in the individuals resident in a given country should be free to move to their highest use, and allocated efficiently. Since they add a surplus value, they would not be driven out of the market, and worldwide efficiency requires a capital export neutrality approach to labor resources as well as capital.

If the asset is uniquely tied to the firm – such as a value through a trademark, intangible R&D, or even a management set-up – the model does not allow for the fact that ownership of the productive assets and ownership of the intangible asset can, in most cases, be separated. Trademarks and patents can be franchised and sold. Or, if the intangible cannot be separately sold (for example,

34. U.S. Department of Treasury, Report on U.S. Portfolio Holdings of Foreign Securities.

35. Mehir Desai and Dhammika Dharmapala, "Taxes, Institutions and Foreign Diversification Opportunities," Working Paper, Oct. 2007, find elasticities between 0.8 and 2.1 depending on specification, examining response across time to corporate tax rates, although one specification was only marginally significant. The same authors find an elasticity of 1.6 comparing non-treaty countries to treaty countries eligible for dividend and capital gains relief after 2003, in "Taxes, Dividends and International Portfolio Choice." An earlier paper by Roger Gordon and Joosung Jun, "Taxes and the Form of Ownership of Foreign Corporate Equity," in Alberto Giovanni, R. Glenn Hubbard and Joel Slemrod, eds., *Studies in International Taxation*, Chicago: University of Chicago Press, 1993 did not find an effect.

if the R&D could be easily copied and thus is not patented but kept secret), there are ways for the firm to operate without ownership of the capital assets, such as factories, machinery, and equipment, that give rise to normal products. These assets could be leased by the firm with the intangible asset. Moreover, if the asset is not closely tied to management, the firm could arrange for contract manufacturing, a technique commonly used to shift profits. These techniques may be less than perfect if there are principal-agent costs,³⁶ but this effect is of questionable importance.

In light of the many ways in which the efficiency costs of capital ownership non-neutrality are unlikely to be significant compared to location distortions, it seems questionable to use meeting this standard of neutrality to evaluate tax reform changes and questionable to see source-based taxation as an efficient international tax regime.

III. TAX AVOIDANCE AND EVASION

A second issue involves the collection of revenues which may be undermined by avoidance and evasion. (This paper does not deal with individual evasion issues such as secret bank accounts.) The line between avoidance and evasion is blurred. By avoidance we mean structuring transactions in a way that is, or appears to be, legal but which distorts the allocation of profits and reduces company taxes without changing the fundamental economic activities. Evasion is generally viewed as an illegal activity. Both of these are different from the real economic effects of reallocating capital and production in response to tax differentials, which have consequences for revenue.

Basic techniques include intercompany pricing for goods and services (charging high prices for sales from low-tax to high-tax operations and low prices in the other direction), increasing debt shares in high-tax jurisdictions, and transferring valuable intangibles to affiliates in low-tax jurisdictions for understated royalties. Transfer pricing issues are discussed in detail by a 2007 Treasury study.³⁷ Subpart F rules were intended to capture some of these effects, such as payments between subsidiaries of interest and royalties, but there are ways to avoid these effects. Recent check-the-box rules which allow firms to elect to be considered non-corporate have led to hybrid firms and have made avoidance of these taxes much easier. Tax code changes in 2006 put this treatment, which was introduced by regulation, into the law, albeit on a

36. Principal-agent costs occur when the objectives of the two parties are not identical. For example, the contract manufacturer (the agent) may want to increase the scale of the operation rather than maximizing profits for the firm authorizing the manufacturing (the principal).

37. U.S. Department of Treasury, *Earnings Strippings, Transfer Pricing, and U.S. Income Tax Treaties*, Nov. 2007.

temporary basis.³⁸ With this mechanism, for example, loans from an affiliate in a tax haven to an affiliate in a high-tax country can generate interest deductions in the high-tax country, but not lead to taxation under Subpart F for the interest income paid to the tax haven because, from the point of view of the U.S. tax authorities, the two affiliates are one company. Similarly, once an intangible has been transferred to a low- tax jurisdiction, earnings can be allocated to that jurisdiction by arranging for contract manufacturing in the (high-tax) country of actual production and sale. If most of the profit from production is due to the intangible, that income will be allocated to the jurisdiction which owns the intangible. This income is considered active income and thus not captured by Subpart F.³⁹

As indicated above, whether these activities constitute avoidance or evasion is not always clear. A firm that deliberately sets its prices knowing that they are not arms length, given the requirement of such pricing, might be deemed to be engaging in evasion rather than avoidance, while a firm that structures transactions using check-the-box and the recently enacted tax revision appears to be engaged in avoidance. One difference between the two is that the remedies for addressing avoidance may be more directly addressed with changes in the law and regulations, while addressing tax evasion may require expenditures on tax enforcement.

