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A Review of International Business Tax Reform

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A REVIEW OF INTERNATIONAL BUSINESS TAX REFORM

*Alexander Lewis**

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I. INTRODUCTION – THE CURRENT SYSTEM & AN OVERVIEW OF POSSIBLE REVISIONS

Over the course of the last few years, while the world has suffered through a financial collapse and recession, more and more attention has been drawn to what Bloomberg describes as "The Great Corporate Tax Dodge."[1] Tax Law professional Edward Kleinbard[2] has written extensively on the subject and has described the methods that a multinational corporation ("MNC") can use to reduce its corporate income tax burdens as the creation of "stateless income."[3] Stateless income represents the income of a U.S. based MNC's foreign subsidiaries that is permanently reinvested abroad, but often invested or held in a jurisdiction other than the one in which the income was earned. The choice to leave this income abroad, rather than repatriate it, allows

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[1] *The Great Corporate Tax Dodge*, Bloomberg (2011), http://topics.bloomberg.com/the-great-corporate-tax-dodge/. "Beginning in force in the mid 90s, U.S. multinationals have been avoiding corporate income taxes by shifting profits into shell companies in havens like Bermuda, the Switzerland and the Cayman Islands. At home, they have exerted tremendous lobbying pressure on Congress to get a second tax break to bring those profits back home."

[2] Edward Kleinbard. Professor of Law, University of Southern California Gould School of Law.

[3] Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011). Stateless income is defined in the paper as "income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factor of production through which the income was derived, and is not the domicile of the group's parent company." *See also, Id.* at 702 n. 1. "The domicile of a multinational enterprise's ultimate parent company is referred to in the literature as the 'residence' country. A country other than the residence country in which a multinational group derives business or investment income is referred to as the 'source' country."

U.S. based MNCs to defer[4] payment of the United State's statutory corporate income tax rate of thirty-five (35%) percent, and instead achieve astonishingly low effective tax rates. The total amount of tax-deferred offshore earnings has been estimated at an amount close to $1.7 trillion.[5]

The ability to generate stateless income is not unique to U.S. based MNCs. The international community has also become acutely aware in the recent years of the aggressive tax-planning strategies being employed and the impact those strategies are having on corporate income tax revenue collections. The Organization for Economic Co-operation and Development ("OECD") recently released a report (hereinafter "BEPS Report") detailing the impact of base erosion and profit shifting ("BEPS") on OECD member and non-member countries.[6] The BEPS Report highlights many of the fundamental issues present in the current system of international taxation.[7] The BEPS Report discusses problems with transfer pricing,[8] corporations' preference for financing themselves with debt rather than equity due to tax benefits,[9] and MNC's ability to legally shift income from high to low-tax jurisdictions through the use of corporate structures[10]. However, the overarching theme throughout the BEPS Report is one that is at the source of all well-planned tax-avoidance schemes: the lack of a cohesive international plan or system to prevent BEPS allows MNCs to utilize each country's individual tax system against each other, thereby greatly reducing or even eliminating their total tax liability.

In 2013, President Obama, in conjunction with the U.S. Department of the Treasury, released a set of proposals[11] (hereinafter

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[4] The concept of deferral is discussed *infra*, in section II, providing an overview of United States tax basics.

[5] Dane Mott, *J.P. Morgan & Co. North America Equity Research* (May 16, 2012).

[6] OECD *Addressing Base Erosion and Profit Shifting* (2013), http://www.oecd.org/tax/beps.htm, (hereinafter "BEPS Report").

[7] *Id.* at 33–45 (Key Tax Principles and Opportunities for Base Erosion and Profit Shifting).

[8] *Id.* at 42.

[9] *Id.* at 43.

[10] *Id.* at 44.

[11] *The President's Framework for Business Tax Reform: A Joint Report by the White House and the Department of the Treasury* (Feb. 2012), http://www.treasury.gov/

the "Proposal") to reform the United States' international tax system. The proposed changes to the current system represent an attempt to combat tax avoidance strategies employed by U.S. based MNCs. In light of the United States' current fiscal situation, there are few reform strategies available that will be popular with corporations as well as boost revenue for the government.[12]

This Note will first provide in Section II an overview of the current international tax system and discuss the essential elements of the United States' domestic international corporate income taxation rules. Next, the common standards and methods used to evaluate international tax systems and proposed changes to those systems will be reviewed. Section III will briefly summarize the methods MNCs employ to produce stateless income, as well as utilize the well-publicized example of Google's Double Dutch Irish Sandwich technique to demonstrate the ease with which MNCs can employ and replicate these strategies. Section IV will then discuss the Proposal's proposed changes to the current U.S. international taxation system and their corresponding implications for MNCs as well as present several critiques that would need to be addressed if adopting the President's framework were in fact to happen. Section V will provide an overview of Representative Dave Camp's discussion draft proposing that the United States move to a territorial tax system. Finally, Section VI will discuss why Representative Camp's proposal should be adopted instead of the President's proposal.

