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## Worse Than Exemption

J. Clifton Fleming Jr.

Robert J. Peroni

Stephen E. Shay

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# WORSE THAN EXEMPTION<sup>†</sup>

*J. Clifton Fleming, Jr.*<sup>\*</sup>

*Robert J. Peroni*<sup>\*\*</sup>

*Stephen E. Shay*<sup>\*\*\*</sup>

INTRODUCTION .....	80
I. THE DEFERRAL PRIVILEGE—THE BASIC BUILDING BLOCK .....	85
A. <i>The Existing Scope of the Deferral Privilege</i> .....	87
B. <i>The Incongruity of Elective Deferral</i> .....	93
C. <i>The Effect of the Deferral Privilege</i> .....	96
D. <i>Transfer Pricing Rules and the Anti-Deferral Regimes</i> .....	105
E. <i>Competitiveness I</i> .....	106
II. ENHANCING THE DEFERRAL PRIVILEGE: PART ONE—EXPLOITING DEFECTIVE COST ALLOCATION RULES .....	110

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Sections I.A and B of this Article contain substantial revisions of material that was drawn from Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999), which the authors have permission from the *SMU Law Review* to use in other publications. In addition, Sections IV.A and B of this Article contain substantial revisions of material that was drawn from J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 541–56 (2008), which Professors Fleming and Peroni have permission from the *Virginia Tax Review* to use in other publications.

<sup>\*</sup> Ernest L. Wilkinson Chair and Professor of Law, J. Reuben Clark Law School, Brigham Young University.

<sup>\*\*</sup> James A. Elkins Centennial Chair in Law and Professor of Law, The University of Texas School of Law; Visiting Professor of Law, Georgetown University Law Center (Fall 2009). Professor Peroni thanks Dean Lawrence Sager for his generous research support, Melissa Bernstein, his superb University of Texas law library liaison, for her research assistance, and Scott Pagel, Associate Dean for Information Services, Director of the Law Library, and Professor of Law at the George Washington University Law School, for permitting him to use the law library at George Washington University in connection with research for this Article. Professor Peroni dedicates this Article to his loving parents, Emil Peroni, his late father, and Betty Peroni, his mother, for their tremendous support and inspiration over the years.

<sup>\*\*\*</sup> Deputy Assistant Secretary for International Tax Affairs, U.S. Department of the Treasury. This Article was written before Mr. Shay's appointment to his current government position. None of the views expressed herein should be attributed to the U.S. Department of the Treasury.

A.	<i>The Allocation of Expenses to Foreign-Source Income for Purposes of the Foreign Tax Credit Limitation</i> .....	110
B.	<i>The Incongruous Benefit of Deducting Expenses Allocable to Deferred Foreign-Source Income</i> .....	116
C.	<i>Competitiveness II</i> .....	118
III.	ENHANCING THE DEFERRAL PRIVILEGE: PART TWO—AGGRESSIVE TRANSFER PRICING .....	119
A.	<i>The Magnified Challenge of the Arm’s-Length Standard with Respect to Intangible Property</i> .....	122
B.	<i>Information Asymmetry and the Limits on Enforcement of Any Transfer Pricing Regime</i> .....	125
C.	<i>Formulary Apportionment Is Not a Panacea</i> .....	128
D.	<i>The Deferral Privilege Is Enhanced by Aggressive Transfer Pricing</i> .....	131
IV.	OVERLY GENEROUS CROSS-CREDITING: ELIMINATING THE SHRUNKEN RESIDUAL TAX AND ACHIEVING A NEGATIVE TAX RATE .....	132
A.	<i>The Basic Effects of Cross-Crediting</i> .....	132
B.	<i>Export Sales Income That Is Effectively Tax-Exempt under the Current U.S. International Tax System</i> .....	137
C.	<i>Possible Zero U.S. Taxation of Foreign-Source Royalties under the Current U.S. International Tax System</i> .....	142
D.	<i>Other Types of Effectively Tax-Exempt, Foreign-Source Income under Current Law</i> .....	145
V.	DEDUCTING FOREIGN LOSSES AGAINST U.S.-SOURCE INCOME: CLEARLY A WORSE-THAN-EXEMPTION RESULT .....	145
	CONCLUSION .....	149

## INTRODUCTION

Customary international law recognizes that every country has the right to impose both source-based taxation on income earned within its borders by foreign persons<sup>1</sup> and residence-based taxation on the worldwide income of its

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<sup>1</sup> See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 411–12 (1986) [hereinafter RESTATEMENT (THIRD)]; REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 27 (2007) [hereinafter AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW]. For a normative justification of this rule, see Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: “What’s Source Got to Do with It?”*—

own residents.<sup>2</sup> Thus, so far as international law is concerned, the legitimacy of these taxing rights is fully accepted, and neither of these forms of taxation represents overreaching by governments. Nevertheless, unless ameliorative steps are taken, their full exercise may produce double taxation of international income. This is because, in the absence of mitigation, international income could be subject to source-based taxation in the country where it arises and to residence-based taxation in the country where the earner is a resident.<sup>3</sup> The resulting tax burden would be a material impediment to international commerce.

Customary international law solves this conundrum by requiring the residence country to provide relief.<sup>4</sup> The foreign tax credit system is one of the two commonly used unilateral approaches for discharging this obligation.<sup>5</sup> Under the foreign tax credit system, the residence country subtracts the source-country tax on a resident's foreign income from the residence-country tax on the resident's foreign income and collects a so-called residual tax to the extent that the residence-country tax exceeds the source-country tax. Where a resident's source-country tax exceeds the residence-country tax, however, the residence country does not refund the excess to the resident.<sup>6</sup>

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*Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 88–106 (2002) [hereinafter Shay, Fleming & Peroni, *Source Rules*]; ROY ROHATGI, BASIC INTERNATIONAL TAXATION 12 (2002).

<sup>2</sup> See RESTATEMENT (THIRD), *supra* note 1, at § 412(1)(a); AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW, *supra* note 1, at 22–27. For a normative justification of this rule, see J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; ROHATGI, *supra* note 1, at 12. For a discussion on the connection of source-based taxation and residence-based taxation to the international law concept of sovereignty, see Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155 (2008).

<sup>3</sup> See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS 33, 276–77 (3d ed. 2006).

<sup>4</sup> See RESTATEMENT (THIRD), *supra* note 1, at § 413, cmt. a; see also Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 265–66, 284 (2003) [hereinafter Brauner, *Crystallization*].

<sup>5</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 3, at 15; Brauner, *Crystallization*, *supra* note 4, at 284.

<sup>6</sup> See HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 362 (2d ed. 2004); Brauner, *Crystallization*, *supra* note 4, at 285; see also ORG. FOR ECONOMIC CO-OPERATION & DEV., OECD TAX POLICY STUDIES 17: TAX EFFECTS ON FOREIGN DIRECT INVESTMENT: RECENT EVIDENCE AND POLICY ANALYSIS 99 (2007) [hereinafter OECD, *Tax Effects*] (“[P]roviding an unlimited tax credit for foreign income and withholding tax would create incentives for capital importing countries to increase their host country tax burden, as this would increase host country revenues without affecting the combined host/home country tax burden on inbound FDI. Thus, foreign tax credit limitations are in order to avoid pure transfers of tax revenue from home to host countries. . . .”); DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 111 (2009) [hereinafter SHAVIRO, DECODING] (“[N]o country is that generous in determining the allowable use of foreign tax credits.”); Paul R. McDaniel, *Territorial vs Worldwide International Tax*

The exemption system is the other internationally accepted unilateral method for mitigating international double taxation.<sup>7</sup> Although the term “exemption” seems to imply that residence countries employing this approach will effectively impose a zero rate of tax on all foreign-source income earned by their residents, in practice, countries that use the exemption system approach usually confine the zero rate to foreign-source active business income of resident corporations; other resident taxpayers and other types of foreign-source income are covered by a worldwide taxation foreign tax credit system.<sup>8</sup>

Where the source-country tax is equal to or greater than the residence-country tax, the foreign tax credit system and the exemption system produce identical results, because the foreign tax credit completely eliminates the residence-country tax and treats the resident as if the foreign-source income were subject to a residence-country tax of zero.<sup>9</sup> A difference between the two

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*Systems: Which Is Better for the U.S.?*, 8 FLA. TAX REV. 283, 298 (2007) [hereinafter McDaniel, *Territorial vs Worldwide*] (“Neither the U.S. nor any other FTC [foreign tax credit] country will accept or has accepted” putting its revenues completely at the mercy of foreign countries’ tax rates by allowing an unlimited foreign tax credit); JANE G. GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., THE FOREIGN TAX CREDIT’S INTEREST ALLOCATION RULES 5 (2009) (“[T]he purpose of the foreign tax credit limit is not to ensure the efficient allocation of resources; rather, it is concerned with protecting the U.S. tax base.”), available at <http://openers.com/document/RL34494/2009-01-28>. Stated differently, allowing an unlimited foreign tax credit would amount to a residence-country tax subsidy of high-tax foreign source countries. See Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 978 (1997) [hereinafter Peroni, *Back to the Future*]; see also SHAVIRO, *DECODING*, *supra*, at 117; Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581, 583 (1990) [hereinafter Frisch, *International Tax Policy*]; Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL’Y 1, 56 (1991) [hereinafter Kingson, *Foreign Tax Credit*]. Moreover, the fundamental purpose of the foreign tax credit is to mitigate international double taxation, and this objective is accomplished if a foreign tax credit is allowed to the extent of the residence-country tax on the resident’s foreign-source income; any credit in excess of this amount goes beyond the double tax mitigation purpose of the foreign tax credit. See, e.g., AULT & ARNOLD, *supra*, at 362; Robert J. Peroni, *A Hitchhiker’s Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 392 (2003).

<sup>7</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 3, at 15; Brauner, *Crystallization*, *supra* note 4, at 284. The residence country’s allowance of a deduction for source-country tax is a third unilateral approach to solving the international double taxation problem, but it is only partially effective and rarely used. See GUSTAFSON, PERONI & PUGH, *supra* note 3, at 19–20.

<sup>8</sup> See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 186–87* (2005) [hereinafter STAFF OF JOINT COMM. ON TAX’N, *OPTIONS*]; AULT & ARNOLD, *supra* note 6, at 357–60; Brauner, *Crystallization*, *supra* note 4, at 286–87. The traditional approach to exemption of foreign income has been to require that foreign income be subject to tax in the source country in order to qualify for exemption treatment. AULT & ARNOLD, *supra* note 6, at 372–75. Since 2007, however, the exemption system in the Netherlands has allowed exemption for dividends from tax haven companies unless they hold more than 50% non-business assets.

<sup>9</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 3, at 19–20.

systems becomes apparent only when the source-country tax is less than the residence-country tax. In that situation, the foreign tax credit system will allow the residence country to collect a residual tax equal to the difference,<sup>10</sup> but this residual tax will be forgone with respect to a resident corporation's active foreign business income if the residence country uses an exemption system.<sup>11</sup>

Thus, the significant difference between a foreign tax credit system and an exemption, or territorial, system is the residence country's opportunity under the former, but not the latter, to collect a residual tax on active business income earned by resident corporations in low-tax foreign countries.<sup>12</sup> This difference would seem to make the exemption approach friendlier to resident corporations than the foreign tax credit system. Indeed, it is often alleged that the U.S. foreign tax credit system places U.S. multinational corporations at a comparative disadvantage when competing for business in low-tax foreign countries against corporate residents of exemption system countries.<sup>13</sup>

Consequently, it seems counterintuitive that U.S. multinational corporations have resisted replacing the U.S. foreign tax credit system with an exemption regime, which has a zero rate of tax on active foreign business income, and have preferred to retain the U.S. system with modifications that weaken some of its rigors.<sup>14</sup> The basis for this odd-seeming preference was

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<sup>10</sup> See *id.* at 280.

<sup>11</sup> See Joann M. Weiner, *Formulary Apportionment: The Way to Tax Profits in the EU*, 47 TAX NOTES INT'L 322, 325 (2007).

<sup>12</sup> See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES 2 (2006) [hereinafter STAFF OF JOINT COMM. ON TAX'N, INTERNATIONAL TAX REFORM]; see generally Weiner, *supra* note 11.

<sup>13</sup> See, e.g., R. Glenn Hubbard, *U.S. Tax Policy and Multinational Corporations: Incentives, Problems, and Directions for Reform*, in BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT, AND INVESTMENT 109 (James M. Poterba ed., 1997); Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, INT'L TAX J., Jan.–Feb. 2009, at 5, 28; Chuck O' Toole, *Obama Presents International Tax Reform Proposals*, 123 TAX NOTES 643, 645–46 (2009).

<sup>14</sup> See Nat'l Foreign Trade Council (NFTC), *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L, 687, 707 (2002) (article by one of the leading U.S. multinational corporate trade associations taking this view); JUDY SCARABELLO, NFTC, THE U.S. INTERNATIONAL TAX SYSTEM AND THE COMPETITIVENESS OF AMERICAN COMPANIES: THE NATIONAL FOREIGN TRADE COUNCIL COMMENTS TO THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, available at [http://govinfo.library.unt.edu/taxreformpanel/comments/\\_files/USInternationalTaxSystem.pdf](http://govinfo.library.unt.edu/taxreformpanel/comments/_files/USInternationalTaxSystem.pdf); see also Robert Goulder & Lee A. Sheppard, *ABA Tax Section Tackles Deferral*, 123 TAX NOTES 817, 817 (2009) (quoting statement by John Buckley, Chief Tax Counsel for the House Ways and Means Committee, that "no group of multinationals in this country has ever supported a territorial system here"); Lee A. Sheppard, *Defending the Obama International Proposals*, 123 TAX NOTES

clarified somewhat in the following statement by the Staff of the Joint Committee on Taxation in connection with its proposal for a U.S. exemption system: “In many cases, the present-law ‘worldwide’ system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the ‘territorial’ exemption systems used by many U.S. trading partners.”<sup>15</sup> Similarly, the American Bar Association Section of Taxation’s Task Force on International Tax Reform recently said that “the current U.S. international rules allow U.S. multinationals to achieve outcomes that are superior to exemption.”<sup>16</sup>

As we have explained in previous articles,<sup>17</sup> exemption systems are inefficient because they distort taxpayer decisions in bizarre ways, and they also are inequitable because they allow residents who earn foreign-source income to avoid the tax burden borne by their fellow residents who are primarily domestic-source income earners. Thus, we regard an exemption system as a poor public policy choice. To the extent that the current U.S. international income tax regime creates more favorable results for foreign income-earning U.S. residents than does a conventional exemption system, the U.S. regime is worse from a public policy standpoint. Thus, this Article, which details how the current U.S. international income tax system produces untoward results, is entitled “Worse Than Exemption,” and we often refer to the overly generous outcomes for foreign income-earning U.S. residents under the U.S. system as “worse-than-exemption” results.

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1391, 1393 (2009) (“American multinationals want all of the benefits of a European-style territorial system and none of the detriments.”).

<sup>15</sup> See STAFF OF JOINT COMM. ON TAX’N, OPTIONS, *supra* note 8, at 189. For a similar conclusion, see PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 104 (2005), available at <http://permanent.access.gpo.gov/lps64969/TaxReformwholedoc.pdf> [hereinafter PRESIDENT’S ADVISORY PANEL ON TAX REFORM].

<sup>16</sup> *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 689 (2006) [hereinafter *International Task Force Report*].