Companies also can avoid Subpart F and other U.S. allocation rules by inversions, or shifting headquarters to other countries, which places the firm's foreign operations outside the reach of U.S. tax law. Inversions also facilitate earnings stripping (reducing the U.S. income tax base through leveraging). In 2004, restrictions on this activity were enacted and those, along with publicity, may have stemmed this activity. But inversion, along with the possibility of international mergers with the foreign firm becoming the parent, remain potential ways of shifting organizational form to avoid taxes without altering real activity.

There is ample evidence that income shifting is occurring, although the degree of the shifting is not as easily known. Grubert and Altshuler, for example, point out that profits of controlled foreign corporations in manufacturing relative to sales in Ireland, a low-tax country, are three times the group mean.⁴⁰ GAO showed that low-tax countries such as Bermuda, Ireland, the UK Caribbean,

38. See David R. Sicular, "The New Look-Through Rule: W(h)ither Subpart F?" Tax Notes, Apr. 23, 2007, pp. 349-378 for a discussion of the evolution of this provision.

39. For a discussion of tax planning techniques see Organization for Economic Development and Cooperation (OECD), Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis, OECD Tax Policy Studies, Nov. 17, 2007, chapter 5.

40. Harry Grubert and Rosanne Altshuler, "Corporate Taxes in a World Economy: Reforming the Taxation of Cross-Border Income," in John W. Diamond and George Zodrow, eds., Fundamental Tax Reform: Issues, Choices and Implications, Cambridge, MIT Press, 2008.

Singapore, and Switzerland had a higher share of pretax profits of U.S. multinationals than they did of value added, sales, physical assets, compensation, or employees.⁴¹ Martin Sullivan has been reporting on the discrepancies in pre-tax return on assets across tax havens for many years. For example, in 2004, he reports a return on assets for 1998 averaged 8.4% for U.S. manufacturing subsidiaries, but the returns were 23.8% in Ireland, 17.9% in Switzerland, and 16.6% in the Cayman Islands, three well-known tax havens.⁴² He has also documented the growth of profits in tax havens.⁴³ More recently, he reported that of the ten countries that accounted for the most foreign multinational profits, the five countries with the highest manufacturing returns for 2004 (the Netherlands, Bermuda, Ireland, Switzerland, and China) all had tax rates below 12% while the five countries with lower returns (Canada, Japan, Mexico, Australia, and the United Kingdom) had tax rates in excess of 23%.⁴⁴ Gravelle points out that the earnings of multinationals in the Cayman Islands is larger than the Cayman Islands GDP.⁴⁵ A number of econometric studies of this issue have also been reported in the economics literature,⁴⁶ and the recent study by the Joint Committee on Taxation reviews the literature.⁴⁷

The magnitude of these effects on revenues is, however, uncertain. The Joint Committee on Taxation, which prepares official revenue estimates projects the revenue gain from ending deferral to be about \$6 billion a year,⁴⁸ a figure that should capture both the income retained abroad and not taxed and income artificially shifted abroad because of lower tax rates. Altshuler and Grubert project a higher number: they estimate for 2002 that the corporate tax could be cut to 28% if deferral were ended, and based on corporate revenue in that year the gain is about \$11 billion.⁴⁹ That year was at a low point because of the

41. Government Accountability Office, U.S. Multinational Corporations: Effective Tax Rates are Correlated With Where Income is Reported, GAO-08-950, Aug. 2008.

42. Martin Sullivan, U.S. Citizens Hide Hundreds of Billions in the Caymans, Tax Notes, May 24, 2004, p. 960.

43. Martin Sullivan, "Data Show Dramatic Shift of Profits to Tax Havens," Tax Notes, Sept. 14, 2004, pp. 1190-1200; "Latest IRS Data Show Jump in Tax Haven Profits, Tax Notes, Oct. 11, 2004, pp. 151-153.

44. Martin Sullivan, "Extraordinary Profitability in Low-Tax Countries," Tax Notes, August 25, 2008, pp. 724-727.

45. Jane G. Gravelle, Reform of International Taxation: Alternatives, CRS Report RL34115, Washington, D.C. Library of Congress, 2008.