II. OVERVIEW

Before discussing the proposed changes to the existing US tax system, it is important to have a general understanding of how the system currently operates. Further it is important to understand how the proposed changes to the system would affect not just the United States, but also the global economy.

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resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf (hereinafter *The President's Framework for Business Tax Reform*).

[12] Kristen A. Parillo, *U.S. Tax Reform More Likely as Part of Larger Economic Package, Says Former Lawmaker*, Tax Analysts (Sep. 28, 2012).

A. *International Tax – Our Current System*

While reading about or listening to discussions concerning reform of the United States' international tax system, the debate is frequently over whether the United States should convert from a worldwide to territorial system of taxation. These two systems of international taxation represent the foundation or starting point from which almost all countries' international tax systems have grown. It is important to note that a worldwide system is actually a residence system, under which a country taxes its own residents on their worldwide income, regardless of where that income is earned. Under the opposing territorial system, income is only taxed at its source, or in the country in which it is earned.

The current U.S. tax system is purportedly a residence-based or worldwide tax system. However, the current system has elements of both a residence-based and territorial tax system. The United States' international tax system can be seen as a worldwide tax system due to the fact that it taxes income earned by U.S. citizens or residents regardless of where the income is earned. The United States' international tax system also contains elements of territorial tax systems in that it includes elements such as deferral and cross-crediting. Deferral and cross-crediting are important tools used by multinational U.S. firms to generate stateless income.[13] Stateless income includes foreign earnings of a U.S. multinational that are retained outside of the U.S. in order to avoid taxation upon repatriation of that income. The creation of stateless income depletes the United States' tax base and is a primary focus of the Obama Administration's proposed changes to the U.S. international tax system.[14]

One of the fundamental concepts within the United States' international tax system is the realization requirement. This requirement provides that income is not taxed until there is a realization event. This concept is key to the creation of stateless income because it provides multinational firms with the ability to defer certain foreign earnings indefinitely. The Proposal seeks to eliminate deferral of income earned by foreign subsidiaries of U.S based MNCs by placing a

[13] Kleinbard, *supra* note 3, at 727–33.
[14] *The President's Framework for Business Tax Reform*, *supra* note 11, at 1.

current, mandatory minimum tax on all foreign-owned subsidiaries' earnings.

The U.S. tax system's realization requirement allows multinational firms to delay taxation of foreign subsidiaries' earnings until the income is repatriated in the form of a dividend to the parent company. This foreign source income can be divided into four categories: (1) profits of foreign incorporated subsidiaries; (2) current payment income; (3) branch income; and (4) Subpart F income.[15] Only the first category, profits of foreign incorporated subsidiaries, is eligible for deferral. Each of the other categories is taxed currently.

The profits of a U.S. multinational's subsidiary incorporated abroad are not taxed until they are repatriated. As discussed below, this ability to defer profits of foreign subsidiaries allows for significant tax arbitrage. When foreign source earnings are repatriated, a foreign tax credit ("FTC") is allowed against the U.S. tax.[16] This foreign tax credit can then be used to offset U.S. taxes on the repatriated earnings or on similar income from another, likely low-tax rate jurisdiction.

Current payment income includes direct payments such as royalties and interest. Current payment income is taxable currently. The methods used to offset the taxes on this income are discussed below. Taxes on this type of income are generally offset through the use of cross-crediting foreign tax credits. Because this income is taxed currently and cannot be deferred, the ability to shield this income through the use of FTCs is very important to large MNCs.

Branch income is income that is earned by foreign branches of a multinational organization. Because these branches are not separately incorporated, their income is treated as having been earned by the parent company and is taxed currently.

Subpart F income is income that falls within the rules specified in Subpart F of the Internal Revenue Code.[17] Subpart F income includes passive income, or income that could easily be shifted to low-tax jurisdictions. However, as seen later in the discussion of the methods used to generate stateless income, Subpart F has become

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[15] Jane G. Gravelle, *Moving to a Territorial Income Tax: Options and Challenges*, 2012 WL 3277161 (Congressional Research Service (C.R.S.) (hereinafter Gravelle, *Moving to a Territorial Income Tax*)).
[16] Internal Revenue Code § 901(a).
[17] Internal Revenue Code, Subpart F, §§ 951–964.

significantly less effective in recent years due to check-the-box regulations[18] and look-thru exceptions. The Proposal does not specifically mention any changes to the current check-the-box rules; although changes to the check-the-box regulations were proposed by the Obama Administration in 2009, they were not retained in the revenue proposals for the 2011 fiscal year.[19]

Another important aspect of international tax planning within the Subpart F regime is the look-thru rule for related controlled foreign corporations. The look-thru exception operates by excluding certain income from the definition of Subpart F income and thus from currently taxable income of the parent company.[20] This is particularly important for intercompany dividends or interest payments, which would otherwise be treated as Subpart F income and thereby includible in the parent company's income.