<sup>17</sup> See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Some Perspectives from the United States on the Worldwide Taxation vs. Territorial Taxation Debate*, 3 J. AUSTRALASIAN TAX TCHERS ASS’N 35 (2008), available at [http://www.atax.unsw.edu.au/atta/jatta/jattavol3no2/1\\_JATTA\\_vol3\\_no2.pdf](http://www.atax.unsw.edu.au/atta/jatta/jattavol3no2/1_JATTA_vol3_no2.pdf); J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005) [hereinafter Fleming & Peroni, *Exploring the Contours*]; Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 2; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]; see also Samuel C. Thompson, Jr., *Obama’s International Tax Proposal Is Too Timid*, 123 TAX NOTES 738 (2009).

In this Article, we explain how (1) the deferral privilege, (2) defective income-sourcing and cost-allocation rules, (3) generous and practically ineffective transfer-pricing rules, (4) largely unrestricted cross-crediting, and (5) the deduction of foreign losses against U.S.-source income combine to make the present U.S. international tax scheme worse than a conventional exemption system—at least with respect to active business income earned in low-tax foreign countries by U.S. resident corporations. Because of this, the efforts of U.S. corporations to preserve, but further weaken, the present U.S. approach in opposition to comprehensive international tax reform are not about achieving tax parity with corporate residents of exemption system countries. That goal has already been accomplished and, in certain circumstances, surpassed by the existing rules. Instead, the efforts of U.S. corporations are actually a campaign to preserve and strengthen the overly generous tax benefits enjoyed by U.S. corporations under the incoherent U.S. regime of current law. That regime gives U.S. corporations a net advantage, at significant cost to the public fisc, over their exemption country competitors. We begin our analysis with a consideration of the deferral privilege, one of the fundamental elements of the current U.S. system.

## I. THE DEFERRAL PRIVILEGE—THE BASIC BUILDING BLOCK

The deferral privilege is the anomalous aspect of U.S. international income tax law that generally allows a U.S. person to conduct profitable overseas business or investment activities through a low-taxed foreign corporation without paying U.S. residual tax until the foreign corporation actually distributes its foreign-source earnings or until the U.S. person sells the foreign corporation's stock.<sup>18</sup> By utilizing this privilege, U.S. shareholders can defer substantial amounts of U.S. residual tax and reinvest those amounts in offshore business operations while incurring only a low foreign tax cost.<sup>19</sup> Therefore, the

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<sup>18</sup> See, e.g., STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES OF ALTERNATIVE U.S. POLICIES FOR FOREIGN DIRECT INVESTMENT 3, 14 (2008) [hereinafter STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES]; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 21–22, 443–44; Thompson, *supra* note 17.

<sup>19</sup> If the foreign country uses income tax rates approaching, or greater than, U.S. rates, no significant U.S. residual tax usually remains after taking into account the foreign tax credit. See PAUL R. MCDANIEL, HUGH J. AULT & JAMES R. REPETTI, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 114 (5th ed. 2005). Deferral, however, also permits dividing high- and low-taxed foreign earnings between foreign corporations to minimize the tax on repatriation. It also permits delay in the repatriation of indirect foreign tax credits under Section 902 during periods that credits would not be allowed because of insufficient



deferral privilege operates as a tax “subsidy” that rewards U.S. persons who locate corporate operations in low-tax foreign countries.<sup>20</sup> This subsidy frustrates the tax policy goal of locational neutrality by providing a major incentive for U.S. persons to conduct business operations in and to shift income to foreign countries that impose little or no tax on the earnings of a resident corporation.<sup>21</sup>

In an effort to constrain the most egregious aspects of the deferral privilege, Congress has enacted a porous set of “anti-deferral” regimes, which, as explained below, curtail deferral in certain circumstances but leave the privilege substantially intact.<sup>22</sup> On balance, these provisions add tremendous

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foreign tax credit limitation—for example, as a result of large domestic losses—and thereby permits avoidance of the limitations on foreign tax credit carryovers.

<sup>20</sup> See *infra* text accompanying notes 68–83; J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 528–41, 547–51 (2008) [hereinafter Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*].

<sup>21</sup> This deferral subsidy also violates the closely related tax policy principle of capital export neutrality. Under capital export neutrality, a U.S. person should pay the same total (U.S. and foreign) tax on all income, regardless of whether the income is from U.S. or foreign sources. Thus, capital export neutrality is aimed at reducing the influence of tax considerations on the decision whether to locate investments in the United States or in a foreign country. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 3, at 17–18; see also David P. Hariton, *Notice 98-11 Notwithstanding, What Should Be Done with Subpart F?*, 79 TAX NOTES 388 (1998). For an argument using a theory of capital ownership neutrality to attack the capital export neutrality model, see Mihir A. Desai, *New Foundations for Taxing Multinational Corporations*, 82 TAXES 39 (Mar. 2004); 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). For a critique of the capital ownership neutrality theory, see Fleming & Peroni, *Exploring the Contours*, *supra* note 17, at 1572–76. For a more favorable review of the capital ownership neutrality theory, see SHAVIRO, *DECODING*, *supra* note 6, at 125–27.

The deferral subsidy also effectively provides an incentive for less-developed countries to attract foreign business investment through low tax rates, instead of through an educated and healthy work force or a legal regime based on the rule of law, reliable enforcement of contract and property rights, and the absence of corruption. See generally Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000). Thus, elimination of the deferral feature from the U.S. international income tax regime would be a major contribution towards ending this distortion of the behavior of less developed countries. See Reuven S. Avi-Yonah, *Obama's International Tax Plan a Major Step Forward*, 123 TAX NOTES 735 (2009). In this Article, however, we focus on the impact of deferral on the U.S. international income tax regime.

<sup>22</sup> The deferral privilege has been the subject of extensive analysis and a spirited academic debate. See, e.g., JOINT COMM. ON TAX'N, *ALTERNATIVE POLICIES*, *supra* note 18; U.S. TREASURY DEP'T, *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY* (2000) [hereinafter U.S. TREAS. DEP'T, *DEFERRAL STUDY*], available at <http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf>; SHAVIRO, *DECODING*, *supra* note 6, at 104–06, 114–15, 136–38; *International Task Force Report*, *supra* note 16; Reuven S. Avi-Yonah, *Comment on Peroni, Fleming and Shay*, “Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income”, 52 SMU L. REV. 531 (1999); Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219 (1997); Asim Bhansali, Note, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401 (1996); Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 528–41; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837 (2000) [hereinafter Fleming, Peroni & Shay, *Consider*

complexity to the Internal Revenue Code without remedying the inequities and distortions caused by the deferral privilege.

### A. *The Existing Scope of the Deferral Privilege*

To appreciate the scope and significance of the deferral privilege, it is helpful to begin by noting that U.S. income tax (net of the credit for foreign income tax)<sup>23</sup> is generally paid on a current, undeferred basis with respect to income realized from:

- (1) U.S. business or investment activities carried on by an individual, corporation, limited liability company (LLC),<sup>24</sup> or partnership;<sup>25</sup>
- (2) foreign business or investment activities carried on by a foreign branch of a U.S. corporation;<sup>26</sup> and
- (3) foreign business or investment activities carried on by a U.S. individual or by an LLC or partnership to the extent that the LLC's or partnership's foreign-source income is allocable to U.S. members or partners.<sup>27</sup>

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*Ending It*]; Frisch, *International Tax Policy*, *supra* note 6; Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062 (1988); Yoshihiro Masui, *Comment: A Japanese View*, 52 SMUL REV. 541 (1999); John McDonald, *Comment, Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 NW. J. INT'L L. & BUS. 248 (1995); Peter Merrill & Carol Dunahoo, *'Runaway Plant' Legislation: Rhetoric and Reality*, 72 TAX NOTES 221 (1996); Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Billions*, 58 TAX NOTES 765 (1993); Peroni, *Back to the Future, supra* note 6, at 986–94; Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609 (2001) [hereinafter Peroni, *End It, Don't Mend It*]; Robert J. Peroni, *The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1579 (2001) [hereinafter Peroni, *The Proper Approach*]; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17; H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525 (2001); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996) [hereinafter Shay, *Revisiting*].

<sup>23</sup> I.R.C. § 901(a) (2009).

<sup>24</sup> In this context, we are assuming that the limited liability company (LLC) is not classified as a corporation and is taxed on a passthrough basis for U.S. tax purposes.

<sup>25</sup> See I.R.C. §§ 1, 11, 61(a)(2), 61(a)(13), 702, 864(b), 864(c), 871 (b), 875(1), 882. In this context, we are assuming that the partnership is not classified as a corporation and is taxed on a passthrough basis for U.S. tax purposes.

<sup>26</sup> See I.R.C. §§ 11, 61(a)(2). For U.S. income tax purposes, a foreign branch is treated as lacking a legal personality separate from its corporate owner. See, e.g., SHAVIRO, *DECODING*, *supra* note 6, at 104. See generally Treas. Reg. § 301.7701-2(a) (as amended in 2008).

<sup>27</sup> See I.R.C. §§ 1, 11, 61(a) (2), 61(a) (13), 702. In this context, we are again assuming that the LLC or partnership is not classified as a corporation and is taxed on a passthrough basis for U.S. tax purposes.

Foreign-source income earned through a foreign corporation is treated very differently, however, as a result of two interacting features of U.S. income tax law. First, the United States does not impose income tax on foreign corporations except to the extent that their income is effectively connected with the conduct of a trade or business within the United States or consists of certain U.S.-source non-business (primarily investment-type) income.<sup>28</sup> Consequently, foreign corporations are not U.S. taxpayers with respect to their foreign operations, even when their stock is primarily or entirely owned by U.S. residents.<sup>29</sup>

Second, the doctrine of *Moline Properties, Inc. v. Commissioner*<sup>30</sup> usually regards a foreign corporation as a foreign taxpayer that is legally distinct from its shareholders, whether or not the corporation is controlled by U.S. persons.<sup>31</sup> This principle applies to any entity (including an LLC) classified as a foreign corporation for U.S. tax law purposes, whether under the current “check-the-box” entity classification regulations<sup>32</sup> or under the prior “corporate resemblance” entity classification regulations.<sup>33</sup>

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<sup>28</sup> See I.R.C. § 882(b) (limiting gross income of a foreign corporation to U.S.-source non-business income and income effectively connected with the conduct of a U.S. trade or business).

<sup>29</sup> See Treas. Reg. § 1.882-3(a)(1) (1973). A foreign corporation cannot be an S corporation taxed under the Subchapter S passthrough regime. See I.R.C. §§ 1361(a)(1), 1361(b)(1).

<sup>30</sup> 319 U.S. 436, 438–39 (1943) (holding that a corporation is recognized as a separate taxable entity for U.S. tax purposes if it is formed for a business purpose or conducts any business activity).

<sup>31</sup> See Treas. Reg. §§ 1.11-1(a) (as amended in 1976), 1.881-1 (as amended in 2005); 1 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 1:12 (4th ed. 2008); Joseph Wear & M. L. McMorris, *Tax System and Allocation Methods in the United States of America*, in TAXATION OF FOREIGN AND NATIONAL ENTERPRISES 199, 202, 263 (League of Nations 1932). Because of the role of *Moline Properties* in establishing the deferral privilege in the United States, we agree with Professor Daniel Shaviro that the origin of deferral of U.S. income tax on foreign subsidiaries’ foreign-source income was “purely formal or legalistic.” SHAVIRO, DECODING, *supra* note 6, at 104. It is certainly a thin reed upon which to base a questionable feature of the U.S. international tax regime that has far-reaching implications.

<sup>32</sup> See Treas. Reg. §§ 301.7701-1–301.7701-3 (as originally adopted in T.D. 8697, 1997-1 C.B. 215). For discussions of these entity classification regulations, see 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02[3] (7th ed. 2006); ROBERT J. PERONI, STEVEN A. BANK & GLENN E. COVEN, CASES AND MATERIALS ON TAXATION OF BUSINESS ENTERPRISES 40–48, 817–21 (3d ed. 2006).

<sup>33</sup> See T.D. 6503, 1960-2 C.B. 409; T.D. 7515, 1977-2 C.B. 482; *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The low level of activities required to satisfy the *Moline Properties* standard is illustrated by *Bass v. Commissioner*, 50 T.C. 595 (1968). In *Bass*, a Swiss corporation organized to hold undivided working interests in oil-producing properties satisfied the *Moline Properties* standard where it (1) purchased and held property (i.e., the interests in oil-producing land), (2) paid expenses relating to the property, (3) signed contracts relating to the management of the property, (4) collected distributions from the properties and deposited them in a bank account, (5) invested excess funds in securities, and (6) filed appropriate tax returns and information reports. *Id.* at 600–01; see also *Hosp. Corp. of Am. v. Comm’r*, 81 T.C. 520 (1983), *nonacq.*, 1987-2 C.B. 1 (finding that a Cayman Islands corporation organized to negotiate and perform a foreign hospital management contract

The preceding rules interact so that U.S. tax on foreign-source business and investment income earned by a U.S. person through a foreign corporation, even a U.S.-taxpayer-controlled foreign corporation,<sup>34</sup> is generally deferred until (1) the income is repatriated to the United States through corporate distributions or (2) the corporation's stock is sold.<sup>35</sup> Deferral may also be curtailed prior to distribution or sale of the corporation's stock if one of the Code's various anti-deferral regimes applies.

In practice, however, the Code's anti-deferral regimes often constitute a weak and idiosyncratic barrier to deferral, particularly in the case of active foreign business income. The most comprehensive of these regimes is the controlled foreign corporation (CFC) provisions, also referred to as Subpart F.<sup>36</sup> When these provisions apply, they impose current U.S. tax on four categories of CFC income, including both active and passive items, which are collectively defined as Subpart F income.<sup>37</sup> The tax is implemented by treating U.S. persons who own at least ten percent of the voting power of a CFC's stock,<sup>38</sup> actually or by reason of certain indirect and constructive ownership rules,<sup>39</sup> as if each had received a dividend of their pro rata shares of the CFC's Subpart F income for the year.<sup>40</sup> In addition, these same persons are treated as receiving dividends equal to their pro rata shares of the CFC's earnings and profits that have not been previously or currently taxed to them as Subpart F income and that are

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was not a sham when it carried out business activities such as taking in payments on the contract, entering into contracts with other entities, making payments to consultants, and observing corporate formalities).

<sup>34</sup> In this Article, we often refer to such an entity as a "controlled foreign corporation" or a "CFC."

<sup>35</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 3, at 21–22, 443–44. In addition, Section 956 of the Code treats a CFC's investment of its earnings in certain U.S. assets as another triggering event for ending deferral under the Subpart F provisions.

<sup>36</sup> I.R.C. §§ 951–64, 1248 (2009). For detailed discussions of the Subpart F provisions, see 2 BITTKER & EUSTICE, *supra* note 32, at ¶¶ 15.60–15.64; 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ch. 69 (rev. 3d ed. 2005); 3 ISENBERGH, *supra* note 31, at chs. 70–75; 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ch. B3 (2005). For a spirited defense of the Subpart F provisions as a reasonable compromise regarding the deferral problem, see Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F*, 79 TEX. L. REV. 1525 (2001). For a critique of this defense, see Peroni, *End It, Don't Mend It*, *supra* note 22.

<sup>37</sup> I.R.C. §§ 951(a)(1)(A)(i), 952. As a practical matter, Subpart F income is usually foreign-source income, *see* I.R.C. § 952(b), but it is theoretically possible for U.S.-source passive income that has been subjected to U.S. withholding tax to nevertheless be included in Subpart F income, *see* I.R.C. §§ 952(b), 954(c)(1)(A); Treas. Reg. § 1.952-1(b)(2) (as amended in 2002).