46. For a review, see James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation," National Tax Journal, vol. 52 (Jun. 1999): 305-322.

47. Joint Committee on Taxation, Economic Efficiency and Structural analyses of Alternative U.S. Tax Policies for Foreign Direct Investment, JCX-55-08, Jun. 25, 2008

48. Joint Committee on Taxation, Estimates of Federal Tax Expenditures for 2007-2011, Sep., 24, 2007, p. 24.

49. Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy, in Fundamental Tax Reform: Issues, Choices, and Implications" ed. John W. diamond and George R. Zodrow, Cambridge, MIT Press, 2008.

recession; if the share remained the same, the gain would be around \$13 billion for 2004 and \$26 billion for 2007.

Martin Sullivan estimates that, based on differences in pre-tax returns, \$75 billion in profits is artificially shifted abroad.⁵⁰ If all of that income were subject to U.S. tax, it would result in a gain of \$26 billion for 2004. He acknowledges that there are many difficulties in determining the revenue gain. Some of this income might already be taxed under Subpart F, some might be absorbed by excess foreign tax credits, and the effective tax rate may be lower than the statutory rate. Sullivan concludes that an estimate of between \$10 billion and \$20 billion is appropriate. Altshuler and Grubert suggest that Sullivan's methodology may involve some double counting; however, their own analysis finds that multinationals saved \$7 billion more between 1997 and 2002 due to check-the-box rules.⁵¹ Some of this gain may have been at the cost of high-tax host countries rather than the United States, however. Sullivan subsequently presents an estimate of a \$17 billion dollar revenue cost.⁵² Christian and Schultz, using rate of return on assets data from tax returns, estimated \$87 billion was shifted in 2001, which, at a 35% tax rate, would imply a revenue loss of about \$30 billion.⁵³ Pak and Zdanowicz estimated that lost revenue due to transfer pricing alone was \$53 billion in 2001.⁵⁴ Kimberly Clausing, using regression techniques on cross country data, which estimated profits reported as a function of tax rates, estimated that revenues of over \$60 billion are lost for 2004 by applying a 35% tax rate to an estimated \$180 billion in corporate profits shifted out of the United States.⁵⁵ She estimates that the profit shifting effects are twice as large as the effects from shifts in actual economic activity. This methodological approach differs from those above, which involve direct

50. "Shifting Profits Offshore Costs U.S. Treasury \$10 Billion or More," Tax Notes, Sept. 27, 2004, pp. 1477-1481.

51. Rosanne Altshuler and Harry Grubert, "Governments and Multinational Corporations in the Race to the Bottom," Tax Notes International, Feb. 2006, pp. 459-474.

52. Martin Sullivan, "U.S. Multinationals Shifting Profits Out of the United States," Tax Notes, Mar. 10, 2008, pp. 1078-1082.

53. Charles W. Christian and Thomas D. Schultz, ROA-Based Estimates of Income Shifting by Multinational Corporations, IRS Research Bulletin, 2005 [<http://www.irs.gov/pub/irs-soi/05christian.pdf>].

54. Simon J. Pak and John S. Zdanowicz, U.S. Trade With the World, An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports. Oct. 31, 2002.

55. Multinational Firm Tax Avoidance and U.S. Government Revenue, Kimberly Clausing, Working Paper, Mar. 2008. Her method involved estimating the profit differentials as a function of tax rate differentials over the period 1982-2004 and then applying that coefficient to current earnings.

calculations based on returns or prices, and is subject to the econometric limitations with cross country panel regressions.⁵⁶

Note, as suggested above, that the consequences of tax planning techniques on U.S. corporate tax revenue are unclear. Consider, for example, the check-the-box provision, with a subsidiary in a high-tax host country and a subsidiary in a tax haven. The tax haven subsidiary loans money to the host country with a deduction for interest in that country, but no taxation of interest by the United States. If inter-company payments were subject to Subpart F through a retraction of check-the-box, companies might pay the Subpart F tax, increasing U.S. revenues. They might, instead, no longer make loans, increasing the host country revenues. In other cases, as well, restrictions on methods of transferring income may benefit foreign high-tax jurisdictions in part.