B. *Evaluating International Tax Systems & Neutrality Standards*

There are several competing methods commonly used to evaluate proposed changes to international tax systems. The older, traditional methods include Capital Export Neutrality, Capital Import Neutrality, and National Neutrality. The more recent model, proposed by Desai and Hines, is Capital Ownership Neutrality.[21]

These models generally evaluate tax systems from the standpoint that a set of tax rules should not dictate, by encouraging or discouraging, particular investment activity. In other words, investment decisions should be based on business reasons rather than taxation. This concept is known as tax neutrality. However, as the OECD's recent BEPS Project indicates, MNCs likely make significant investment or corporate structuring decisions that arise out of the desire to minimize their income tax burdens.

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[18] U.S. Dep't of the Treasury Reg. § 301.7701-3(b)(2).

[19] U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals 28–40, 28 (2009).

[20] Internal Revenue Code § 954(c)(6)(A). The look-thru exception actually excludes certain income received from a controlled foreign corporation from the definition of "foreign personal holding company income," which is defined in § 954(c)(1).

[21] Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003) (hereinafter Desai & Hines, *Evaluating International Tax Reform*).

The Capital Export Neutrality ("CEN") standard, largely shaped by the work of Peggy Musgrave, states that a tax system will meet the standard if a firm's investments are taxed at the same rate, regardless of where the investment is made.[22] Thus, under a tax system that satisfies the CEN standard, the firm's decision to invest domestically or abroad is not affected by taxation, but rather by business factors and will lead to more efficient allocation of capital. The United States' current worldwide tax system is in line with this standard; however, this is not entirely true due to the fact that the current deferral rules create incentives to increase foreign investments.

Capital Import Neutrality ("CIN") states that all firms doing business within a market will be taxed the same rate.[23] CIN is thus embodied in the territorial or source-based tax systems. MNCs have been strong advocates of this approach and there have been several proposals in Congress that have advocated this approach.[24]

The third traditional standard used to evaluate international tax systems is national neutrality ("NN"). Under the NN standard, a nation's total returns on capital, which are shared by the government and the taxpayer, are the same no matter which jurisdiction the investment is made in.[25] Under this standard, taxes paid in foreign jurisdictions are deductible rather than creditable against domestic taxes. Thus, foreign taxes on foreign-source income are only deductible and the domestic taxpayers incur a higher domestic tax liability because the foreign taxes do not reduce domestic taxes dollar-for-dollar.

Desai and Hines' capital ownership neutrality ("CON") represents a break from prior neutrality standards in that it takes into account both where capital is invested as well as who owns the

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[22] Peggy Brewer Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (1963); Peggy B Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (1969) (hereinafter Musgrave, *Issues*).

[23] Michael S. Kroll, *Reconsidering International Tax Neutrality*, 64 TAX L. REV. 99, 119–21 (2011).

[24] *See* Grubert-Mutti proposal (included in President Bush's Advisory Panel on Tax Reform proposal in 2005). *See also* Gravelle, *Moving to a Territorial Income Tax*, *supra* note 15, for a discussion of other past proposals and recommendations to Congress that the United States move to a Territorial system.

[25] Musgrave, *Issues*, *supra* note 22, at 134 n. 7.

capital.[26] The analysis considers who owns capital from the perspective that investors in countries with varying tax systems will have differing incentives to choose particular investments. This new model represents an important step in evaluating tax systems in that it takes into account additional real life factors beyond the location of investment. Under Desai and Hines' model, CON may be achieved by the adoption of either a worldwide or territorial system of taxation by all countries.[27]

III. STATELESS INCOME

A. *An Example of Stateless Income: The Double Dutch Irish Sandwich*

The recent proposals to alter the U.S. international tax system came after it was noted in the news that Google, Inc., as well as other prominent U.S. multinational organizations, had recently paid taxes at astonishingly low income tax rates. Prior to discussing the general methods with which companies are able to create stateless income, it is important to see an example of a commonly employed and easily replicated method of avoiding the U.S. taxes. The method that Google employed is commonly referred to as the Double Dutch Irish Sandwich. This method is used to remove income from the jurisdiction in which the actual production of the income occurs. The resulting level of taxation on that income is significantly lower than would otherwise be the case.

The first step in the process required the transfer of intellectual property to an Irish subsidiary that is a registered Bermudan tax resident. Prior to its public offering in 2003, Google, Inc. began this process by entering into a cost sharing agreement with a wholly-owned Irish subsidiary, Google Ireland Holdings ("Ireland Holdings"). The cost sharing agreement provided that Ireland Holdings would acquire the rights to some of Google Inc.'s intangible property for a territory consisting of Europe, the Middle East, and Africa ("EMEA"). This transaction likely occurred at the time it did due to the fact that

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[26] Desai & Hines, *Evaluating International Tax Reform*, *supra* note 21, at 487. *See also* 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).