<sup>38</sup> I.R.C. § 951(a)(1), (b).

<sup>39</sup> I.R.C. §§ 951(b), 958, 318.

<sup>40</sup> I.R.C. § 951(a)(1)(A)(i), (a)(2). For convenience, this Article refers to income inclusions under Section 951 as dividends, even though they are not technically dividends under the Code. These inclusions are, however, subject to earnings and profits limitations, carry indirect foreign tax credits, and are similar in most respects to dividends.

invested in certain U.S. assets during the year.<sup>41</sup> Section 960 further provides to the U.S. persons who are charged with receipt of either of these constructive dividends an indirect credit for foreign income tax liabilities allocable thereto, if the U.S. persons actually own at least ten percent of the CFC's voting stock and if the U.S. persons are either domestic corporations or individuals who have elected under Section 962 to be taxed as domestic corporations.<sup>42</sup>

The CFC regime does not apply to all foreign corporations in which U.S. persons have an ownership interest. A foreign corporation comes within this regime only if more than fifty percent of the voting power or value of its shares<sup>43</sup> is owned by U.S. persons who each own at least ten percent of the voting power of the corporation's stock.<sup>44</sup> Moreover, constructive dividends of Subpart F income and amounts invested in U.S. assets are imputed only to those U.S. shareholders who own, actually or under certain statutory indirect and constructive ownership rules, at least ten percent of the CFC's stock voting power.<sup>45</sup> This means that the CFC provisions are avoidable if U.S. persons keep their aggregate ownership of a CFC's stock from exceeding fifty percent of the voting power or value of the outstanding shares or if each U.S. person's stock ownership is kept below the ten percent of voting power threshold.<sup>46</sup>

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<sup>41</sup> I.R.C. §§ 951(a)(1)(B), 956, 959; Treas. Reg. § 1.959-1(c) (as amended in 1983); *see, e.g.*, Melvin S. Adess, Barbara M. Angus & Keith E. Villmow, *The Erosion of Deferral: Subpart F After the 1993 Act*, 47 TAX LAW. 933, 954 (1994).

<sup>42</sup> I.R.C. §§ 960(a)(1), 962(a); *see also* I.R.C. § 902 (providing an indirect credit in the case of an actual dividend from a foreign corporation, including a CFC, to a U.S. corporation that actually owns at least ten percent of its voting power). When the income is reported by a qualifying ten-percent-or-more U.S. shareholder as an actual dividend, an inclusion under one of the anti-deferral regimes, or a deemed dividend under Section 1248 on the sale of a CFC's stock, the U.S. shareholder will obtain an indirect foreign tax credit (subject to the foreign tax credit limitations in Section 904) for a proportionate amount of the creditable foreign taxes paid or accrued by the foreign corporation (which are "deemed paid" by the U.S. shareholder at the time of the actual dividend, income inclusion, or deemed dividend income). In addition, the amount of the U.S. shareholder's income inclusion or deemed dividend will be "grossed up" (that is, increased) by the amount of the foreign corporation's foreign taxes deemed paid by the U.S. shareholder under Section 902 or 960. I.R.C. § 78. The U.S. shareholder will also receive a direct credit for any creditable foreign tax withheld from an actual dividend, also subject to the foreign tax credit limitations. I.R.C. §§ 901, 904.

<sup>43</sup> I.R.C. § 957(a). The Code lowers the stock ownership threshold for attaining CFC status from fifty percent to twenty-five percent for certain foreign insurance companies. I.R.C. §§ 953(c), 957(b).

<sup>44</sup> I.R.C. §§ 951(b), 957(a). The indirect stock ownership rules in Section 958(a) and the constructive stock ownership rules in Section 958(b) apply for this purpose.

<sup>45</sup> I.R.C. § 951(a)(1).

<sup>46</sup> Although a domestic partnership is treated as a U.S. person for purposes of the Subpart F rules, a foreign partnership is not. I.R.C. §§ 957(c), 7701(a)(30). This has led to the development of foreign partnership structures for use by U.S. private equity firms making international investments. *See* Arturo

Furthermore, the Code's definition of Subpart F income excludes manufacturing income.<sup>47</sup> Thus, a CFC is effectively outside the Subpart F constructive dividend provisions to the extent that its income is earned through selling goods of its own manufacture. By carefully observing the stock ownership rules described above<sup>48</sup> or by ensuring that a CFC has only manufacturing income and that it abstains from investments in U.S. assets, U.S. shareholders of a CFC can, and do, readily avoid current U.S. tax on the CFC's income.<sup>49</sup> Current U.S. taxation under the CFC provisions also can be avoided in many cases involving a CFC's resale of purchased property or performance of services.<sup>50</sup>

Section 1248 is a provision that is closely related to the Code's CFC provisions. As a general matter, Section 1248 uses a complex set of rules to characterize gain recognized on the disposition of CFC stock as dividend income.<sup>51</sup> Nevertheless, it is largely ineffectual as an anti-deferral device because it does not affect deferral's time-value-of-money benefit, illustrated below.<sup>52</sup>

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Requenez II & Timothy S. Shuman, *U.S. Private Equity Funds Making Cross-Border Investments—Primary Tax Considerations*, 106 J. TAX'N 349 (2007).

<sup>47</sup> Treas. Reg. § 1.954-3(a)(4) (as amended in 2008); *Treasury's Daniel Berman Reflects on Past and Future International Tax Law*, 76 TAX NOTES 1387 (1997); N.Y. State Bar Ass'n Tax Section, *Notice 98-11: Tax Treatment of Hybrid Entities*, 79 TAX NOTES 877 (1998); David R. Tillinghast, Letter to the Editor, *An Old-Timer's Comment on Subpart F*, 78 TAX NOTES 1739 (1998). Under the current amended regulations, the scope of activity treated as "manufacturing" by a CFC for the purposes of Subpart F is expanded if a CFC satisfies a loosely drawn substantial contribution test in relation to contract manufacturing by another person. See Treas. Reg. § 1.954-3(a)(4) (as amended in 2008).

<sup>48</sup> To be successful, this planning maneuver must navigate carefully both the indirect stock ownership rules in Section 958(a) and the constructive stock ownership rules in Section 958(b).

<sup>49</sup> See 3 ISENBERGH, *supra* note 31, at ¶ 74:28; Adess, Angus & Villmow, *supra* note 41, at 935; Mike Cooper, Gary Melcher & Clint Stretch, *Suddenly Saving Foreign Taxes Is Abusive? An Untenable Proposal*, 79 TAX NOTES 885 (1998); see also Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1326–28 (1996) [hereinafter Avi-Yonah, *Proposal for Simplification*].

<sup>50</sup> See I.R.C. §§ 954(d)–(e); Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 503–05; Stephen E. Shay, *Exploring Alternatives to Subpart F*, 82 TAXES 29, 31–33 (Mar. 2004).

<sup>51</sup> See 2 BITTKER & EUSTICE, *supra* note 32, at ¶ 15.63; 3 BITTKER & LOKKEN, *supra* note 36, at ¶ 69.14; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 549–51; 3 ISENBERGH, *supra* note 31, at ch. 77; 2 KUNTZ & PERONI, *supra* note 36, at ¶ B6.03[6].

<sup>52</sup> See *infra* text accompanying notes 69–83. Moreover, Section 1248's "deemed dividend" treatment of all or a part of a U.S. shareholder's gain from the disposition of a CFC's stock is actually beneficial when the shareholder is a U.S. corporation that owns at least ten percent of the CFC's voting stock. It is beneficial because the deemed dividend treatment will carry an indirect foreign tax credit under Section 902 for a proportionate amount of the CFC's foreign taxes "deemed paid" by the U.S. corporate shareholder with respect to the deemed dividend. In addition, realization of dividend income under Section 1248 on the sale or liquidation of a CFC's stock often has the advantage of avoiding foreign withholding tax imposed on actual

Finally, the most recent addition to the panoply of anti-deferral regimes is the passive foreign investment company (PFIC) provisions.<sup>53</sup> Generally speaking, this regime attacks the deferral privilege through a complicated offsetting interest charge mechanism that is applied at the shareholder level.<sup>54</sup> The coverage of the PFIC provisions is quite broad in two important respects: (1) they apply to any U.S. person who owns stock in a foreign corporation satisfying the definition of a PFIC, no matter how small that shareholder's ownership interest in the corporation, and (2) unlike the Subpart F provisions, the definition of a PFIC does not depend on any degree of concentrated ownership by U.S. persons of stock in the corporation. The PFIC regime, however, does not apply to foreign corporations predominantly engaged in active business operations because it applies only if (1) a corporation's annual gross income is at least seventy-five percent passive or (2) at least fifty percent of the average value (or, in specified circumstances, the adjusted basis) of the corporation's assets held during the year produced passive income or were held for the production of passive income.<sup>55</sup> Thus, the PFIC regime does little or nothing to remedy the problem of deferral of U.S. tax on a U.S. person's share of the active business profits earned through a foreign corporation operating in a low-tax foreign country.

Moreover, the PFIC regime's role in preventing abuse of the deferral privilege was further weakened by a 1997 amendment to the Code. That amendment

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dividends because gain on a sale of stock or liquidation of a corporation often is exempt from such a withholding tax. Thus, a corporate shareholder that disposes of CFC stock often prefers dividend treatment under Section 1248 to sale treatment, particularly in the light of the fact that there is no general capital gain preference for corporate taxpayers under current law, *see* GUSTAFSON, PERONI & PUGH, *supra* note 3, at 549–50, and that such gains will usually be treated as U.S.-source income for foreign tax credit purposes, *see* I.R.C. § 865(a). *But see* I.R.C. § 865(f), (h).

<sup>53</sup> I.R.C. §§ 1291–1298. The PFIC regime, in its original form, was added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1235(a), 100 Stat. 2085, 2566–74 (1986). For detailed discussions of the PFIC provisions, *see* 2 BITTKER & EUSTICE, *supra* note 32, at ¶ 15.44; 3 BITTKER & LOKKEN, *supra* note 36, at ¶ 70.1; 3 ISENBERGH, *supra* note 31, at ch. 80; 1 KUNTZ & PERONI, *supra* note 36, at ¶ B2.08.

<sup>54</sup> I.R.C. § 1291(a); *see also* GUSTAFSON, PERONI & PUGH, *supra* note 3, at 560–62. Elective alternatives also exist in the form of a passthrough regime for a qualified electing fund (QEF), *see* I.R.C. § 1293, and a mark-to-market regime, *see* I.R.C. § 1296. To make the QEF election, the fund must supply certain information. Often, non-U.S. managed funds are reluctant to provide the fund-level information necessary to make a QEF election. Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 463 n.48. Nevertheless, these funds will do so if they are being marketed to U.S. individual investors who are eligible for a preferential tax rate on capital gains and want the capital gain passthrough treatment accorded the QEF's long-term capital gains. *Id.* Obtaining entity-level information is a potential problem whenever an anti-deferral regime requires current inclusion by a U.S. shareholder of the income of a non-U.S.-controlled foreign corporation and is exacerbated when the shareholder owns only a small interest in the corporation. *Id.*

<sup>55</sup> I.R.C. § 1297(a).

provided that a foreign corporation otherwise qualifying as both a CFC and a PFIC would not be treated as a PFIC with respect to any Section 951(b) “United States shareholder,” thus eliminating the overlap between the CFC and PFIC regimes.<sup>56</sup> This was a critical development because after the 1996 repeal of the excess passive asset rules of former Section 956A, the PFIC fifty percent passive asset test was the only aggregate limitation on a CFC’s ability to engage in two U.S. tax-deferred offshore accumulation strategies. The first strategy applies where none of the CFC’s U.S. resident shareholders are covered by Subpart F because they all fall below the ten percent ownership requirement. In this case, the CFC can accumulate its earnings for the economic benefit of its shareholders simply by investing and reinvesting its earnings in passive foreign assets. Where the CFC has shareholders to whom Subpart F does apply, the second strategy becomes relevant. It involves the CFC investing its earnings in foreign property, such as land and non-dividend-paying stock, that does not produce current Subpart F income. Thus, the 1997 elimination of the CFC/PFIC overlap allowed CFCs to employ these accumulation strategies to defer indefinitely U.S. tax on unlimited amounts of low-taxed foreign-source earnings.<sup>57</sup> This legislative change significantly reduced the effectiveness of the PFIC regime as an anti-deferral device and represented a major step backward in anti-deferral reform.

As demonstrated by the preceding discussion, the Internal Revenue Code’s anti-deferral provisions do not reach substantial amounts of low-taxed foreign-source earnings, for example, when the foreign corporation has substantial active business income or its U.S. ownership is below applicable thresholds. In short, the anti-deferral regimes are more like a set of sieves than barriers to deferral.<sup>58</sup>

### *B. The Incongruity of Elective Deferral*

The generous availability of deferral has been characterized as representing a balance between (1) a concern for the ability of U.S. businesses to compete in

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<sup>56</sup> I.R.C. § 1297(e) (added by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1175, 111 Stat. 788, 990–93 (1997)).

<sup>57</sup> See Charles I. Kingson, *The Great American Jobs Act Capers*, 58 TAX L. REV. 327, 382–84 (2005).

<sup>58</sup> See Michael C. Durst, *The President’s International Tax Proposals in Historical and Economic Perspective*, 54 TAX NOTES INT’L 747, 751 (2009) [hereinafter Durst, *President’s Proposals*] (characterizing the U.S. anti-deferral rules as “porous”). See generally STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1021–22 (1987); GUSTAFSON, PERONI & PUGH, *supra* note 3, at 446–49; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 478–92.



foreign markets and (2) protection of the U.S. tax base and, perhaps, the goal of promoting worldwide economic well-being through the principle of capital export neutrality. To be specific, the general availability of deferral for CFC income reduces the effective rate of U.S. tax on foreign-source income. This outcome is said to make U.S. controlled businesses more competitive in low-tax foreign jurisdictions vis-à-vis both indigenous businesses and foreign-controlled corporations whose home countries either impose no home country tax on income earned outside their borders or permit deferral of home country tax until the income is repatriated from the low-tax jurisdiction.<sup>59</sup> However, in the limited circumstances where Subpart F or the PFIC regime strips away the deferral privilege, unprivileged foreign-source income is subject to current U.S. tax as if it had been earned in the United States. Therefore, U.S. taxation becomes a neutral factor in the decision of a U.S. taxpayer to locate the unprivileged income-generating operations in either the United States or abroad—a result that effectuates the principle of capital export neutrality as well as protecting residence-based taxation. Thus, as noted above, the present U.S. regime of elective deferral, tempered by anti-deferral limitations, is often characterized as balancing international competitiveness objectives against a concern for capital export neutrality.<sup>60</sup>

Arguably, however, the Internal Revenue Code's overall structure strikes a larger and different balance regarding the taxation of foreign-source income earned by U.S. persons, and the general rule of CFC income deferral represents a dramatic departure from this larger balance. To be specific, since 1913, the Code has provided that all domestic taxpayers—U.S. citizens, resident aliens, and domestic corporations—are currently taxable on their worldwide income, including their foreign-source earnings. The 1913 language expressed this point by imposing the tax on “gains or profits and income derived

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<sup>59</sup> See NAT'L FOREIGN TRADE COUNCIL, INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 12, 127 (2001) [hereinafter NFTC, INTERNATIONAL TAX POLICY]. There is, however, no strong empirical evidence that U.S. multinational businesses generally require this tax system assistance to be competitive in foreign markets. See *infra* Section I.E.