Issues relating to evasion in general in tax havens have been addressed by some international agencies including the OECD and the European Union, which has sought to expand the exchange of information and limit harmful tax practices.⁵⁷ The scope of the original OECD proposal was, some argue, undermined by the withdrawal of support by the U.S. in 2001, although it may not have been very effective in any case, since the exchange of information is on a request basis, requiring the requesting country to be able to identify the tax evader in advance.⁵⁸ The European Union initiative which requires automatic information sharing or automatic withholding might be more effective but does not include the United States.⁵⁹ As noted above, the evasion of this type is more likely to be associated with individuals rather than large multinational corporations, but developing automatic information exchange would be helpful in achieving greater tax compliance for business as well as individuals.

IV. PROPOSALS FOR REVISION

There is general agreement that the current system could be worse than either a purer residence or a purer territorial system. It is effectively a territorial system, in that taxes imposed on measured foreign source income are negligible and it may also shelter domestic income from tax. By allowing deferral, companies can elect when to repatriate to match taxes with excess credits, allow deductions of parent company overhead such as interest while not taxing income, and allow foreign losses to offset domestic income. As indicated in the previous discussion, many of the Subpart F taxes on passive income may be avoided by

56. These approaches often find it difficult to account for country-specific effects.

57. See Tax Justice Network, *Tax Us if You Can*, Sep. 2005, pp. 39-42, for a brief discussion of some of these efforts.

58. For a discussion see Martin A. Sullivan, "Lessons from the Last War on Tax Havens," *Tax Notes*, Jul. 30, 2007, pp. 327-337.

59. *Ibid.*

provisions such as check-the-box, and passive income in the aggregate, as the result of changes made in 2004, is eligible for cross-crediting.

In this section we discuss proposals for revision that can be revenue neutral (by altering the corporate tax rate) and that maintain a capital income tax, thus avoiding concerns regarding distributional effects of more fundamental tax reforms.⁶⁰

The proposals discussed below fall into four main categories. The first category is narrow changes in the international tax regime that largely address international tax avoidance. The second is a proposal to move to an explicit territorial regime for active business while limiting some of the benefits associated with the current regime. The third is a proposal to move in an opposite direction, by eliminating deferral and possibly taking other measures to enforce more of a residence-based tax system. The final is some reforms in the domestic corporate tax that may alleviate some of the problems with the international tax regime. All of these changes at least claim to raise revenues or be revenue neutral, permitting the corporate tax rate to remain fixed or to fall.

A. Specific Provisions to Address Tax Avoidance and Tax Havens

In this section, a series of targeted proposals that largely address tax avoidance are discussed. Some of these provisions would, however, be quite sweeping, such as those affecting tax havens or those disallowing parent company cost deductions for deferred income. Note that this list is not exhaustive, as there are numerous narrow technical changes in the law and regulations that might reduce tax avoidance; this list focuses on broader proposals.

Reverse Check-the-Box for Foreign Subsidiaries – One change that would reduce profit shifting is to disallow the application of check-the-box rules for multinationals, which would require revising the regulatory rules and repealing the legislative provision for look-through adopted in 2006. As noted earlier, this change may not necessarily raise much revenue for the United States, if the response is to shift income to high-tax host countries rather than to pay Subpart F taxes. Such a change would not, therefore, be in pursuance of national optimality to the extent that it increases revenues of high-tax countries, but it would reduce

60. Thus, this section does not discuss the Advisory Panel's proposal to move to a consumption tax base by allowing expensing of investment. Note, also, that one problem with this approach is, while it would introduce investment neutrality, it is not clear that it would deal with profit shifting unless the tax were on a destination basis (so that tax on cash flows would hinge on the place of sale rather than the place of production). Current international rules do not allow rebates of direct taxes. There are also many challenges, largely relating to distribution and transition, because such a tax, although it appears to be a tax on capital, no longer functions that way. See Jane G. Gravelle, *The Advisory Panel's Tax Reform Proposals*, Congressional Research Service Report RL33545, Washington, D.C., Library of Congress, 2007.

those circumstances where profits are not taxed anywhere, which, after all, was the original point of Subpart F. Indeed, one can make the case that this check-the-box regulation as applied to multinational firms may have effectively undone, through regulation, much of the legislated Subpart F provisions.

Formula Apportionment – One proposal that would directly address profit shifting behavior is a formula apportionment, such as is typically applied by the states and the Canadian provinces. The states typically allocate income based on a formula that includes assets, payroll, and sales, while the Canadian provinces use payroll and sales. The proposal for formula apportionment has been the subject of a lengthy study by Clausing and Avi-Yonah,⁶¹ who propose a formula based on sales, which is the least responsive of the factors. Charles McLure discusses a similar proposal being considered in the European Union.⁶² Clausing and Avi-Yonah suggest a significant revenue gain for the U.S. Treasury is likely in such a system, on the order of \$50 billion per year, in part because the fraction of worldwide income in the United States is smaller than the fraction of worldwide sales. This revenue gain may be larger than the gain from repealing deferral, discussed below, because there would be less scope for the use of foreign tax credits to offset U.S. taxes on foreign source income.