[27] James R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 276 (2009).

the transaction was potentially taxable and thus it was likely more beneficial to complete the transaction prior to the intellectual property undergoing any significant appreciation in value.[28] This portion of the transaction also included an agreement that Ireland Holdings would bear future development costs in proportion to the size that the EMEA market bore to worldwide market for the particular Google technologies.[29] The Internal Revenue Service approved this portion of the transaction in a non-public Advance Pricing Agreement in 2006.

It is important to note that while Ireland Holdings was incorporated in Ireland, Ireland Holdings is a Bermudan tax resident. This is crucial because Ireland has a low corporate tax rate, and, under Irish law Ireland Holdings is treated as a Bermudan company.[30]

The next step in the process occurred when Google established a Dutch subsidiary ("Google BV") to which Ireland Holdings then licensed its rights to the intellectual property. Google BV then licensed the rights to a lower tier subsidiary, Google Ireland Limited ("Ireland Limited"). Ireland Limited then began licensing the intellectual property through the EMEA territories and collecting billions of dollars of income.[31] Importantly, Google BV and Ireland Limited had likely "checked-the-box" for U.S. tax purposes and thus effectively disappeared for purposes of applying U.S. international tax rules.

The entire picture can be seen once each of the subsidiaries is established. Income earned throughout the EMEA territories first goes to Ireland Limited. This income is effectively only taxed in Ireland; however, Ireland Limited must only pay the 12.5 percent Irish corporate tax rate on the residual income left over after Ireland Limited makes sizable royalty payments to Google BV. Google BV then makes almost identical payments to Ireland Holdings. Because Ireland Holdings is a Bermudan company from an Irish perspective, income earned by Ireland Holdings is not taxed in Ireland. However, Ireland Holding is not subject to tax in Bermuda because Bermuda has no corporate income tax. Google BV is also a critical component of this tax planning scheme due to the fact that it eliminates any potential

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[28] Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY'S L.J. 825, 837 n.44 (hereinafter Loomis, *The Double Irish Sandwich*).
[29] Kleinbard, *supra* note 3, at 709 n. 14.
[30] Loomis, *The Double Irish Sandwich, supra* note 28, at 50.
[31] Kleinbard, *supra* note 3, at 708.

withholding tax that Ireland would impose if the royalty payments were made from an Irish company, Ireland Limited, to a Bermudan company, Ireland Holdings.[32]

Astonishingly, through the use of its subsidiaries, Google is able to stream the income, in the form of royalties it receives throughout the EMEA territories from Ireland Limited, to Google BV and then back to Ireland Holdings, all the while paying minimal taxes on the residual income left after the royalty payments are made. For U.S. tax purposes, Ireland Holdings, an Irish company with a Bermudan branch, is the only company that seemingly exists. Further, Google is able to defer repatriating the income that comes to rest with Ireland Holdings and achieve the incredibly low 2.4 percent tax rate.[33]

There is one major limitation to the repatriation of foreign source income: the income cannot be brought back into the United States unless the corporation is willing to pay the difference between the taxes already paid on the income and the United States statutory rate of thirty-five percent. The IRS has been largely successful at stopping tax avoidance schemes.[34] Because repatriating foreign source income is not favorable for corporations that go to great lengths to avoid paying taxes, many corporations wait for repatriation holidays such as the one that took place in 2005 as a result of Internal Revenue Code section 965.[35]

B. *Production of Stateless Income*

The production of stateless income is an issue that may result in significant erosion of the domestic tax base of U.S. multinationals. In Edward D. Kleinbard's *Stateless Income*, Kleinbard compares the production of stateless income by U.S. multinationals to the work of a master distiller who, through careful planning, is able to draw upon various casks of foreign source income and the related foreign tax

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[32] *Id.* at 713 n. 20.

[33] 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.

[34] Hal Hicks & David J. Sotos, *The Empire Strikes Back (Again)—Killer Bs, Deadly Ds and Code Sec. 367 As the Death Star Against Repatriation Rebels*, May–June INT'L TAX J. 37 (2008).