<sup>60</sup> See NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 56, 59, 93, 126. This balance characterization appears in the legislative history of Subpart F, see, e.g., H.R. REP. NO. 87-1447, at 57-58 (1962), and has been repeated, expressly or by implication, in various Treasury documents, see, e.g., U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 22, at 22; U.S. TREASURY DEP'T, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 7-8 (1993) [hereinafter U.S. TREAS. DEP'T, INTERIM REP.]; 1 U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 142 (1984) [hereinafter U.S. TREAS. DEP'T, TAX REFORM], available at <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/tres84v1All.pdf>.

from *any source whatever*.”<sup>61</sup> The present statutory language is “all income from whatever source derived.”<sup>62</sup>

Of course the countries in which foreign-source income is earned assert a right to impose their own levies. This means that the U.S. tax on foreign-source income of U.S. persons is effectively a second layer of taxation that would, in the absence of mitigation, cause foreign-source income to be much more heavily burdened than domestic-source income. The United States responded to this problem in 1918 by adopting a foreign tax credit, which allows a U.S. person to take a credit against her U.S. income tax liability for qualifying foreign taxes. But if this credit had been allowed without limitation in the full amount of a U.S. resident’s foreign tax liability, the U.S. person who earned income in a country with income tax rates greater than U.S. rates could have used the excess of her foreign tax payments over the U.S. tax on her foreign-source income to offset U.S. tax on her domestic-source income. If this were permitted, foreign countries could adopt very high rates of tax and feel secure in the knowledge that the excess tax on U.S. persons would actually be funded out of the U.S. Treasury in the form of forgone U.S. tax on U.S.-source income. To prevent this result, the credit was limited to the U.S. tax on a domestic taxpayer’s foreign-source income<sup>63</sup> and this limitation, with many additional layers of complexity, persists today.<sup>64</sup>

This U.S. tax structure—consisting of a current levy on domestic taxpayers’ income “from whatever source derived” but mitigated by a foreign tax credit limited to the U.S. tax on foreign-source income—balances multiple competing factors. First, it balances the claim of the United States to a current tax on foreign-source income of its residents against the legitimate taxing claims of source countries with respect to that income; but, in turn, this structure also balances the source-country taxing claims against the legitimate U.S. interest in

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<sup>61</sup> Act of October 3, 1913, ch. 16, § II.B., 38 Stat. 114, 167 (1913) (emphasis added).

<sup>62</sup> I.R.C. § 61(a) (2009).

<sup>63</sup> U.S. TREASURY DEP’T, BACKGROUND PAPER: TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 45 (2007) [hereinafter U.S. TREAS. DEP’T, BACKGROUND PAPER], available at <http://www.treas.gov/press/releases/reports/07230%20r.pdf>; STAFF OF JOINT COMM. ON TAX’N, INTERNATIONAL TAX REFORM, *supra* note 12, at 13.

<sup>64</sup> See I.R.C. § 904. To be completely consistent with the principle of capital export neutrality, the United States would have to repeal its foreign tax credit limit and make the foreign tax credit completely refundable. See STAFF OF JOINT COMM. ON TAX’N, INTERNATIONAL TAX REFORM, *supra* note 12, at 65. However, the United States has determined that weightier considerations trump capital export neutrality and require the imposition of the present foreign tax credit limitation. See *supra* note 6, text accompanying notes 63–64.

preventing foreign governments from raiding the U.S. Treasury to finance their operations and programs. The general framework that emerges from this balance is that foreign-source income of U.S. persons is subject to current U.S. tax except to the extent that a creditable foreign tax offsets the U.S. tax. When the U.S. tax structure is understood in these terms, the elective deferral of U.S. residual tax on the foreign-source income of a CFC stands out as an incongruity.

Of course, deferral proponents will return to the earlier discussion of how deferral derives from the combination of (1) U.S. non-taxation of a foreign corporation's foreign-source income and (2) the separate legal personalities of a foreign corporation and its U.S. shareholders.<sup>65</sup> They will argue that these features of the U.S. income tax regime establish that deferral is the norm.<sup>66</sup>

As previously explained, however, the Code's larger pattern requires U.S. business owners and investors to pay current U.S. tax on their realized income "from whatever source derived," except when U.S. residents earn foreign-source income through a foreign C corporation. Thus, this exception is a clear departure from the general tax treatment of U.S. business owners and investors. Stated differently, current U.S. taxation of business income is the norm and deferral is an anomaly.<sup>67</sup>

### *C. The Effect of the Deferral Privilege*

The anomalous deferral of U.S. tax on foreign-source income of a U.S.-controlled foreign corporation provides a well-known incentive for U.S. persons to carry on business in low-tax countries through a CFC and then to

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<sup>65</sup> See *supra* text accompanying notes 28–33.

<sup>66</sup> See NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 3 n.3; see also STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 10 (2008) (characterizing present U.S. law as "ambiguous" with respect to what the general rule is for taxing foreign-source income earned by U.S. persons through a foreign corporation).

<sup>67</sup> See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 159 (1985); Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 532–34. Thus, we respectfully disagree with the conclusion of the Staff of the Joint Committee on Taxation that "present law is ambiguous as to what constitutes the general rule for taxing foreign earnings." STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 41 (2008). This conclusion has led the Joint Committee Staff to recharacterize deferral as a "Tax-Induced Structural Distortion" instead of a tax expenditure. *Id.* Nevertheless, the views of the Joint Committee Staff are generally consistent with the views expressed in this Article regarding the untoward effects of deferral. See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 14–20. Moreover, deferral continues to be treated as a tax expenditure in the tax expenditure lists prepared by the Treasury Department. See, e.g., BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009, ANALYTICAL PERSPECTIVES 288 (2008) [hereinafter 2009 ANALYTICAL PERSPECTIVES].

reinvest the profits in the CFC's business instead of repatriating them to the United States.<sup>68</sup> This is contrary to the goal of locational neutrality and violates the policy of capital export neutrality. For purposes of this Article,

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<sup>68</sup> U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 7. In overall terms, the deferral subsidy may be quite large. Thus, the tax expenditures discussion in the Bush administration's fiscal year 2009 budget document estimated that the revenue effect of deferral would be \$13.78 billion for fiscal year 2009 and a total of \$76.28 billion for the fiscal years 2009–2013. See 2009 ANALYTICAL PERSPECTIVES, *supra* note 67, at 298. The budget document also estimated that deferral would be the 17th largest tax expenditure (out of 161) for fiscal year 2009 and the 19th largest aggregate tax expenditure over the fiscal years 2009–2013. See *id.*

Deferral can also be large factor at the firm level. A recent *Wall Street Journal* study concluded that General Electric, Goldman Sachs, Exxon Mobil, Cisco Systems, Hewlett-Packard, Merck, Eli Lilly, Procter & Gamble, Johnson & Johnson, and Google deferred tax recognition of a total of \$57.5 billion of foreign-source profits for 2008 alone. See Jesse Drucker, *Titans Vow Overseas-Tax Fight*, WALL ST. J., Apr. 22, 2009, at C1. The article noted that "Johnson & Johnson's effective tax rate was 12.4 percentage points lower because of its \$4 billion it said was earned and reinvested overseas, primarily in Puerto Rico and Ireland." *Id.* at C5. Another recent article in Business Week discusses how corporations taking advantage of deferral of U.S. tax on overseas profits are often among the least-taxed industries in the United States. See Nanette Byrnes, *The Unequal Tax Burden on Companies*, BUSINESS WEEK, May 4, 2009, at 49.

There has been a lively debate over whether increased foreign investment by U.S. multinationals causes net job loss or net job creation in the United States. Compare Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181 (2009), with Martin A. Sullivan, *Will Obama's International Proposals Kill U.S. Jobs?*, 123 TAX NOTES 1063 (2009). Regardless of how this controversy is ultimately settled, it is clear that deferral imposes a revenue cost on the U.S. Treasury for the reasons shown *infra* in Example 1 and Tables 1 and 2. Moreover, even if this cost produces a net job gain in the United States, it is still necessary to ask whether the gain is sufficient to justify the cost and whether the lost revenue should have been devoted to other important matters such as financing a reduction in the general corporate income tax rate, increased spending for antiterrorism measures, or healthcare. See generally Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 525–28.

Some commentators have disputed all of this, however. They have argued that if deferral were eliminated, CFC losses would become deductible by U.S. shareholders. They also have argued that the excess foreign tax credits of many U.S. corporations would become usable against current U.S. tax on CFC income. They assert that as a result of these two developments, little revenue would be gained from ending deferral. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 10; Frisch, *International Tax Policy*, *supra* note 22, at 585–86; LaBrenda Garrett-Nelson, *The Future of Deferral*, in TAXING AMERICA 239 (Karen B. Brown & Mary Louise Fellows eds., 1996); Oosterhuis & Currone, *supra* note 22, at 767–68; Shay, *Revisiting*, *supra* note 22, at 1061; see also Kathleen Matthews, *How Should Clinton Handle International Tax Issues?*, 57 TAX NOTES 985, 986 (1992); *Roundtable Discussion—International Taxation: D. Kevin Dolan, Stephen E. Shay, and David R. Tillinghast*, ABA SEC. OF TAX'N NEWSL., Fall 1993, at 8. Under this view, the preceding revenue loss estimate may be substantially overstated. Nevertheless, any restriction on the ability to *electively* defer income or take losses into account currently would surely raise revenue in the long run because taxpayers always make elections to the detriment of the fisc. In any event, regardless of how this empirical question is resolved, the deferral privilege clearly encourages U.S. taxpayers to carry on business operations through CFCs in low-tax foreign countries if the foreign operations will be profitable. Thus, those who are primarily concerned with capital export neutrality and/or locational neutrality will favor ending deferral regardless of whether the revenue consequences to the U.S. Treasury are a large gain, a small gain, or a loss. See Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 TAX NOTES 1775 (1998); Shay, *Revisiting*, *supra* note 22, at 1061, 1063; STATEMENT OF STANFORD G. ROSS, 93D CONG., GENERAL TAX REFORM, PT. II 1720, 1724–25 (Comm. Print 1973).

however, the salient points are that the combination of deferral and reinvestment of CFC profits effectively shrinks the U.S. residual tax on income earned by a CFC in a low-tax foreign country. The following example illustrates this consequence of the deferral privilege:

#### EXAMPLE 1

DC, a U.S. resident multinational corporation on the cusp of building a new manufacturing plant, is considering whether to locate this facility in the United States or in Country A, a tax haven that lacks a business profits tax, a withholding tax regime, and a branch profits tax.<sup>69</sup> DC pays U.S. federal income tax at a thirty-five-percent rate. Regardless of where DC's new plant is situated, it will produce a \$2 million before-tax profit in Year 1 that will be reinvested at a ten percent rate of return in the new manufacturing operation and then extracted and paid to DC's headquarters at the end of Year 2. The interest and discount rates are ten percent per annum. The columns of Table 1 illustrate the outcomes of two different scenarios. In Column (1), the new factory is located in the United States and governed by current law. In Column (2), the new factory is a Country A asset of DC's 100-percent-controlled Country A subsidiary, and the United States employs a worldwide income tax system that has the deferral privilege but also has effective cross-crediting barriers so that the U.S. residual tax on repatriated foreign-source income is not offset by excess foreign tax credits on high-taxed foreign income.<sup>70</sup>

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<sup>69</sup> This example expressly assumes that Country A is a tax haven. Accordingly, if these omitted taxes were imposed, they would have a very low rate and would be fully eliminated through foreign tax credits against DC's U.S. income tax liability. Thus, all three taxes would likely be inconsequential and, to simplify this and succeeding examples, we assume that they are not imposed by Country A.

<sup>70</sup> As discussed in more detail in *infra* Section IV of this Article, cross-crediting involves applying excess foreign tax credits from high-taxed foreign income against the U.S. residual tax on low-taxed foreign income, such as the business profits earned in Country A.

Table 1

	<u>Column (1)</u> U.S. Location, Current Law <sup>71</sup>	<u>Column (2)</u> Country A CFC, Worldwide Taxation with Deferral, But No Cross- Crediting
Year 1 Net Profit	\$2,000,000	\$2,000,000
Year 1 U.S. Tax @ 35%	<u>- 700,000</u>	<u>-0-</u> <sup>73</sup>
Invested in Year 2 @ 10%	\$1,300,000	\$2,000,000
Year 2 Return	+ 130,000	+ 200,000
Year 2 35% U.S. Tax on Year 2 Return	<u>- 45,500</u>	<u>-0-</u>
Distribution to DC Headquarters	\$1,384,500	\$2,200,000
Dividend Tax @ 35%	<u>-0-</u> <sup>72</sup>	<u>- 770,000</u>
After-Tax Net To DC	\$1,384,500	\$1,430,000
Total Tax Payments Valued at End of Year 2	\$770,000 (700,000 x 1.1) <u>+ 45,500</u> \$815,500	\$770,000
Difference Between Total Tax in Column (1) and Total Tax in Column (2) Valued at End of Year 2—i.e., Total Tax Lost in Column (2): \$815,500 - \$770,000 = \$45,500		

Table 1 illustrates the simultaneous occurrence of two related phenomena. First, the \$770,000 dividend tax in Column (2) of Table 1 is simply the Year 2

<sup>71</sup> Column (1) also shows the results if the factory were owned in Country A by DC's Country A subsidiary, but U.S. tax law was reformed to (i) end international tax deferral completely and (ii) effectively prevent cross-crediting.

<sup>72</sup> There is no U.S. dividend tax in this column because the distribution to U.S. headquarters is either an intracorporate payment from a U.S. branch or a distribution by a wholly owned U.S. subsidiary that is non-taxable under either the consolidated return rules or Section 243(a)(3). Alternatively, if DC located the factory in Country A and used a Country A subsidiary to make the investment, but deferral were ended completely and cross-crediting were prevented, the distribution by the Country A subsidiary to DC would be exempt from U.S. tax because the earnings of the Country A subsidiary out of which the distribution was made would have already been subject to U.S. tax in the hands of its U.S. shareholder, DC, in years 1 and 2. *Cf.* I.R.C. § 959 (2009).

<sup>73</sup> Because the Country A income is manufacturing income, Subpart F does not subject it to a Year 1 U.S. tax. *See* I.R.C. § 954(d). Thus, the \$700,000 Year 1 tax in Column (1) is deferred in Column (2) and this causes the Year 2 investment to be scaled up from \$1,300,000 in Column (1) to \$2,000,000 in Column (2).

value of the \$700,000 U.S. tax that was collected at the end of Year 1 in Column (1) but deferred until the end of Year 2 in Column (2).<sup>74</sup> In other words, in Column (2) the thirty-five percent Year 1 tax grew at a market rate of interest (assumed to be ten percent in this example) during the one-year deferral period, and because it did so, its Year 1 present value remained at \$700,000 and the government was indifferent to the deferral. But if the rate of growth of the deferred tax is less than the market rate of interest, then the value of the Column (1) \$700,000 tax will shrink over the deferral period and approach zero if the deferral period is sufficiently long (i.e., deferral is tantamount to exemption in this scenario).