There are a number of reservations about formula apportionment. Theoretically, using a formula based on assets would more closely allocate income to its origin, but it is very difficult to value intangible assets or determine their location, and intangibles could be easily manipulated. One could base part of the formula on tangible assets instead, but, again, for a company where the largest asset is an intangible one, there would be considerable incentive to locate these assets (as well as employment) in a low-tax country that facilitates manufacturing activity (such as Ireland or Singapore). Basing the formula largely or solely on sales would reduce or avoid these problems but would convert the tax in part to a sales tax. Using other factors changes the nature of the tax and its incidence.

Adopting such a formula unilaterally may be problematic and lead to double taxation (although if the European Union countries could also agree to such a formula, the problems would be much lessened). Yet, given the powerful evidence on profit shifting, such costs may be worth the benefits.

Sourcing Royalty Income to the Country of Development – Under current law, when foreign subsidiaries pay royalties to the U.S., they are considered foreign source income and eligible for foreign tax credits, which, under overall credit limits, are often available. Harry Grubert has suggested that such income

61. Kimberly A. Clausing and Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Brookings Institution: The Hamilton Project, Discussion paper 2007-2008, Jun. 2007.

62. Charles E. McLure, "Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications," In *Tax Policy and the Economy*, ed. James M. Poterba, forthcoming 2008.

be considered domestic source and not eligible for the foreign tax credit.⁶³ Or as an alternative, he suggests a separate foreign tax credit basket be allowed, which would reduce cross crediting. His motivations are less for dealing with tax avoidance issues and directed toward neutrality in the locational choice of where to exploit an intangible.

Extending Subpart F to Tax Haven Countries: Treating Tax Haven Firms as U.S. Firms – The Clinton administration proposed to apply current taxation to tax haven countries, and it spelled out this approach as one of its three options in its 2000 study of Subpart F.⁶⁴ It is obvious that little or no real activity is taking place in tax haven countries, and that, rather, the allocation of income is simply a blatant tax avoidance mechanism. This treatment could also be extended to branch income of tax havens under check-the-box rules or applied simultaneously with eliminating check-the-box. A tax haven could be defined with reference to the tax rate (as proposed by Treasury) and perhaps other factors (such as bank secrecy and lack of information sharing.) This tax haven income could also be segregated (either by country, or as a group) into a separate foreign tax credit basket so it could not be shielded from tax by excess foreign tax credits, or denied any foreign tax credit. Such an approach has also been proposed by Senator Levin.

A related approach, proposed by Senators Dorgan and Levin (S. 396, 100th Congress) would treat any firm not engaged in an active business in any tax haven as a U.S. firm, similarly making them ineligible for deferral or foreign tax credits.

Disallowing Interest and Other Overhead Expense Deductions for Deferred Income – A 2007 tax reform proposal by Chairman Rangel of the Ways and Means Committee (H.R.3970) proposed to disallow the deduction of parent company costs (the most important of which is interest) to the extent that profits of foreign subsidiaries are repatriated.⁶⁵ This proposal would also allocate foreign tax credits based on the share of total deferred income repatriated. The proposal was estimated by the Joint Committee on Taxation to raise \$106 billion over ten years. The revenue raised by this proposal suggests that deferred income may have been effectively subsidized to the extent that borrowing in the U.S. and the attendant interest deductions allowed deductions of effective costs without inclusion of income. The restriction also reduces the disincentive to repatriate income.

63. Harry Grubert, Tax Credits, Source Rules, Trade and Electronic Commerce: Behavioral Margins and the Design of International Tax Systems, CESIFO Working paper 1366, Dec. 2004.

64. U.S. Treasury Department, Office of Tax Policy, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, Dec. 2000.

65. This proposal is discussed in Jane G. Gravelle, The Tax Reduction and Reform Act of 2007: An Overview, Congressional Research Service Report RL34249, Washington, D.C., Library of Congress, 2007.