[35] Kleinbard, *supra* note 3, at 720 n. 33.

credits in order to create a blend of income to be repatriated with the minimum U.S. tax possible.[36] The goal is to have neither excess foreign tax credits, nor excess limitation. The master distiller has several tools at his disposal to generate stateless income; however, at a fundamental level each of those tools is premised on the global tax norm of treating corporate subsidiaries as entirely separate jurisdictional entities.[37]

The first tool available to the master distiller is the ability to "strip out" high-tax source country earnings through internal group leverage.[38] Prior to the check-the-box regulations enacted in 1997, it was slightly more difficult for U.S. multinationals to generate stateless income through internal group leverage.[39] However, with the enactment of the check-the-box regulations[40] it is now possible to easily avoid generating Subpart F income.[41] As discussed previously, the controlled foreign corporation look-thru rules also allow corporations to shift income abroad without incurring U.S. taxes under Subpart F.[42]

Transfer pricing is another mechanism U.S. multinationals can use to generate stateless income.[43] Transfer pricing is the term used to refer to the prices at which intragroup transactions are effected. Transfer pricing strategies are extremely valuable to U.S. firms seeking to remove income to foreign jurisdictions due to the fact that the previously described earnings striping strategies are ineffective due to Subpart F rules.

A third commonly employed method of stateless income generation is the arbitrage of different legal systems. For example, looking back at the Double Dutch Irish Sandwich example, Google has ability to "check-the-box" and hide its subsidiaries completely for U.S. tax purposes but not for Irish or Dutch purposes.

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[36] *Id.* at 725.
[37] *Id.* at 728.
[38] *Id.*
[39] *Id.* at 730.
[40] U.S. Dep't of the Treasury Reg. § 301.7701–3.
[41] Kleinbard, *supra* note 3, at 731.
[42] *See* Internal Revenue Code § 954(c)(6)(A), *supra* note 20.
[43] *Id.* at 734. *See also id.* at 734 n. 71 for representative list of notable works studying the impact of transfer pricing on the generation of stateless income.

IV. PRESIDENT OBAMA'S PROPOSAL

A. *The Proposal's Main Points*

The Obama Administration's framework for tax reform contained four key components: (1) a reduction of the corporate tax rate from 35 percent to 28 percent, (2) a minimum tax on foreign source income in low-tax countries, (3) a current tax on excess profits associated with shifting intangibles low tax jurisdictions, and (4) limitations on the deductibility of interest payments attributable to overseas investment.[44] While the Proposal would effectuate significant change within the current U.S. tax system, it fails to address the issues arising out the check-the-box regulations. This section will discuss each of the proposals in turn.

1. Reducing the Corporate Tax Rate from 35 Percent to 28 Percent

The Administration's first proposal recommends reducing the corporate tax rate from 35 percent to 28 percent. The Administration justifies reducing the corporate tax rate on the grounds that the reduction would encourage greater investment in the United States as well as reduce tax-related economic distortions.[45] The Proposal recognizes that the current relatively high U.S. statutory rate encourages multinational corporations to shift income and investments away from the U.S. Further, the Proposal recognizes that the high statutory rate encourages firms to engage in the practice of generating stateless income, thereby eroding the U.S. tax base and decreasing corporate tax receipts.[46]

2. A Mandatory Minimum Tax on Foreign Source Income in Low Tax Countries

The second major proposal the Administration puts forth is placing a mandatory minimum tax on foreign source income. The Proposal does not state what that rate would be. While this is not a complete end to deferral, it would represent a step in that direction.

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[44] *The President's Framework for Business Tax Reform*, *supra* note 11, at 1.

[45] *Id.* at 6–7.

[46] *Id.* at 7 n. 11.

The Proposal recognizes that firms do have legitimate business reasons for leaving some income abroad;[47] however, the Proposal goes on to state that this minimum tax seeks to deter corporations from locating income in low-tax jurisdictions solely in an attempt to avoid paying taxes in the U.S.[48]

3. Tax on Excess Intangibles

The third reform proposed by the Administration states that excess profits associated with shifting intangibles to low tax jurisdictions would be taxed currently as opposed to the year in which those profits are repatriated to U.S.[49] This proposal would be accomplished by expanding subpart F income to include excess intangible income generated by a sale, lease, license, and shared risk, development or cost sharing agreement.[50] This proposal is aimed at curbing the abuse of transfer pricing rules.[51] Under Internal Revenue Code Section 482 and its corresponding regulations, transfers of intangible assets must be conducted at arm's length[52] and the income received must be commensurate with the income attributable to the intangible asset.[53]

4. Limiting Interest Deductions

The Administration's last major change to the U.S. international tax system is a clear attempt at reducing U.S. multinationals' preference for debt financing. The Proposal would require that interest deductions attributable to an overseas investment be delayed until the related income is repatriated and subsequently taxed in the United

[47] *Id.* at 9.
[48] *Id.*
[49] *Id.* at 14.
[50] U.S. Dep't of Treasury, General Explanations of the Administration's FY2013 Revenue Proposals, February 2012, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf, at 88-89 (hereinafter Treasury, General Explanations FY2013).
[51] *Id.* at 88.
[52] Kleinbard, *supra* note 3, at 710. As Kleinbard points out in *Stateless Income*, it is somewhat hard to believe that a wholly owned subsidiary could truly negotiate at "arm's length" with its parent company.
[53] Treasury, General Explanations FY2013, *supra* note 50, at 88.