The rate of growth of DC's deferred tax will, indeed, be less than the ten percent market rate because of a second phenomenon illustrated in Table 1. Note that the difference in tax payment amounts between Columns (1) and (2) is \$45,500,<sup>75</sup> which equals DC's tax incurred in Column (1) on the Year 2 investment return when the factory is built in the United States. In other words, the consequence of deferral in Column (2) is to allow DC to avoid the \$45,500 Year 2 U.S. tax that DC would have paid if it had forgone the deferral benefit of Column (2) and built the factory in the United States. Stated differently, in Table 1, DC and the U.S. Treasury experienced two different tax consequences that moved on parallel tracks. In Column (2), the Year 1 corporate profits tax of \$700,000 grew at a market rate of interest from \$700,000 to \$770,000 and was transformed into a deferred dividend tax equal to that latter amount. This allowed the deferred tax collected at the end of Year 2 in Column (2) to maintain a Year 1 value of \$700,000 so that the U.S. Treasury lost nothing and DC gained nothing from the deferral of the Year 1 \$700,000 tax to the close of Year 2. On the other parallel track, however, the Column (2) deferral of the Column (1) \$700,000 Year 1 tax caused the U.S. Treasury to lose a Year 2 tax of \$45,500. Thus, even though the deferred \$700,000 Year 1 tax seemingly "grew" in Column (2) to \$770,000 at the end of Year 2, the U.S. Treasury, nevertheless, suffered a simultaneous loss from deferral in the amount of \$45,500,<sup>76</sup> and DC experienced an equal

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<sup>74</sup>  $\$700,000 + (\$700,000 \times .10) = \$770,000$ . See generally STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 14; 3 ISENBERGH, *supra* note 31, at ¶¶ 68.1.2, 70.4.

<sup>75</sup>  $\$815,500 - \$770,000 = \$45,500$ .

<sup>76</sup> It is tempting to argue that the \$770,000 tax that the U.S. Treasury collects in Column (2) at the end of Year 2 must surely include the \$45,500 Year 2 tax shown in Column (1). To see why this is incorrect, however, note that a comparison of the total tax collected in Column (1) with the Column (2) tax collection requires bringing the \$700,000 Year 1 tax in Column (1) forward to the end of Year 2, where we have already seen that it will have a value of \$770,000 under the 10% interest rate assumption. When this value is

simultaneous gain compared to the no-deferral scenario illustrated in Column (1).

This loss effectively reduces DC's Year 2 tax burden and the U.S. Treasury's Year 2 tax collection from \$770,000 to \$724,500.<sup>77</sup> Stated

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combined with the \$45,500 Year 2 tax in Column (1), the total Column (1) tax collection equals \$815,500 at the end of Year 2. This is \$45,500 more than Treasury's \$770,000 Year 2 tax collection in Column (2). Thus, the \$770,000 Column (2) tax collection does not include the \$45,500 Year 2 tax shown in Column (1). (As explained above, the \$770,000 Year 2 tax in Column (2) is merely the \$700,000 Year 1 deferred tax plus 10% interest thereon to reflect the twelve-month collection delay.) Clearly, the Column (2) tax result that DC achieves through deferral causes the U.S. Treasury to suffer a real loss of \$45,500, compared to the non-deferral result in Column (1).

Example 1 bears a superficial resemblance to a topic that is important in the field of consumption taxation—the equivalent end results of (1) expensing (deducting) the cost of an income producing asset but taxing the total yield of the asset and (2) not deducting the cost of the asset but exempting its yield from taxation. *See, e.g.,* JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 72 (3d ed. 2004). This equivalence is dependent on several assumptions including unchanging tax rates during the period in question. *See* Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 *TAX LAW* 549, 551–52 (1985). However, the basic point of Example 1—that deferral effectively avoids income tax on the yield produced by investing the deferred income—is not dependent on these assumptions because it is not based on the expensing/exemption equivalency. Instead it is based on a comparison of current and deferred income taxation.

One commentator, however, argues that the U.S. Treasury's loss from deferral is limited to the interest charge on the additional government borrowing that results from the Treasury's deferred receipt of tax. *See* Dilworth, *supra* note 13, at 29, 34, 39. For the reasons discussed above, we disagree.

<sup>77</sup>  $\$770,000 - \$45,500 = \$724,500$ . *See generally* 3 ISENBERGH, *supra* note 31, at ¶ 68.1.2.

It is fair to ask why the U.S. Treasury's net tax collection is not simply \$815,500 (the Column (1) tax payments valued at the end of Year 2) - \$45,500 (the Year 2 tax lost on account of deferral) = \$770,000. Are we double counting when we also subtract \$45,500 from \$770,000 and conclude that the net tax collection is \$724,500? We conclude that our approach is correct because two distinct phenomena are occurring in Column (2). First, the \$700,000 Year 1 deferred tax is apparently growing at a rate of 10% per annum to \$770,000 ( $\$700,000 + [\$700,000 \times .10] = \$770,000$ ). But a comparison of Columns (1) and (2) shows a second and different phenomenon occurring at the same time—a loss of a \$45,500 Year 2 tax in the Column (2) deferral scenario. Although these two events occur over the same time period, they are distinct. There is a growth event and a loss event and each must be accounted for. Because both involve the same taxpayer (DC) and both become noticeable at the same time (the end of Year 2), a reasonable and informative way to account for both events is to offset them. *See generally* STAFF OF JOINT COMM. ON TAX'N, *ALTERNATIVE POLICIES*, *supra* note 18, at 14. We have done so by subtracting the U.S. Treasury's \$45,500 Year 2 loss from its nominal \$770,000 tax collection at the end of Year 2. This shows that the Year 2 tax collection in the deferral scenario is only \$724,500 instead of \$770,000.

A second way to describe the U.S. Treasury's situation in Column (2) is to note that the U.S. Treasury effectively had a \$700,000 investment in the Country A subsidiary during Year 2. *See* Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 465–66; *see also* STAFF OF JOINT COMM. ON TAX'N, *ALTERNATIVE POLICIES*, *supra* note 18, at 14–15. Under the 10% interest rate assumption, the yield on this investment at the end of Year 2 should have been \$70,000. Instead, the U.S. Treasury's \$45,500 loss reduced the yield to \$24,500 ( $\$70,000 - \$45,500$ ), which means that the loss reduced the U.S. Treasury's rate of return from 10% to 3.5% ( $\$24,500 \div \$700,000 = 3.5\%$ ). Thus, deferral resulted in the U.S. Treasury receiving a below-market return. The 6.5 percentage point difference between the 10% market rate of return and the 3.5% actual return



differently, because of the U.S. Treasury's \$45,500 loss in Column (2), the net tax collected in Column (2) shrank to only 94.1 percent of its \$770,000 nominal amount,<sup>78</sup> which is the amount required for the deferred tax to maintain a Year 1 present value of \$700,000. By extending this analysis to Year 5 in Table 2, we can see that this shrinkage increases if the earnings on the investment of the \$700,000 tax that was deferred in Column (2) are themselves reinvested, along with the deferred tax, in the CFC's business instead of being withdrawn at the end of Year 2.

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was captured by DC ( $.065 \times \$700,000 = \$45,500$  of tax avoided by DC). See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 14.

Of course, consumption tax advocates regard the \$45,500 avoided tax as an illegitimate double tax that should not be imposed in the first place. The federal income tax is, however, predominantly an income tax based on the ability-to-pay principle, instead of a consumption tax, and when income tax analysis is applied, DC has avoided \$45,500 in Column 2. See Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 511–17, 532.

<sup>78</sup>  $(\$770,000 - \$45,500) \div \$770,000 = 94.1\%$ . The approach taken in Example 1 differs from the more traditional way of illustrating the effect of deferral, which is to characterize the deferred tax as an interest-free loan from the government and to describe the taxpayer's benefit, as well as the U.S. Treasury's loss, as forgone interest. See U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 22, at 16 (quoting U.S. Treasury Secretary Dillon). Under this more conventional approach, the \$700,000 Year 1 deferred tax in Column (2) is treated as loan principal with respect to which there is \$70,000 of Year 2 forgone interest resulting from the 10% interest rate assumption. If DC had paid this interest, however, it would have deducted the \$70,000 payment under Section 163 and generated a \$24,500 tax saving ( $\$70,000$  deduction  $\times$  35% marginal tax rate). Thus, the benefit to DC from the interest-free loan during Year 2 is DC's after-tax avoided interest cost, which is  $\$70,000 - \$24,500$  tax saving = \$45,500. This exactly equals the \$45,500 of tax that DC avoided in Column (2) of Example 1. Thus, the interest-free loan approach and the avoided tax approach reach the same result. We have chosen to use the avoided tax approach in Example 1, and in *infra* Table 2, because, as we have explained elsewhere, the analogy of deferral to an interest-free loan is significantly flawed and the better analogy regards the U.S. Treasury as a forced equity investor in the business of DC's Country A CFC. See Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 22, at 843–44; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 465–66; see also STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 14–15.

Table 2—Example 1 Extended Through Year 5

	<u>Column 1</u> U.S. Location, Current Law	<u>Column 2</u> Country A CFC, Worldwide Taxation with Deferral, But No Cross-Crediting
Invested in Year 3 @ 10%	\$1,384,500	\$2,200,000
Year 3 Return	+ 138,450	+220,000
Year 3 35% Tax on Year 3 Return	<u>- 48,458</u>	<u>-0-</u>
Invested in Year 4 @ 10%	\$1,474,492	\$2,420,000
Year 4 Return	+ 147,449	+ 242,000
Year 4 35% Tax on Year 4 Return	<u>- 51,607</u>	<u>-0-</u>
Invested in Year 5 @ 10%	\$1,570,334	\$2,662,000
Year 5 Return	+ 157,033	+ 266,200
Year 5 35% Tax on Year 5 Return	<u>- 54,962</u>	<u>-0-</u>
Distribution to DC Headquarters	\$1,672,405	\$2,928,200
Dividend Tax @ 35%	<u>-0-</u>	<u>- 1,024,870</u>
After-Tax Net to DC	<u>\$1,672,405</u>	<u>\$1,903,330</u>
Total Tax Payments Valued at End of Year 5	\$1,255,794	\$1,024,870
Difference Between Total Tax in Column (1) and Total Tax in Column (2) Valued at End of Year 5—i.e., Total Tax Lost in Column (2): \$1,255,794 - \$1,024,870 = \$230,924		

At the end of Year 5, the difference between the tax totals in Columns (1) and (2) is now \$230,924,<sup>79</sup> as opposed to the \$45,500 difference in Table 1 at

<sup>79</sup> \$1,255,794 - \$1,024,870 = \$230,924. This is the sum of the annual taxes on the Column (1) investment returns for Years 2–5, with each year's tax being valued at the end of Year 5 under the 10% interest assumption. Thus, the annual taxes for Years 2–5 in Column (1) were effectively avoided in Column (2). See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 14–15.

the end of Year 2. This means that the U.S. Treasury suffers a \$230,924 cumulative loss over the deferral period and the Year 5 tax in Column 2 effectively shrinks to \$793,946.<sup>80</sup> This is only 77.5 percent<sup>81</sup> of the \$1,024,870 nominal amount, which is the amount necessary for the deferred tax to stay “even” with a 10 percent market rate of return. By contrast, the Year 2 tax in Column (2) of Table 1 was effectively 94.1 percent of the \$770,000 nominal amount. Thus, as deferral is prolonged through reinvestment in DC’s Country A subsidiary, the U.S. residual tax on each year’s reinvested profit will continue to shrink.<sup>82</sup> Eventually, the residual tax will be negligible and DC will have effectively achieved, on an elective basis, the result of an exemption system<sup>83</sup> because there is no residual tax in an exemption regime.

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<sup>80</sup>  $\$1,024,870 - \$230,924 = \$793,946$ .

<sup>81</sup>  $\$793,946 \div \$1,024,870 = 77.5\%$ .

<sup>82</sup> The reason for this increasing shrinkage is that in Table 2 only \$724,500 of deferred tax was effectively carried from Year 2 into Year 3, instead of the \$770,000 amount that was necessary for the U.S. Treasury to enjoy a 10% market rate of return during Year 2 on the \$700,000 of Year 1 deferred tax. See *supra* text accompanying note 76. Thus, the U.S. Treasury began Year 3 at \$724,500, instead of \$770,000. To keep from falling farther behind, the U.S. Treasury needed to have a return of \$72,450 ( $\$724,500 \times .10$ ) during Year 3 on the deferred tax so that its Year 3 tax collection would be \$796,950 ( $\$724,500 + \$72,450$ ). However, after taking the \$48,458 Year 3 avoided tax loss into account, the U.S. Treasury earned only \$23,992 ( $\$72,450 - \$48,458$ ) on the \$724,500 “principal” amount, which is a return of only 3.3% ( $\$23,992 \div \$724,500$ ) at a time when the market rate is assumed to be 10%. Accordingly, the U.S. Treasury’s net Year 3 tax collection is only \$748,492 ( $\$724,500$  deferred from Year 2 + \$23,992 Year 3 net tax collection = \$748,492), instead of \$796,950. Thus, the combination of the U.S. Treasury’s inadequate starting point plus its below-market rate of return accounts for the increasing shrinkage at the end of Year 3. A similar scenario plays out for Years 4 and 5.

<sup>83</sup> See STAFF OF JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES, *supra* note 18, at 16 n.41; OECD, *Tax Effects*, *supra* note 6, at 63–64 (empirical data indicate that deferral and other features of worldwide systems tend to minimize the difference between foreign tax credit systems and territorial systems); Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639, 682 (2005) (stating that by allowing deferral, the United States and other residence-based taxing jurisdictions “mirror” territorial tax systems “by effectively providing tax exemptions for foreign income”); see also Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 844 (2000) (“[A] worldwide system that defers the tax on foreign source income until repatriation has the same effect on allocation of capital between U.S. MNEs [multinational enterprises] and foreign MNEs as an exemption system.”). The preceding analysis also shows that with respect to a CFC’s retained earnings, deferral allows the CFC to function for its U.S. shareholders as if it were a Section 103 tax-exempt bond fund. Unlike the Section 103 exemption, however, the effective exemption for the investment return on the CFC’s retained earnings does not inure to the benefit of a U.S. state or local government. Instead, the exemption is captured by the CFC’s U.S. shareholders. See STAFF OF JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES, *supra* note 18, at 14–15.

#### D. Transfer Pricing Rules and the Anti-Deferral Regimes

An important function of Subpart F and related regimes is to serve as a backstop to the Section 482 rules on intercompany pricing with respect to outbound transactions.<sup>84</sup> Some deferral proponents contend that “transfer pricing law and administration have undergone profound changes that seriously call into question the continued relevance of Subpart F to transfer pricing enforcement.”<sup>85</sup> We disagree with this overly optimistic assessment of the effectiveness of the current transfer pricing rules.

The arm’s-length standard, as interpreted in the current regulations under Section 482, allows a taxpayer to fully comply with the transfer pricing rules by selecting the most advantageous price that falls within a range of allowable alternatives.<sup>86</sup> This approach leaves a generous area within which U.S. corporations enhance the effect of deferral by shifting income at the margin to foreign subsidiaries in low-tax foreign jurisdictions without violating the rules in the Section 482 regulations.<sup>87</sup> In addition, enforcement of the U.S. transfer pricing rules is problematic.<sup>88</sup> We explore the implications of these points in *infra* Section III.

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<sup>84</sup> See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 3, at 458 n.12.

<sup>85</sup> NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 65; see also 3 ISENBERGH, *supra* note 31, at ¶ 68.1.2.

<sup>86</sup> See Treas. Reg. § 1.482-1(e) (as amended in 2006).