B. Moving To a Territorial Tax

Several researchers have proposed a territorial tax system with cost allocation rules and current taxation of passive income.⁶⁶ This proposal was also advanced by the President's Advisory Panel on Tax Reform and the Joint Committee on Taxation in 2005; the Joint Committee on Taxation also recently discussed such an approach along with the alternative of a full-inclusion system.⁶⁷ The analyses of these proposals by Harry Grubert indicated that the plan would raise revenue compared to the current system, estimated at \$10 billion,⁶⁸ presumably due to the restriction on deductions such as interest and the taxation of royalties. (The Rangel proposal, discussed above, imposes the deduction restriction while leaving deferral in place).

By moving to an explicit exemption, this provision encourages capital and investment to move abroad, a provision that is consistent with neither worldwide efficiency or national optimization. At the same time, the current system is, more or less, a territorial one and an explicit territorial approach eliminates the disincentive to repatriate. Studies of the response to the repatriation holiday (which temporarily allowed a lower tax on repatriations) showed a significant response, suggesting this distortion is important.⁶⁹ Thus, in economic efficiency terms, it might be an improvement over current law. It is less clear (since the change is projected to raise revenues, whether it reduces the incentive for foreign portfolio investments (since the returns to corporations reflect on taxes on real activity and taxes avoided through profit shifting).

66. This proposal was originally advanced by Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, Washington, D.C. AEI Press, 2001. It is further discussed, along with a full inclusion approach, by Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy," in *Fundamental Tax Reform: Issues, Choices, and Implications*, ed. John W. Diamond and George R. Zodrow Cambridge, MIT Press, 2008.

67. President's Advisory Panel on Federal Tax Reform (2005), *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, DC: U.S. Government Printing Office); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, Jan. 27, 2005; Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Investment*, JCX-55-08, Jun. 26, 2008..

68. Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," *National Tax Journal*, vol. 54, Dec. 2001, pp. 811-827.

69. See Joann M. Weiner, "Measuring the Effects of the Dividend Repatriation Holiday," *Tax Notes*, Nov. 26, 2007, pp. 853-854 reporting on a presentation at the National Tax Association meetings in Nov. 2007 by Melissa Redmiles of the IRS and Roy Clemmons and Michael R. Kinney, "An Analysis of the Tax Holiday for Repatriation Under the Jobs Act," *Tax Notes*, Aug. 25, 2007, pp. 759-768.

A number of criticisms and problems with the territorial tax have been identified.⁷⁰ The main reservation with an explicit territorial approach is that it increases the pressure to shift profits into active business enterprises in low-tax jurisdictions. The increased pressures on transfer pricing, including shifting of intangibles and the income from those intangibles into low-tax jurisdictions, were cited by the Joint Committee on Taxation and others as a problem with a territorial approach. This problem is probably worse than it was when this territorial proposal was first discussed in 1995 (with check-the-box, which was introduced in 1997). In other words, the anti-abuse system in a territorial tax system may not work very well, and may work less effectively than it did in the past and less effectively than it does under the current system. One option discussed by the Joint Committee on Taxation was to require income to be subject to a certain level of foreign tax before it could become exempt, an approach used by some other countries. Various observers have also pointed out a number of reservations and controversial details that would have to be addressed in moving to a territorial tax. For example, there may be pressure to exempt royalties, there is the issue of whether to include mobile income related to active income in the tax base, and there is the issue of the incompatibility of this regime with the 2006 provision that facilitates the activities carried out by hybrid corporations.

There is also considerable uncertainty about whether such a territorial tax, often justified as a simpler approach to international taxation, would achieve that purpose given the need to retain anti-abuse provisions and allocate expenses.

C. Moving Toward Worldwide Taxation

This section discusses several proposals that might move the United States towards the economically efficient residence based, or worldwide tax system. The centerpiece of such a proposal would be to end deferral entirely and tax foreign income currently. Several variations of an inclusive system have been proposed, which vary in the extent they would apply to minority owned subsidiaries and the extent to which foreign losses would be offset against U.S. income.⁷¹ As noted above, Altshuler and Grubert projected a higher number:

70. See Joint Committee on Taxation, Economic Efficiency and Structural analyses of Alternative U.S. Tax Policies for Foreign Investment, JCX-55-08, Jun. 26, 2008; Edward Kleinbard, "Throw Territorial Taxation from the Train," Tax Notes, Feb. 5, 2007, pp. 547-564; J. Clifton Fleming, Jr. and Robert J. Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System," Tax Notes, Dec. 19, 2005, pp. 1557-1577.