States.[54] This provision would effectively limit multinational's ability to use foreign tax credits to shelter income from low tax countries. The Proposal would also decrease the incentives that U.S.-based corporations have for moving investments and jobs overseas.[55]

B. *A Critique of the President's Framework If It Were Adopted*

If the President's Proposal was evaluated in a vacuum, irrespective of other current proposals for reforming the United States' international tax system, there are two major issues that need to be clarified. The first major issue is the lack of a specific rate for the mandatory minimum tax. Second, the Proposal lacks a plan to deal with interim issues that arise during the transition between the new and current system.

1. Mandatory Minimum Tax Rate Is Missing

The Proposal's first major issue is the lack of a specified rate for the mandatory minimum tax placed on all U.S. based MNC's foreign subsidiaries. This is obviously an issue for multiple reasons. It is difficult to evaluate the impact or likelihood of success of this provision without knowing what the rate will be. The provision is aimed at reducing the attractiveness of tax havens as well as curbing the benefits offered by deferral.

If the rate is set too low U.S. based MNCs will merely continue their stateless income planning with a slightly higher marginal rate; however, a low rate would not achieve the goal of incentivizing MNCs to repatriate more of their excess cash. If the rate is set too high U.S. based MNCs may be put at a competitive disadvantage in foreign markets due to the fact that their competitors can earn the same returns while operating at a less efficient level.

2. Implementation and Transition

The second issue with the Proposal is its lack of a timeline for implementation and its lack of a plan for how U.S. based MNCs operating under the current system would be treated in the interim or

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[54] *The President's Framework for Business Tax Reform*, *supra* note 11, at 15.
[55] Treasury, General Explanations FY2013, *supra* note 50, at 85.

transition period. The likelihood of implementation is a question of politics and speculation and based on current partisan behavior may never come to pass. However, reform of the United States' international tax system may be done in the near future as Congress has made this an important issue in the recent months. Representative Dave Camp has taken it upon himself to head the reform and has begun making headway – at the very least, another step in the right direction.

However, this article's focus is not on the likelihood of the Proposal's political success, it is an analysis of the merits. As such, the greater issue with the implementation of the Proposal is the lack of a plan for dealing with the transition period. Contrary to the Proposal's claim that it will simplify the Code, even a simplified version of the current system will be immensely complex. This is a massive undertaking that will require analysis of multiple issues as well as working with U.S. based MNCs to ensure that they are not disproportionally impacted. The undertaking will need to determine what will happen to U.S. based MNC's excess cash currently held abroad as well as when the new system will begin taking effect.

V. REPRESENTATIVE CAMP'S PROPOSAL TO MOVE TO A TERRITORIAL SYSTEM

A. *A Review of David Camp's Discussion Draft*

Representative Camp's discussion draft[56] ("Discussion Draft") represents a radical change in the way the United States taxes income earned by U.S. MNCs abroad. Generally, the proposal would move the U.S. to a territorial system of taxation whereby the majority of U.S. MNC's foreign source income would be exempt from tax currently and would be subject to minimal tax upon repatriation to the U.S. This portion of the paper will first discuss the major points of the Discussion Draft and then discuss the three alternative methods that the proposal would alter the Subpart F regime.

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[56] House Ways and Means Chairman David Camp's Discussion Draft (hereinafter Camp Discussion Draft) (Oct. 2011), *available at* http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf.

1. The Main Points

The Discussion Draft would make several major revisions to the current U.S. international tax system. The first change would be a reduction in the top statutory corporate tax rate from the current 35 percent to 25 percent.[57] The Discussion Draft would also mandate a one-time tax of 5.25 percent on currently unremitted earnings.[58]

The Discussion Draft's major departure from the current international tax system comes in the form the adoption of a 95 percent dividend received deduction for foreign-sourced dividends from controlled foreign corporations in which the U.S. shareholder owns at least 10 percent.[59] There is no foreign tax credit available for this dividend income, but, as will be discussed, foreign tax credits are available for income subject to the revised Subpart F rules. There is also no deduction for foreign taxes paid on dividends.[60] The 95 percent exemption is denied if the shareholder has held the stock of controlled foreign corporation for less than one year.[61] Foreign branches of U.S. corporations are also treated as controlled foreign corporations in that the branch's income is treated as a dividend paid to the parent corporation and is eligible for the 95 percent exemption.

The next major change is the elimination of earnings and profits and foreign tax credit pooling.[62] This elimination is made because foreign tax credits would only be available to offset U.S. tax on Subpart F income. This will likely be a well-received change as the calculation of these items for numerous subsidiaries can be incredibly time consuming and complicated. This provision is aimed at simplifying the current tax system.