<sup>87</sup> As stated in a report by the ABA Section of Taxation’s Task Force on International Tax Reform: “Even with small price adjustments, the aggregate amount of income that may be shifted within the range allowable under the regulations (and amount of tax saved) can be material.” *International Task Force Report*, *supra* note 16, at 703. Thus, recent studies suggest that, notwithstanding improvements in transfer pricing law and administration, revenue losses due to transfer pricing may be substantial. See, e.g., Martin A. Sullivan, *U.S. Multinationals Shifting Profits Out of the United States*, 118 TAX NOTES 1078 (2008); Michael M. Phillips, *Taking Shelter—As Congress Ponders New Tax Breaks, Firms Already Find Plenty*, WALL ST. J., Aug. 4, 1999, at A1; Mitchell J. Tropin, *U.S. Lost Estimated \$35.6 Billion in 1998 Due to Abnormal Transfer Pricing, Study Says*, BNA DAILY TAX REP., June 1, 1999, at G-2 (discussing study prepared by Professors Simon J. Pak and John S. Zdanowicz); see also IRS, REPORT ON THE APPLICATION AND ADMINISTRATION OF SECTION 482, at ch. 1 (1999) (estimating that annual gross tax shortfall due to improper transfer pricing is \$2.8 billion, although the IRS noted a number of upward and downward biases in the estimate); cf. GOV’T ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: FOREIGN- AND U.S.-CONTROLLED CORPORATIONS THAT DID NOT PAY U.S. INCOME TAXES, 1989-95 (1999) (indicating that the majority of large international corporations, foreign- and U.S.-controlled, paid no U.S. income tax from 1989 to 1995). Finally, even where transfer prices are set in total harmony with prices in comparable uncontrolled transactions, the deferral privilege is still objectionable because it distorts the business location decisions.

<sup>88</sup> See Lee A. Sheppard, *Treasury Officials Discuss Reform, Contract Manufacturing*, 118 TAX NOTES 1083, 1084 (2008) (“Transfer pricing is dead . . . . Despite everyone’s efforts, we’re not collecting tax.” (quoting Edward D. Kleinbard, chief of staff of the Joint Committee on Taxation of the U.S. Congress)); OECD, *Tax Effects*, *supra* note 6, at 112 (“For many transactions[,]” the enforcement of transfer pricing rules “is very difficult and may be impossible.”).

### *E. Competitiveness I*

Deferral is a poorly constructed tax expenditure that distorts taxpayer decisions by providing an incentive for U.S. persons to carry on business in low-tax foreign countries through a CFC, instead of in the United States, and then to reinvest the resulting profits in the CFC's foreign business instead of repatriating the profits to the United States.<sup>89</sup> In addition, deferral violates the ability-to-pay fairness norm that is the major equity standard of U.S. tax policy.<sup>90</sup> Nevertheless, it is warmly defended by advocates who rely principally on a competitiveness argument that can be stated as follows: the only non-deferred income tax paid by indigenous businesses in a low-tax foreign country is the local income tax on in-country profits. The same is true of foreign corporations operating in the low-tax country but resident in a country that exempts foreign-source income from residence-country tax or that allows deferral of residence-country tax on foreign-source income. Without deferral, U.S. companies would be unduly disadvantaged when competing in low-tax foreign countries because in addition to the low foreign tax, they would pay a current U.S. residual tax on their foreign profits while their local and exemption country competitors would pay only the low foreign tax. Therefore, so the argument goes, the United States should defer U.S. tax on the foreign-source income of U.S. companies.<sup>91</sup>

This is not a request for the United States to give double taxation relief that would otherwise be unavailable. Amelioration of double taxation is provided by means of the U.S. foreign tax credit. Instead, the competitiveness argument is a request for tax system assistance that is not available to earners of U.S.-source income.<sup>92</sup> This appeal for preferential treatment of foreign-source income should be closely scrutinized. In our judgment, such scrutiny reveals

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<sup>89</sup> See Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 528, 530–31, 537–40; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 468–69.

<sup>90</sup> See generally Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 2; *International Task Force Report*, *supra* note 16, at 678–80.

<sup>91</sup> See generally GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 49–55 (1992); Dilworth, *supra* note 13; Hubbard, *supra* note 6; William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How A Tilted Playing Field Developed*, 43 TAX NOTES 1379 (1989); Merrill & Dunahoo, *supra* note 22, at 226; John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593, 1596–97 (2009); Mark A. Weinberger, *Six Observations on Obama's International Proposals*, 123 TAX NOTES 1599, 1600–01 (2009); OECD, *Tax Effects*, *supra* note 6, at 108–11; NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 12.

<sup>92</sup> Thus, the competitiveness argument in favor of deferral is an admission that deferral is a tax expenditure. For application of tax expenditure analysis to deferral, see Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 528–41.

that there is no persuasive case for deferring U.S. income tax on foreign-source income.

This is so principally because there is no convincing empirical evidence that a general competitiveness problem exists or that deferral is the appropriate cure in any event. Claims that U.S. businesses suffer from a competitiveness handicap are rendered questionable at best by their extensive overseas success.<sup>93</sup> Where is the proof (as contrasted with anecdotes<sup>94</sup> and special pleading) of a systemic competitiveness problem<sup>95</sup> that is substantially caused

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<sup>93</sup> For a sample of sources regarding the successes of U.S. multinational corporations in foreign markets, see Matt Andrejczak & Donna Kardos, *Heinz Earnings Rise by 7.2%, Helped by Higher Prices*, WALL ST. J., May 30, 2008, at B4; Valerie Bauerlein, *Coke Net Buoyed by China, India – Profit Is Better Than Expected Despite Stronger Dollar, Tepid Sales in U.S., Europe*, WALL ST. J., July 22, 2009, at B3; William M. Bulkeley, *High-Margin Services Lift IBM*, WALL ST. J., Oct. 17, 2008, at B2; Russell Gold, *Exxon to Boost Spending, Broaden Exploration*, WALL ST. J., Mar. 6, 2008, at B1; Christopher Hinton, *Monsanto Net Nearly Triples*, WALL ST. J., Jan. 4, 2008, at C14; Kathryn Kranhold, *GE's Strength Abroad Helps It Weather Weakness in U.S.*, WALL ST. J., Jan. 19, 2008, at A3; Tom Lauricella, *Earnings Show Split Emerging in Economy*, WALL ST. J., Apr. 18, 2008, at A1 (even in the midst of the recession of 2008, U.S. businesses continued to perform well in foreign markets); Betsy McKay, *Pepsi to Boost China Outlay by \$1 Billion*, WALL ST. J., Nov. 4, 2008, at B3; Betsy McKay, *Coke Net Rises 19%, Aided by Weak Dollar*, WALL ST. J., Apr. 17, 2008, at B3; Betsy McKay & Anjali Cordeiro, *Coke Overcomes Weak U.S. Results; Beverage Giant Posts Better-Than-Expected Profit as International Sales Continue to Drive Growth*, WALL ST. J., Oct. 16, 2008, at B3; Shira Ovide, *P&G Profit Rises 33%; Costs Hit Outlook*, WALL ST. J., Aug. 6, 2008, at B3.

<sup>94</sup> One anecdote that has been repeated in the literature is the decline of the U.S.-owned foreign-flag shipping fleet following the 1986 repeal of deferral with respect to that industry. See NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 106–07; Ken Kies, Letter to the Editor, *Mythbusters II: Kies Provides His Thoughts on Avi-Yonah's Article*, 123 TAX NOTES 1487 (2009); Ken Kies, *A Perfect Experiment: 'Deferral' and the U.S. Shipping Industry*, 116 TAX NOTES 997 (2007). Causation has not been convincingly demonstrated in this case, however, because the U.S.-owned foreign-flag shipping fleet had been in decline for several years before 1986. See NFTC, INTERNATIONAL TAX POLICY, *supra* note 59, at 107. Even if causation exists, the case for extending conclusions drawn from this narrow industry to software, beverages, aircraft, pharmaceuticals, agricultural commodities, and other industries has not been established.

<sup>95</sup> See U.S. TREAS. DEP'T., DEFERRAL STUDY, *supra* note 22, at 56–57 (“[T]he United States, as a general matter, is agreed upon by almost any measure to be one of the most competitive countries in the world.”), Martin A. Sullivan, *Tax Incentives and Economists*, 111 TAX NOTES 20, 23–25 (2006); Timothy Aepfel, *Overseas Profits Provide Shelter for U.S. Firms*, WALL ST. J., Aug. 9, 2007, at A1 (U.S. companies continue to experience growth in foreign-source profits); *U.S. Again Holds No. 1 Rank in Competitiveness Survey*, WALL ST. J., Oct. 9, 2008, at A8 (2008 World Economic Forum Report ranks U.S. economy as most competitive in the world); Marc Champion, *U.S. Ranked Most Competitive; Oil-Rich Nations Show Promise*, WALL ST. J., Nov. 1, 2007, at A4 (2007 World Economic Forum report characterized the U.S. economy as the most competitive in the world); AUGUSTO LOPEZ-CARLOS, WORLD ECON. FORUM, EXECUTIVE SUMMARY, xv, available at [http://www.weforum.org/pdf/Gcr/GCR\\_05\\_06\\_Executive\\_Summary.pdf](http://www.weforum.org/pdf/Gcr/GCR_05_06_Executive_Summary.pdf) (finding that the United States had the world's second most competitive economy in 2005 because of “continuing technological supremacy, and a pipeline of innovation second to none in the world”); see also Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53, 64–65 (2006); Richard C. Pugh, *The Deferral Principle and U.S. Investment in Developing Countries*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 267, 280 (Robert Hellawell ed., 1980) (stating that “one

by the U.S. international income tax regime<sup>96</sup> instead of by labor cost differentials, product quality differences, regulatory differences, and other non-tax factors? Stated differently, if there are specific industries that face an international competitiveness problem, why is taxation the cause, how does deferral solve the problem, and why do the facts with respect to certain industries extend to other unrelated sectors of the U.S. economy? Answers to these questions have not been forthcoming.<sup>97</sup>

Of course, a deferral advocate might shift ground by conceding that U.S. businesses are competing effectively abroad but then argue that this success is due to the generous tax assistance provided by the current U.S. income tax regime,<sup>98</sup> that withdrawal of this aid would cause U.S. businesses to flounder in foreign markets, and that copious tax assistance should be continued. This argument, however, fails for the same reason as the basic competitiveness argument. Just as there is a paucity of evidence supporting the allegation that

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faces a relative scarcity of detailed empirical analysis” in assessing the claims of advocates and opponents of deferral). *But cf.* STAFF OF JOINT COMM. ON TAX’N, OPTIONS, *supra* note 8, at 189 (opining that the current U.S. international tax system “arguably” impairs the competitiveness of U.S. multinationals “in some cases” but giving no details); U.S. TREAS. DEP’T, BACKGROUND PAPER, *supra* note 63, at 43 (“[T]he United States likely experiences some reduction of both foreign direct investment and its corporate tax base due to its above-average CIT [corporate income tax] rate.” If this problem exists, however, it could be solved by a general rate reduction.). For a skeptical economic efficiency critique of the competitiveness arguments for the deferral subsidy, see Jane G. Gravelle, *Foreign Tax Provisions of American Jobs Act of 1996*, 72 TAX NOTES 1165, 1168 (1996).

<sup>96</sup> See Peter Mullins, *Moving to Territoriality? Implications for the U.S. and the Rest of the World*, 43 TAX NOTES INT’L 839, 844 (2006) (“[T]here is little evidence to assess the impact of U.S. taxes on the competitiveness of multinational corporations in foreign markets, and especially the extent to which competitiveness is affected by the use of the worldwide system.”).

<sup>97</sup> See Harry Grubert & John Mutti, *Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?*, 2 INT’L TAX & PUB. FIN. 439, 446 (1995) (“The implication is that cutting tax on foreign income would not be a very effective way of encouraging U.S. R&D because it has little impact on foreign sales.”); *id.* at 453 (“Reducing U.S. taxes on foreign income does not seem to be any more effective in strengthening U.S. companies’ worldwide competitiveness than reducing taxes on domestic corporate income.”); see also Sheppard, *supra* note 14, at 1393 (“Competitiveness has come to mean not paying taxes to any government, especially a multinational’s home government . . .”).

In the text above, we are effectively arguing that deferral advocates have a heavy burden of proof. This is because deferral is a tax expenditure that discriminates in favor of foreign investment by effectively transferring billions of dollars annually as subsidies to the foreign operations of U.S. multinational corporations. See Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 20, at 532–34. As noted by one prominent tax economist: “The burden of proof, in effect, always remains with the advocates for discrimination.” Gene Steuerle, *A Consensus Base for Tax Reform*, 113 TAX NOTES 371, 371 (2006). Moreover, “[i]n most situations, a good rule of thumb is that the tax system should be neutral with respect to the location of investment.” JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES* 137 (4th ed. 2008).

<sup>98</sup> See *supra* text accompanying notes 15–16.

U.S. businesses are at a competitive disadvantage, there is an absence of evidence that their competitive success is dependent on tax benefits.<sup>99</sup>

Finally, we question the validity of defining competitiveness in terms of the after-tax profitability of a country's multinational corporations instead of an improved living standard for its citizens.<sup>100</sup> When competitiveness is viewed in that latter way, the linkage, for example, between public investment in education and improved U.S. competitiveness<sup>101</sup> is far more immediate and powerful than is a tax subsidy tailored to enhance the investment returns of U.S. multinational corporations.<sup>102</sup> Basically, it is difficult to see how deferral,

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<sup>99</sup> See U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 22, at 57 (“[T]he available data simply do not provide a reliable basis for evaluating whether . . . [the current U.S. international tax regime] has affected multinational competitiveness to any significant extent.”); see also authorities cited *supra* notes 94 and 95.

<sup>100</sup> The empirical evidence has failed to establish that expansion by U.S. multinationals into low-tax foreign countries results in net employment gains within the United States or net trade gains for the United States. See Martin A. Sullivan, *Offshore Jobs and Taxes: Will Democrats Attack?*, 119 TAX NOTES 24 (2008); Martin A. Sullivan, *U.S. Multinationals Moving Jobs to Low-Tax, Low-Wage Countries*, 119 TAX NOTES 119 (2008); Martin A. Sullivan, *A Challenge to Conventional International Tax Wisdom*, 113 TAX NOTES 951, 956–58 (2006); see also ABA SECTION OF TAXATION, STATEMENT OF POLICY REGARDING U.S. INTERNATIONAL TAXATION 2, available at <http://www.abanet.org/tax/pubpolicy/2009/090609policyintlax.pdf> (“The primary focus of U.S. income tax policy generally should be to raise revenue in a manner that improves the lives and living standards of U.S. citizens and residents.” (footnote omitted)); Samuels, *supra* note 91, at 1593 (“[T]he goal of any reform of our international tax system should be . . . to advance national and not global welfare—to improve the quality of life for all Americans to the maximum extent possible.”); Lawrence H. Summers, *TCPI's Ninth Annual Tax Policy & Practice Symposium Keynote Address by Lawrence H. Summers*, 86 TAXES 35, 40 (June 2008) (statement by former U.S. Treasury Secretary that “I think the basic criterion for measuring the success of national economic policy is what is happening to the growth in the incomes of average families . . .”); Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 294–95, 307 (2001).

The economic theories of capital export neutrality and capital import neutrality, which have played a large role in the debate over the desirability of deferral, are concerned with maximizing global welfare rather than the welfare of residents of a particular country. See OECD, *Tax Effects*, *supra* note 6, at 96–100.