71. See the discussion in J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Deferral: Consider Ending It Instead of Expanding It," Tax Notes, Feb. 7, 2000; Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy," in *Fundamental Tax Reform: Issues, Choices, and Implications*, ed. John W. Diamond and George R. Zodrow Cambridge, MIT Press, 2008; Joint Committee on Taxation,

they estimate for 2002 that the corporate tax could be cut to 28% if deferral were ended, and based on corporate revenue in that year the gain is about \$11 billion.⁷² That year was at a low point because of the recession; if the share remained the same, the gain would be around \$13 billion for 2004 and \$26 billion for 2007.

The effectiveness of a worldwide taxation system in achieving capital export neutrality from the point of view of the United States depends on whether firms have excess credits. Without excess credits, which would be less common to the extent that the U.S. tends to be at the higher end of the tax rate scale, there is no benefit to investing in a low-tax jurisdiction. Grubert and Altshuler estimated that about 30% of active foreign source income would be in excess credit with a 28% rate, but that this group is dominated by petroleum countries; among manufacturing firms only 18% of income is in excess credit. Even with excess credits, it might be possible to provide more separate baskets, such as a basket for oil production income (as was allowed in the past) or a per country limit (with tracing rules) to limit cross-crediting.

A major benefit of current taxation of foreign source income is that it would greatly reduce the opportunities for income shifting through transfer pricing, sourcing intangibles in low-tax countries, and even check-the-box.

Ending deferral tends to score well both on achieving more economic efficiency (and optimality for the United States) and reducing opportunities for international tax avoidance. But what are the drawbacks? One such drawback is the increased incentive for corporate inversions or for originally establishing a foreign headquarters. The Joint Committee on Taxation study suggests the possibility of basing residence on a facts and circumstances basis (such as where management and control of the company is carried out) rather than nominal incorporation. Another, and related, issue is the increased incentive to make portfolio investments in other countries. It is not clear, as discussed above, that this ownership non-neutrality would contribute to inefficiency, but it might undermine revenues.

One possibility would be to create a tax differential in the United States for stock of domestic versus foreign-owned companies. When a lower dividend tax rate was enacted in 2003, it was not extended to foreign stock where a treaty did not exist; such preferential treatments could be solely limited to stock of companies headquartered in the United States.

Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Investment, JCX-55-08, Jun. 26, 2008;

72. Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy," in *Fundamental Tax Reform: Issues, Choices, and Implications*, ed. John W. Diamond and George R. Zodrow, Cambridge, MIT Press, 2008.

D. Revisions in the U.S. Corporate Tax

If direct revisions in international tax rules are not made, is it possible to make basic revisions in the U.S. tax that might mitigate some of the international tax issues? The following revenue neutral reforms might be considered.

Lower the Corporate Rate and Raise Rates at the Individual Level – Under the current U.S. system, taxes on corporate profits at the individual level (dividends and capital gains) tend to be collected (due to tax treaties) on a residence basis. If taxes at the individual level could be increased and taxes at the corporate level decreased, the tax would shift towards a residence-based system without any other changes and without any additional concerns about portfolio substitution. In 2003, relief for double taxation was provided by reducing the tax rate on corporate dividends from the ordinary tax rate to 15% for those in brackets above the 15% rate, and to 5% for others. The 5% rate is now scheduled to fall to zero. Capital gains tax rates were lowered from 20% to 15%.

According to Gravelle, the 35% corporate tax rate could have been rolled back to a 31% rate, or even less, for the same revenue cost if a corporate rate reduction rather than reductions in the individual level tax had occurred. Another two to three percentage points would be possible if capital gains are taxed at full rates. Even more revenue could be raised by accrual taxation of corporation capital gains.⁷³ Additional rate reductions would be possible if non-profits and pension and savings plans were taxed to offset their savings from lower corporate rates.

Broaden the U.S. Corporate Tax Base and Lower the Statutory Rate – Since profit shifting is generally motivated by differences in statutory tax rates, a broader base and a lower statutory tax rate would reduce the amount of profit shifting. Some of these options are discussed in Gravelle, including a list of preferences mentioned by Treasury that could reduce the tax to 27% and a bill, H.R. 3790, introduced by Ways and Means Chairman Rangel that could reduce the rate to 30.5%, and other provisions including indexing interest deductions for inflation, eliminating corporate graduated tax rates, and repealing the title passage rule.⁷⁴ A major difficulty with this approach is that there are a limited number of items that are not extremely controversial or have mixed effects. One of the large revenue raisers in the Treasury list is accelerated depreciation, and the cost of investment would likely rise if a rate reduction is traded for slower

73. Jane G. Gravelle, *Reform of International Taxation: Alternatives*, CRS Report RL34115, Washington, D.C. Library of Congress, 2008.