The Discussion Draft also modifies the way foreign-source income is characterized. Under current law, foreign-source income and related tax credits are segregated into two statutory baskets: general category income and passive category income.[63] Under the Discussion Draft, the basketing rules would be eliminated and there would only

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[57] *Id.* at 3.
[58] *Id.* at 24.
[59] *Id.* at 9.
[60] *Id.*
[61] *Id.* at 16.
[62] *Id.* at 31–40.
[63] Internal Revenue Code § 904(d)(2).

be one category of foreign-source income, which would be subject to the Subpart F rules.[64]

2. Subpart F Options

The Discussion Draft proposes three alternatives for modifying the Subpart F regime.[65] As discussed, income deemed Subpart F income is income that is earned abroad, included currently in the corporation's taxable income, and subject to the statutory income tax rate (under the Discussion Draft that rate would be 25 percent).

Option A of the Discussion Draft would apply to excess income earned from the transfer of intangibles from the U.S. to a foreign controlled corporation, and the income generated from the intangible would be taxed at a rate below 10 percent. Income derived from the intangible that exceeds 150 percent of the costs associated with the intangible would be considered Subpart F income.[66] Under Option B of the Discussion Draft, income earned by a controlled foreign corporation would be considered Subpart F if it is neither derived from the active conduct of a trade or business in the controlled foreign corporations home country, nor if it is not taxed at an effective rate above 10 percent.[67]

Option C of the Discussion Draft would tax foreign intangible income at a reduced rate by providing a 40 percent deduction in the U.S.[68] Further, all income earned by controlled foreign corporations from exploitation of intangibles would be considered Subpart F income if it is not subject to a tax rate in excess of the United States' statutory rate (21 percent), regardless of where the intangibles are exploited.[69]

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[64] Camp Discussion Draft, *supra* note 57, at 36.
[65] *Id.* at 44–57.
[66] *Id.* at 44.
[67] *Id.* at 50.
[68] *Id.* at 53.
[69] *Id.* at 56.

VI. MOVING TO A TERRITORIAL SYSTEM – CAMP SUCCEEDS WHERE THE PRESIDENT FAILS

A. *Reducing the Corporate Income Tax Rate and Preference for Debt over Equity*

As discussed above, the Proposal would reduce the corporate income tax rate from 35 percent to 28 percent and the Discussion Draft would reduce it to 25 percent. This is a much-needed reduction as the United States' high corporate tax rate is an outlier among developed countries. The current high corporate tax rate reduces incentive for investment in the U.S. by both domestic and foreign corporations. The high corporate tax rate also discourages U.S. based MNCs from repatriating income that could be invested at home, in the United States.

Another benefit of reducing the corporate income tax rate is the reduction of corporations' preference for debt over equity financing. There is a natural bias towards debt financing because interest payments are deductible by corporations whereas dividends are not. A reduction in the corporate tax rate alone would reduce corporations' preference for debt because a lower rate reduces taxation of equity-financed investments and increases the after-tax cost of debt finance.[70]

The deductibility of interest payments gives rise to a basic tax arbitrage opportunity, whereby a corporation incurs debt domestically to fund operations, instead of repatriating foreign source income, and uses the resultant interest deductions to decrease the firm's U.S. tax liability. The President's proposal seeks to address this issue by limiting interest deductions until related income is repatriated.[71] This provision, along with the proposed mandatory minimum tax on income earned by foreign subsidiaries, seeks to force corporations to bring income back to the United States. This provision would force corporations to track income related to specific debt and add even more complexity to an already complex web of tax laws. As discussed below, there are other methods of taxation which may be more useful in incentivizing U.S. based MNCs to repatriate income without adding

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[70] *Corporate Tax Reform – The Time Is Now*, Business Round Table (hereinafter Bus. Round Table, *Corporate Tax Reform*), Apr. 15, 2013, at 24.

[71] *The President's Framework for Business Tax Reform*, *supra* note 11, at 15.

more layers of complexity to the United States' already flawed system. The Discussion Draft would accomplish this simplification by eliminating the need to track earning and profits pools as well as foreign tax credit pools.

B. *Scratch the Mandatory Minimum Tax and Move to a Territorial Based Tax System*

One of the arguments frequently put forth by corporations lobbying for the adoption of a territorial system in the United States revolves around maintaining competitiveness of U.S. MNCs abroad.[72] The argument is premised on the idea that U.S. MNCs are less competitive in foreign markets because they are taxed more heavily than the domestic competitors in the foreign market. Further, American firms are allegedly disadvantaged as compared to foreign MNCs because U.S. based MNCs are faced with a greater tax burden when they bring foreign earnings back to the United States whereas foreign firms face a lower tax burden upon repatriation to their home countries. While this may be true, it is important to point out that U.S. based MNCs have the ability to generate stateless income, and thereby "tax rents," while they defer this greater tax burden indefinitely through deferral.[73]

While a mandatory minimum tax on U.S. MNC's foreign subsidiaries may sound good in a political debate, the employment of such a tax is an unnecessarily burdensome method of achieving the Proposal's stated goals. The minimum tax on U.S. MNC's foreign subsidiaries seeks to reduce incentives U.S. MNCs have for leaving income offshore rather than repatriating the income. The minimum tax would purportedly diminish the incentives U.S. MNCs have to locate income in low or no-tax jurisdictions and instead encourage them to repatriate income on the premise that the increase in tax rate from the

[72] *See generally* Bus. Round Table, *Corporate Tax Reform*, *supra* note 70.