<sup>101</sup> See Joann M. Weiner, *Conversations: Harvey S. Rosen*, 117 TAX NOTES 857, 859 (2007) (“Empirical studies . . . show that the growth in income inequality is largely due to differences in educational attainment. . . . [T]hose who are less educated fall further behind. . . . [W]e need to focus on providing more education to these segments of the population.”); Sara Murray, *Study Finds Sharp Math, Science Skills Help Expand Economy*, WALL ST. J., Mar. 3, 2008, at A2 (reporting on a study concluding that if U.S. students had achieved the improvements in math and science called for by the National Governors Association nearly twenty years ago, U.S. GDP would be two percentage points higher today and 4.5 points higher by 2015); see also Conor Dougherty, *High-Degree Professionals Show Power; Survey Highlights Worry of Winners, Losers in Economy*, WALL ST. J., Sept. 10, 2008, at A3 (“In 2007, the median income [in the U.S.] for people with a bachelor's degree was about two-thirds more than those with only a high-school diploma.”).

<sup>102</sup> See J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Point: The United States Should Tax U.S. Corporations on Their Worldwide Income*, ABA SEC. OF TAX'N NEWSL., Fall 2001, at 14, 15; authorities cited *supra* note 101.



which encourages U.S. multinational corporations to shift investment to lower-tax countries, is improving the living standards of U.S. citizens and residents.

## II. ENHANCING THE DEFERRAL PRIVILEGE: PART ONE—EXPLOITING DEFECTIVE COST ALLOCATION RULES

The U.S. federal income tax is a tax on worldwide net income. In that context, the treatment of costs in the determination of foreign-source net income poses at least two issues. The first is the proper allocation of expenses to foreign-source income when implementing the foreign tax credit method for mitigating international double taxation. The second is whether or when an expense allocable to a foreign corporation's foreign-source income should be deductible by a U.S. shareholder where the income falls within the scope of the deferral privilege discussed above.<sup>103</sup>

### A. *The Allocation of Expenses to Foreign-Source Income for Purposes of the Foreign Tax Credit Limitation*

Under current law, the most significant reason that expenses of a U.S. person are allocated between U.S.-source and foreign-source income is to determine the foreign tax credit limitation.<sup>104</sup> The amount of foreign tax credits available to a U.S. taxpayer with respect to the U.S. tax on foreign-source income is calculated on the basis of the net foreign-source taxable income in each of two separate foreign tax credit limitation categories.<sup>105</sup> The foreign tax credit limitation is determined by the following formula: the tentative U.S. tax (before allowance of the foreign tax credit) is multiplied by

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An additional way to view competitiveness is to compare full current taxation of U.S. corporations that sell only in the U.S. market with deferral treatment for the foreign-source income of U.S. multinational corporations. Both groups of corporations compete for capital; yet deferral of U.S. tax on foreign-source income gives U.S. multinationals a competitive advantage over U.S. corporations that sell exclusively within the United States. There is no apparent justification for this disparity. *See generally* OECD, *Tax Effects*, *supra* note 6, at 96.

<sup>103</sup> There is a third question, which is the transfer pricing issue of when do expenses sufficiently benefit a foreign subsidiary such that they should be charged to the foreign subsidiary. Transfer pricing will be discussed *infra* Section III of this Article. A fourth question is the extent to which foreign persons should be allowed to allocate expenses to their U.S.-source business income, but that issue is outside the scope of this Article.

<sup>104</sup> *See* I.R.C. §§ 904, 861(b), 862(b), 864(e)–(f) (2009); GRAVELLE & MARPLES, *supra* note 6, at 2–3; *International Task Force Report*, *supra* note 16, at 765.

<sup>105</sup> I.R.C. § 904(d). These categories are often referred to as foreign tax credit “baskets.” Under current law, there are two categories or baskets in Section 904(d): the passive category income basket and the general category income basket.

the quotient of foreign-source taxable income divided by worldwide taxable income.<sup>106</sup> To determine the amount of foreign-source taxable income in each limitation category, a taxpayer must allocate and apportion its expenses between U.S.-source and foreign-source income and then further allocate and apportion the expense allocated to foreign-source income between the two separate foreign tax credit limitation categories. Expenses that are allocated and apportioned to a separate limitation category reduce the amount of net foreign-source taxable income in that category and, therefore, the potentially creditable foreign taxes in that category.<sup>107</sup> The purpose of these computations is to cap the foreign tax credit limitation for each of the two separate limitation categories at an amount equal to the U.S. federal income tax imposed on the foreign-source income in the respective category.

Because of the limitation's purpose and structure (which involves multiplying a tentative U.S. tax determined under U.S. tax law principles by a fraction, the denominator of which is worldwide taxable income under U.S. tax law principles), it would be incoherent to determine the numerator of the limitation fraction (net foreign-source taxable income in the limitation category), by reference solely to expenses that are deductible under the law of the foreign country imposing the tax. Indeed, it is fundamental that expenses that might not be deductible for foreign tax purposes (such as interest on U.S. debt and U.S. research and development (R&D) expense) should, nevertheless, be allocated to foreign-source income if they support the earning of that income. Otherwise, the numerator of the limitation fraction would be inflated and foreign taxes would be effectively allowable as a credit against U.S. tax on what properly should be considered U.S.-source net income. The most important expenses incurred by a U.S. shareholder that routinely are not allowable as a deduction by a foreign subsidiary under the law of the subsidiary's country of residence are interest, R&D expense, and general and administrative expense.

With regard to interest expense, it was once the case that an affiliated group of corporations could maximize the foreign tax credit limitation by causing the group's borrowing to be done by U.S. affiliates that earned only U.S.-source

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<sup>106</sup> I.R.C. § 904(a). This basic limitation in Section 904(a) is often referred to as the overall limitation.

<sup>107</sup> For foreign tax credit limitation purposes, taxpayers generally prefer that an expense be allocated to U.S.-source income unless an expense allocable to foreign-source income either (1) does not limit the foreign tax credit (because there is sufficient foreign income in the limitation category irrespective of the allocation of the expense to that category), or (2) may be charged to a foreign subsidiary with an effective rate of tax at or above the effective tax rate for U.S.-source income and is allowed as a deduction in the other country.

income. The related interest expense was then allocated entirely to U.S.-source income even though the borrowed funds might have been used, directly or indirectly, to finance the group's foreign affiliates.<sup>108</sup> This tactic inflated the foreign-source income component of the group's worldwide taxable income, thereby expanding the foreign tax credit limitation.<sup>109</sup> The Tax Reform Act of 1986<sup>110</sup> ended this form of manipulation by adopting the currently applicable interest expense allocation rules. These rules rest on the premise "that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid."<sup>111</sup> This idea is implemented by treating all members of an affiliated group as if they were unincorporated units of a single corporation<sup>112</sup> and allocating the group's aggregate interest expense in proportion to its foreign and domestic assets.<sup>113</sup> Foreign affiliates, however, are regarded as non-members of the group for this purpose<sup>114</sup> in spite of the fact that their outstanding stock is included in the group's foreign property.<sup>115</sup> The upshot of this treatment of foreign affiliates is that regardless of how borrowed funds are actually used within an affiliated group, interest paid by U.S. affiliates can be partially allocated to foreign affiliates, but none of the interest paid by foreign affiliates can be allocated to U.S. affiliates.<sup>116</sup> This inconsistency has no effect on the calculation of the group's worldwide aggregate net income, but it can result in over-apportionment of interest expense to foreign-source income which, in turn, can cause an unwarranted reduction in the foreign tax credit.<sup>117</sup>

Congress substantially cured this problem for years after 2010 by enacting a worldwide group interest allocation rule that allows a U.S. corporate taxpayer

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<sup>108</sup> See STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 944-45 (1987); 1 ISENBERGH, *supra* note 31, at ¶ 22.17.

<sup>109</sup> See authorities cited *supra* note 108.

<sup>110</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>111</sup> STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 289 (2005); see also Temp. Treas. Reg. § 1.861-9T(a) (as amended in 2006).

<sup>112</sup> See I.R.C. § 864(e)(1) (2009). For exceptions, see Temp. Treas. Reg. §§ 1.861-11T(b)(2), (d)(4) (as amended in 2001).

<sup>113</sup> See I.R.C. § 864(e)(2). For exceptions to the rule of allocation in proportion to assets, see Temp. Treas. Reg. §§ 1.861-10T(b)(1), (c), (e) (1988).

<sup>114</sup> See I.R.C. §§ 864(e)(5)(A), 1504 (b)(3).

<sup>115</sup> See Temp. Treas. Reg. § 1.861-12T(c)(1) (as amended in 2006); 1 ISENBERGH, *supra* note 31, at ¶¶ 22.17.1-22.17.2.

<sup>116</sup> See 1 ISENBERGH, *supra* note 31, at ¶ 22.17.1; MCDANIEL, AULT & REPETTI, *supra* note 19, at 48.

<sup>117</sup> See 1 ISENBERGH, *supra* note 31, at ¶ 22.17.2.

a one-time election to take into account the interest expense and assets of 80 percent-owned foreign affiliates in determining the proportion of the interest expense of U.S. affiliated group members that should be allocated to foreign-source income.<sup>118</sup> If an election is made, the interest expense of the domestic members of a worldwide affiliated group is allocated and apportioned to foreign-source income, but only to the extent that (i) the total interest expense of the worldwide affiliated group, multiplied by the ratio which the foreign assets of the worldwide affiliated group's domestic and foreign members bear to the total assets of the worldwide affiliated group, exceeds (ii) the interest expense of the foreign members of the worldwide affiliated group that they would have allocated and apportioned to foreign-source income had they formed their own separate affiliated group.<sup>119</sup> This new approach avoids the manipulation opportunities that existed under pre-1986 Act law while also avoiding the over-correction that resulted from the 1986 Act. Nevertheless, a serious problem remains as explained below in Section II.B.

With respect to R&D expenditures, the regulations require that such expenditures be allocated and apportioned "to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)."<sup>120</sup> If a taxpayer conducts R&D with respect to more than one product category, the taxpayer is permitted to aggregate the categories for purposes of allocating and apportioning R&D expenditures.<sup>121</sup> Where R&D is not clearly identifiable with any one product category, it is considered to be conducted with respect to all of the taxpayer's product categories.<sup>122</sup> The current regulations allow the allocation of R&D expenditures to three-digit classifications of the Standard Industrial Classification Manual (SIC) product categories of gross income (or, with

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<sup>118</sup> I.R.C. § 864(f) (as amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 401(a), 118 Stat. 1418, 1488 (2004), which was originally effective for tax years starting after 2008). The Housing Assistance Tax Act of 2008, Pub. L. No. 110-289, § 3093, 122 Stat. 2654, 2912 (2008), amended this provision to delay its effective date until tax years starting after 2010. See STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 257-58 (2009).

<sup>119</sup> Note that there is a "one way" aspect to this formula, i.e., "excess" interest expense associated with foreign assets would not be deemed to be associated with U.S. assets, even for purposes of the foreign tax credit limitation.

<sup>120</sup> Treas. Reg. § 1.861-17(a)(1) (adopted in T.D. 8646, 1996-1 C.B. 144).

<sup>121</sup> Treas. Reg. § 1.861-17(a)(2)(i) (1995).

<sup>122</sup> *Id.*

consent of the Internal Revenue Service (IRS), to another classification).<sup>123</sup> For each relevant product category, all or part of the R&D expenditures are potentially allocated between U.S.-source and foreign-source income under special rules. First, where research is undertaken solely to meet legal requirements imposed by a political entity concerning improvement or marketing of specific products or processes, and the results cannot be reasonably expected to generate gross income (beyond *de minimis* amounts) outside a single geographic source, the deduction is allocable only to the gross income within that geographic source (the “legal requirement” rule).<sup>124</sup>

Second, if R&D activities accounting for more than fifty percent of the amount of the deductions in the product category are performed at a single geographic source, the current regulations provide that a fixed percentage of the relevant deduction is allocated to gross income corresponding to that source.<sup>125</sup> Thus, the current regulations include a fifty percent (increased from thirty percent under prior law) exclusive place-of-performance apportionment under the sales method (described below) and twenty-five percent exclusive place-of-performance apportionment under the optional gross income methods (described below) (in both cases, applied after the application of the “legal requirement” rule).<sup>126</sup>

That portion of the R&D deduction that is not apportioned under either the “legal requirement” rule or the place-of-performance apportionment rule is apportioned using either the sales method or the gross income methods.<sup>127</sup> Under the sales method, an amount equal to the remaining portion of such deduction is apportioned between U.S.-source and foreign-source income

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<sup>123</sup> Treas. Reg. §§ 1.861-17(a)(2)(ii)–(iii) (1995). A two-digit code denotes the “major group” (e.g., agricultural services) and a three-digit code denotes the “industry group” (e.g., crop services), with increasing digit codes denoting increasingly detailed classifications.

<sup>124</sup> Treas. Reg. § 1.861-17(a)(4) (1995).

<sup>125</sup> Treas. Reg. § 1.861-17(b)(1) (1995).

<sup>126</sup> Treas. Reg. § 1.861-17(b)(1)(i)–(ii) (1995). A rule permitting exclusive apportionment at a higher percentage based on facts and circumstances such as very limited or long delayed application abroad may apply to the exclusive apportionment under the sales method and the optional gross income methods. *See* Treas. Reg. § 1.861-17(b)(2) (1995).

<sup>127</sup> Treas. Reg. § 1.861-17(c)–(d) (1995). The regulations provide that if the amount of sales of a licensed product is unknown (for example, when a licensed product is imbedded in or bundled with another product), a reasonable estimate based on the principles of Section 482 should be made. In the case of intangible property, “if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually.” Treas. Reg. § 1.861-17(c)(2)(iii) (1995). (Under the prior regulatory regime, the sales amount taken into account was 10 times the amount received or accrued for the intangible property during the tax year.) The taxpayer does not have to obtain permission from the IRS to change a method of apportionment that the taxpayer has used for at least five tax years. Treas. Reg. § 1.861-17(e) (1995).

based on sales.<sup>128</sup> Under the gross income methods, subject to certain conditions, the taxpayer may apportion its R&D expenditures ratably based on the ratio of foreign-source income to total gross income.<sup>129</sup> The amount of R&D expense ratably apportioned to foreign-source income must not be less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the sales method.<sup>130</sup>

Over the years, taxpayers have successfully lobbied for numerous rules, mostly elective, to reduce the allocation of interest and R&D expense to foreign-source income. For interest expense, these special rules include use of tax basis instead of fair market value to value assets and an optional gross income method.<sup>131</sup> For R&D expense, concessions from use of a pure sales method include (1) use of a gross income allocation method that does not look through to the gross income of foreign subsidiaries, (2) use of three-digit instead of two-digit SIC product categories to group gross income, (3) an increase in the percentage of R&D expenditures that may be exclusively apportioned to U.S.-source income under the sales method of apportionment from thirty percent to fifty percent, and (4) a twenty-five percent exclusive apportionment for the gross income method (as compared with none under prior regulations).<sup>132</sup> These concessions permit U.S. taxpayers to significantly under allocate interest expense and R&D expense to foreign-source income and over allocate such expenses to U.S.-source income. This both expands cross-crediting opportunities<sup>133</sup> and, as discussed in the next section of this Article, enhances the value of deferred income (and, hence, the benefits of the deferral privilege under U.S. tax law).

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<sup>128</sup> Treas. Reg. § 1.861-17(c)(1) (1995). For purposes of such apportionment, special rules exist for taking into account sales of uncontrolled and controlled parties, including foreign corporations. Treas. Reg. § 1.861-17(c)(2)–(3) (1995).

<sup>129</sup> Treas. Reg. § 1.861-17(d)(1) (1995).

<sup>130</sup> Treas. Reg. § 1.861-17(d)(2)–(3) (1995).

<sup>131</sup> See Temp. Treas. Reg. § 1.861-9T (as amended in 2006).