74. Jane G. Gravelle and Thomas L. Hungerford, *Corporate Tax Reform: Issues for Congress*, Congressional Research Service Report RL34229, Library of Congress, Washington, D.C. 2008. The title passage rule allows half of income to be allocated to the jurisdiction in which title passes for purposes of the foreign tax credit limit. It generally functions as an incentive to exports, not foreign investment.

depreciation, since investment subsidies have more bang for the buck. Similarly, while the production activities deduction is a questionable provision in terms of administration and neutrality, it does operate similarly to a rate reduction and not a great deal may be gained from that trade off. The indexing of interest deductions could also result in a reduction in total capital net inflows into the United States if debt is more mobile than equity, since this provision subsidizes debt capital.

Restrict the Ability to Operate in the Noncorporate Form – The Treasury study issued in July of 2007 provided some dramatic evidence about the ease with which mid-sized and even large firms are able to operate in the noncorporate form.⁷⁵ Income from non-corporate business grew from 21% in 1980 to 50% in 2004. While sole proprietorships declined from 17% to 14%, partnerships rose from 3% to 21% and Subchapter S firms (incorporated firms that can elect to be taxed as partnerships) from 3% to 15%. Subchapter S firms are limited by the number of shareholders – the limit of 10 was raised to 35 in 1982, to 75 in 1996, and to 100 in 2004. The expansion in partnerships came largely after 1990 and presumably reflected the new forms of firms recognized in the states and check-the-box rules in 1997. The Treasury also indicated that the U.S. has much more liberal rules for allowing non-corporate status and a more prevalent non-corporate sector.

Returning to greater restrictions on shareholders for Subchapter S and restricting the ability of large firms to operate as partnerships (for example, by requiring corporate status in any case of limited liability) would increase revenues and allow a much lower corporate tax rate.

Change the Basic Nature of the Tax System – A final approach is to change the fundamental nature of the system. A recent proposal made by Kleinbard, for example, would require that all businesses pay the same tax with riskless returns taxed at the individual level and the corporate tax applies to excess returns.⁷⁶ This approach combines elements of some of the proposals above, particular treating debt and equity and corporate and non-corporate firms the same, is a form of integration, and shifts more of the tax burden back to the individual level. Such a proposal might be explored, although it already has its critics and would probably face some barriers, both technical and political.⁷⁷

75. United States Department of the Treasury, Treasury Tax Conference on Business Taxation and Global Competitiveness: Background Paper, Jul. 30, 2007 at [<http://www.ustreas.gov/press/releases/hp500.htm>].

76. See Edward Kleinbard, *Rehabilitating the Business Income Tax*, The amilton Project, Discussion Paper 2007-09, Washington, D.C., The Brookings Institution, 2007. Posted at: [http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes_kleinbard/200706kleinbard.pdf].

77. See Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, Tax Notes Feb. 25, 2008, pp. 921-939. For a rejoinder, see the letter to the editor from Kelinbard, Tax Notes, Mar. 3, 2008, pp. 1043-1048. For further reply see Warren's

V. CONCLUSION

Our current stance on international taxation involves both misallocation of investment and considerable scope for tax avoidance, not only for avoiding tax on foreign source income but also shifting profits from the domestic economy to foreign jurisdictions.

The analysis in this paper suggests that proposals to move to a source-based or territorial tax, which have been proposed by businesses, by some academics, and by the President's Advisory Panel, would exacerbate both of those problems. With a territorial system, other provisions such as formula apportionment or current taxation of income earned in low-income systems would likely be needed to limit shifting of profits. A worldwide system, while eliminating the benefits of profit shifting by U.S. firms would face the problem of shifting residency, so that such a shift might need to be accompanied with other measures, such as determining residency by a facts and circumstances rule and perhaps taxing foreign and domestic corporations differently at the individual level.

Even if we retain the current deferral and credit system there are some provisions without that framework that might address avoidance and misallocation. Finally, measures that would shift the tax burden from the firm level to the individual level and/or that would expand the base of corporate taxation and permit lower rates could be considered. The barriers to such changes appear to be largely political, not technical.

letter to the editor, *Tax Notes*, Mar. 17, 2008, pp. 1254-1255 and further rejoinder by Kleinbard. Mar. 31, 2008, pp. 1417-1419.