[73] Kleinbard, *supra* note 3, at 754. "Stateless income tax planning offers multinational firms, but not wholly domestic ones, the opportunity to convert high-tax country pre-tax marginal returns into low-tax country inframarginal returns, by redirecting pre-tax income from high-tax country to the low-tax one. By doing so multinational firms can be said to capture 'tax rents.' Their inframarginal returns stem not from some unique high-value asset, but rather from their unique status as structurally able to move pretax income across national borders."

minimum tax to the U.S. statutory rate would be minimal and thus more justifiable to shareholders and investors.

The proposed minimum tax seeks to encourage U.S. MNC's to repatriate deferred foreign income in order to invest here at home in the United States. While the Proposal touts the benefits of this repatriation and investment in the United States, the main goal of the mandatory minimum tax is clearly increasing corporate income tax revenues. While fiscal responsibility is important, it is this Note's position that both economic growth and fiscal responsibility will both benefit from moving to a territorial tax system.

Moving to a territorial tax system would allow U.S. MNCs to bring currently deferred and future income back into the United States with little tax consequence. An in-depth discussion and analysis of whether economic growth benefits more from government versus corporate spending and investment is beyond the scope of this Note. However, it significant that if U.S. MNCs repatriated just half of the $1.7 trillion currently maintained abroad, the funds available for investment in the United States would be approximately greater than the government spending and tax relief provided by the 2009 American Recovery and Reinvestment Act.[74]

C. *Harmonizing the United States' International Tax Policies and the International Systems of Corporate Income Taxation*

At the very least, the Obama Administration's proposal represents a starting point from which future discussions of reform can be had. The Proposal also represents an attempt to begin limiting multinational enterprises ability to strip income out of high-tax jurisdictions around the world. As evidenced by the current global debate about base erosion and profit shifting, the United States is not the only country facing this issue. As noted in the OECD's BEPS Report, international tax reform must be done at the domestic level – i.e. by each individual country.[75] As such, each country must begin developing its own methods capable of dealing with the issue.

While the Proposal may be a starting point for a larger discussion about international tax reform in the United States, it is not

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[74] Bus. Round Table, *Corporate Tax Reform*, *supra* note 70, at 34.
[75] BEPS Report, *supra* note 6, at 10.

the best proposal available. Representative David Camp has proposed a territorial system that is not only revenue neutral, but also in line with the reforms taking place internationally. Enacting Representative Camp's proposal would not only benefit U.S. based MNCs but also the United States' economy.

As other countries begin reforming their own tax codes, an effort must be made to come to a consensus about how tax havens are to be dealt with. Countries with extremely low corporate income tax rates, or none at all, must be included in the discussion so that they do not continue to offer MNCs the ability to avoid taxes elsewhere. Also, it is important to recognize that countries such as Ireland and the Netherlands must be dealt with as well due to their current systems, which encourage tax arbitrage, at the detriment of many countries within the EU and elsewhere.

It is the logical result of the current international tax system that capital flows from the high tax jurisdictions and into low tax ones. When considering how to reform the current system, it is important to think about how to structure the rules so as to maximize the efficient use of capital. While the United States is facing a fiscal crisis, increasing taxes and dampening the rate of economic growth is not an effective solution to the problem.

VII. CONCLUSION

As mentioned in the Arguments section, the Proposal is not an end point for United States international tax reform, but is in fact a starting point from which future debates can be had. The current system not only fails at collecting an adequate amount of revenue for the Treasury, but also distorts U.S. based MNC's investment decisions. While it is not guaranteed that altering the current system will immediately create new domestic investment, it will decrease the significant tax incentives U.S. based MNCs have to invest abroad and in turn foster more economically meaningful investment. The Obama Administration's proposals represent a step toward that goal, albeit a misguided one. While the Proposal does present lofty goals, it seeks to achieve those goals with overly broad reforms that will not simplify the currently opaque system, but instead add more layers of complexity. Where the President's framework for reform lacks details, Representative Camp's does not. Rep. Camp's proposal is more in line

with international norms and represents a comprehensive overhaul of the current tax system. As most will agree, our current system of international taxation is in desperate need of reform, and simply adding additional complex rules to an already intricate system is not going to be the solution.