<sup>132</sup> Some of the changes were justified in a study performed by the U.S. Treasury Department, which was published simultaneously with the 1995 proposed changes to the research and development (R&D) expense allocation and apportionment regulations. See U.S. TREASURY DEP'T, THE RELATIONSHIP BETWEEN U.S. RESEARCH AND DEVELOPMENT AND FOREIGN INCOME (1995). The Treasury study concluded that “[r]educing allocations [of domestic R&D expense] to foreign income by about 25 percent compared to the 1977 regulations . . . would reduce the potential that the regulations are unfair to many taxpayers while being within the range of allocations that cannot be rejected in view of the uncertainty of the evidence.” *Id.* at 11. In the Treasury study’s view, this change “would imply an exclusive apportionment percentage of about 50 percent.” *Id.*

<sup>133</sup> See *infra* Section IV.

*B. The Incongruous Benefit of Deducting Expenses Allocable to Deferred Foreign-Source Income*

Under an income tax, it is generally accepted that expenses allocable to exempt income should not be allowed as deductions unless the intended result is to increase the exemption advantage by reducing the zero effective tax rate to a negative rate.<sup>134</sup> Accordingly, sound income tax theory holds that under an exemption system for avoiding double taxation, expenses allocable to exempt foreign-source income should be denied as deductions against taxable domestic-source income.<sup>135</sup> Thus, the proposal developed by the President's 2005 Advisory Panel on Tax Reform to exempt active foreign-source income would disallow domestic deductions for costs directly allocated to exempt foreign-source income and also interest (allocated under a worldwide apportionment approach) and overhead-type expenses allocated to exempt foreign-source income (without regard to the effective rate of foreign tax imposed on the foreign income).<sup>136</sup> The

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<sup>134</sup> See, e.g., I.R.C. § 265 (2009).

<sup>135</sup> See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 25; AULT & ARNOLD, *supra* note 6, at 375; Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 781 (2001); Joann Martens Weiner, *Practical Aspects of Implementing Formulary Apportionment in the European Union*, 8 FLA. TAX REV. 629, 653–54 (2007); see also BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER 48 (2d ed. 2002) (“A country that allows such expenses to be deductible . . . is providing an exemption not only for foreign-source income but also for a portion of domestic-source income.”).

To achieve a measure of simplification, some exemption system countries tax a portion of otherwise exempt foreign-source income in lieu of denying the deduction of costs allocable to such income. See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 45; Samuels, *supra* note 91.

One commentator has argued that under a properly designed exemption system, a taxpayer should be allowed a full deduction by the country of residence for expenses incurred domestically, even to the extent that those expenses contribute to the earning of the exempt foreign-source income. He claims that such a full deductibility approach fosters productivity in the home country by promoting efficient capital ownership. See James R. Hines, Jr., *Foreign Income and Domestic Deductions*, 51 NAT'L TAX J. 461 (2008). For a critique of this capital ownership neutrality theory, see Fleming & Peroni, *Exploring the Contours*, *supra* note 17, at 1572–76. Professor Hines' capital ownership neutrality argument appears indistinguishable in practical effect from the competitiveness claims made by proponents of the capital import neutrality model and suffers from the same defects as that model.

<sup>136</sup> PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note 15, at 102–105, 132–35, 239–43. There have been a number of proposals to exempt foreign business income, including one by the Staff of the Joint Committee on Taxation that was more detailed than the proposal by the President's Advisory Panel. See STAFF OF JOINT COMM. ON TAX'N, OPTIONS, *supra* note 8, at 191. The principal difference between the approach to expense allocation used by the Joint Committee Staff and the President's Advisory Panel is that the President's Advisory Panel would allocate all R&D expense to taxable income. See also Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J. 811 (2001) [hereinafter Grubert, *Enacting Dividend Exemption*].

reason for disallowing deductions allocable to exempt income is to avoid a negative effective tax rate on the foreign-source income.<sup>137</sup>

The failure under current law to defer deductions properly allocated to foreign-source income until the income is repatriated<sup>138</sup> enhances the deferral benefit by producing a worse-than-exemption negative tax rate on the deferred foreign-source income during the deferral period. For example, if the domestic tax rate is 35% and the foreign tax rate is zero, currently deducting \$100 of foreign expense against domestic-source income produces \$35 of tax savings that is effectively a \$35 negative tax on the related foreign-source income and results in \$35 of additional deferred income until repatriation occurs.

#### EXAMPLE 2

Assume that DC, a U.S. multinational corporation, has a marginal effective tax rate of 35% on its U.S.-source income and a marginal effective tax rate of 10% on its income earned in Country A by F Sub, a wholly owned Country A subsidiary. In support of F Sub's Country A operations, DC incurs \$100 of interest on U.S. borrowing and \$100 of general and administrative expense at DC's U.S. headquarters. Country A does not allow F Sub to deduct a cost reimbursement paid to DC for these expenses.

If the United States defers F Sub's income, but allows a current \$200 deduction for these expenses, the result is a benefit of \$50 (i.e., \$200 multiplied by the 25% difference in the U.S. and Country A marginal tax rates) until the income taxed at a 10% rate by Country A is repatriated. In other words, allowing the deduction creates a negative tax on (i.e., subsidizes) the exempt foreign-source income during the deferral period to the extent of the difference between the U.S. and foreign tax rates times the deduction amount for the period of the deferral.<sup>139</sup> Allowing a current deduction for interest and other costs

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<sup>137</sup> See Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-border Income*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 319, 328 (John W. Diamond & George R. Zodrow eds., 2008) [hereinafter Grubert & Altshuler, *Corporate Taxes in the World Economy*]; see also Goulder & Sheppard, *supra* note 14, at 819 (quoting statement by John Buckley, Chief Tax Counsel for the House Ways and Means Committee, that "like borrowing to carry exempt assets, you either disallow [deductions allocable to deferred income] or you have a negative tax").

<sup>138</sup> See U.S. TREASURY DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 29 (2009).

<sup>139</sup> See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 36; Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. INT'L TAX'N 486,



attributable to deferred foreign-source income cannot be justified on tax policy grounds.<sup>140</sup>

### C. *Competitiveness II*

There seems to be a general recognition that if deductions are allowed against U.S.-source income for costs that economically support the earning of deferred foreign-source income, the result can be a negative U.S. rate of tax on the foreign-source income as illustrated in Example 2 above.<sup>141</sup> Thus, the case for allocating the costs of earning foreign-source income to that income and barring their deduction against U.S.-source income would seem to be clear and convincing.<sup>142</sup>

Nevertheless, some commentators oppose these steps where the cost, though economically connected to foreign-source income, was incurred within the United States. This position is based on two arguments that initially appear to be distinct but that actually collapse into a single proposition.

The first argument is that several major commercial nations allow their resident corporations to deduct costs that support the earning of foreign-source income if the costs are incurred within the residence country. Therefore, U.S. resident corporations should not be barred from deducting such costs against their U.S.-source income because to do so would make them less competitive

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491 (2008) [hereinafter Graetz, *Multilateral Solution*] (“[A]llowing a deduction in a higher-tax country for borrowing to invest in a lower-tax country can produce after-tax returns greater than the investment’s pre-tax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments clearly will decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.” (footnote omitted)).

<sup>140</sup> See Graetz, *Multilateral Solution*, *supra* note 139, at 491 (“Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy . . . would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place.”)

<sup>141</sup> See generally STAFF OF JOINT COMM. ON TAX’N, OPTIONS, *supra* note 8, at 190; PRESIDENT’S ADVISORY PANEL ON TAX REFORM, *supra* note 15, at 123, 241; Dilworth, *supra* note 13, at 92; Samuels, *supra* note 91, at 1594; Martin A. Sullivan, *Obama Chooses a Clumsy Way to Limit Deferral*, 123 TAX NOTES 1163, 1164 (2009) [hereinafter Sullivan, *Clumsy Way*]; Goulder & Sheppard, *supra* note 14, at 819.

<sup>142</sup> Opponents of expense allocation have argued that if the United States adopted expense allocation rules without a full repeal of deferral, there would be undesirable distortions and disparate effects. See Samuels, *supra* note 91, at 1595–97; Sullivan, *Clumsy Way*, *supra* note 141, at 1164–65. That is a matter outside the scope of this Article but if the critics are correct, their argument is an additional reason for repealing deferral.

in foreign markets.<sup>143</sup> This is, of course, nothing more than a reiteration of the competitiveness argument that is regularly made in behalf of deferral and that fails for the reasons given above in Section I.E.

Closely related is the argument that if the costs incurred in the United States are allocated to deferred foreign-source income and made deductible only against that income, it is highly likely that the relevant foreign countries will reject the U.S. position and will not allow the allocated expenses to be deducted for purposes of computing source-country tax on the foreign-source income. Thus, there will be no current deduction in either the United States or the foreign country for the affected costs in spite of the fact that the costs have actually been incurred.<sup>144</sup>

In other words, U.S. opponents of cost allocation implicitly insist that tax competition will not force foreign countries to respect the U.S. allocation and that the inability of U.S. multinationals to currently deduct the allocated costs in the respective foreign countries will render these multinationals less competitive in foreign markets.<sup>145</sup> We are not convinced that all source countries are so resistant to tax competition but even if they are, this line of argument is nothing more than a tailored version of the competitiveness rationale that was examined and found wanting above in Section I.E.

### III. ENHANCING THE DEFERRAL PRIVILEGE: PART TWO—AGGRESSIVE TRANSFER PRICING

The preceding discussion considered how over-allocation of deductions to domestic-source income for purposes of the foreign tax credit limitation can facilitate worse-than-exemption outcomes by creating excessive foreign tax credits and greater cross-crediting possibilities. The preceding discussion also demonstrated how the failure to suspend deductions allocable to deferred foreign-source income contributes to worse-than-exemption results by magnifying the effects of the deferral privilege. This section of the Article adds the next layer—transfer pricing. To the extent that either deductions are

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<sup>143</sup> See Samuels, *supra* note 91, at 1594–95; see also ADVISORY PANEL ON CANADA'S SYSTEM OF INTERNATIONAL TAXATION FINAL REPORT: ENHANCING CANADA'S INTERNATIONAL TAX ADVANTAGE 53 (2008), available at [http://www.apcsit-gcrctf.ca/07/cp-dc/pdf/finalReport\\_eng.pdf](http://www.apcsit-gcrctf.ca/07/cp-dc/pdf/finalReport_eng.pdf) (making the competitiveness argument to justify allowing deductions against Canadian domestic income for interest expenses that support foreign investment).

<sup>144</sup> See Sullivan, *Clumsy Way*, *supra* note 141, at 1164–65; Graetz & Oosterhuis, *supra* note 135, at 782.

<sup>145</sup> See authorities cited *supra* note 143.

not properly charged to foreign subsidiaries or income is not properly allocated to U.S. affiliates, the benefits of the deferral privilege are enhanced. This section reviews the challenges that transfer pricing presents to the government's efforts at preventing under-allocation of expenses and over-allocation of income to foreign subsidiaries when the deferral privilege provides an incentive for U.S. taxpayers to take advantage of low foreign tax rates. Example 3 illustrates the basic nature of the transfer-pricing problem.

### EXAMPLE 3

DP is a U.S. corporation with a wholly owned foreign corporate subsidiary, FS. DP makes widgets in the United States for \$5 each and they are sold by FS in its country of incorporation for \$100 each. FS's sales costs are \$2 per widget. Obviously, each widget produces \$93 of profit. If the United States has much higher taxes than FS's home country and inadequate transfer pricing controls, DP might sell each widget to FS for \$5, which means that there will be no taxable U.S. profit ( $\$5 - \$5 = 0$ ). When FS resells each widget in its country of incorporation, it will have \$93 of taxable profit ( $\$100 - (\$5 + \$2) = \$93$ ). Essentially, this pricing tactic moves the \$93 profit inherent in each widget to FS's country of incorporation, where it is taxed at the low home country rate with the U.S. residual tax on the \$93 being deferred until repatriation occurs.<sup>146</sup> Since DP and FS do not deal at

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<sup>146</sup> FS's only activity is selling DP's widgets for use or consumption in FS's country of incorporation. On these facts, none of FS's income is foreign personal holding company income, foreign base company sales income, or any other type of Subpart F income. See I.R.C. §§ 954 (c)(1)(B) (last paragraph), 954 (d)(1)(B) (2009). Thus, no U.S. tax will be incurred until a dividend is paid by FS to DP, FS engages in a Section 956 triggering act, or DP disposes of the FS stock.

Michael Durst has stated that the transfer pricing strategy in Example 3, under which the manufacturing member of a multinational group sells at cost to a selling member or members of the group, is "almost universal among multinationals." Durst, *President's Proposals*, *supra* note 58, at 748. Durst argues that this "almost universal" pricing approach is, however, driven by non-tax business strategy reasons and "has nothing to do with taxation." *Id.* His argument is rendered doubtful by studies showing that U.S. multinationals have chosen to concentrate disproportionate amounts of their profits in low-tax foreign countries. See, e.g., Martin A. Sullivan, *Obama Launches International Reform: The Battle Begins*, 123 TAX NOTES 646, 648–49 (2009) (presenting a study showing that for 2006, five low-tax countries were the source of 23.1% of all U.S. multinationals' foreign profits—even though those five countries accounted for only 3.1% of the worldwide employment of U.S. multinationals, only 6% of their tangible property, and only 15.7% of their worldwide sales); see also authorities cited *infra* note 150. But even if Durst's argument is correct regarding motivation, the result of the transfer pricing technique under which the manufacturing member of a multinational group sells at cost, without any profit, to one or more foreign selling members of the group, is to ignore the manufacturer's contribution to the group's overall profitability and, therefore, to create overstated income for the foreign selling members, which means enlarged losses to the U.S. Treasury from deferral of U.S. income tax.

arm's length and because, in an economic sense, DP owns the \$93 profit on each widget regardless of whether the profit is realized by DP or FS (because DP owns all of FS's stock), there are no economic or market constraints on DP's pricing behavior that prevent DP from freely moving the entire profit to FS's low-tax home country, or from splitting the profit arbitrarily between the two countries.

To restrain the behavior illustrated in Example 3, the United States employs a transfer pricing regime that attempts to impose the same price on the DP to FS widget sales that would have applied if DP and FS were unrelated parties that bargained at arm's length.<sup>147</sup> Given the absence of economic constraints, however, the pressure on the arm's-length standard as an enforcement device is enormous,<sup>148</sup> and this pressure is exacerbated as tax rate differentials between the United States and other countries increase.<sup>149</sup> For various reasons, unfortunately, the administration of U.S. transfer pricing rules has not measured up to the challenge. Evidence consistently shows that imprecise transfer pricing standards and weak or non-existent enforcement of those standards are contributing to significant income shifting from high-tax jurisdictions to lower-tax jurisdictions.<sup>150</sup>

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<sup>147</sup> See Treas. Reg. § 1.482-1(b)(1) (as amended in 2006).

<sup>148</sup> For critiques of the use of the arm's-length standard as the basis for formulating rules governing the allocation of the taxable income of multinational enterprises among different countries, see Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995); Avi-Yonah, *Proposal for Simplification*, *supra* note 49, at 1339–52; Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008) [hereinafter Brauner, *Valuation of Intangibles*]; Durst, *President's Proposals*, *supra* note 58, at 752 (asserting that the current U.S. arm's-length transfer pricing rules “doom the system to unenforceability and unadministrability”); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 669–70 (1986); Brian Lebowitz, *Profit Sharing as a New World Order in International Taxation*, 52 TAX NOTES INT'L 585 (2008); Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 344–55 (1992).

<sup>149</sup> See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 18 (stating that “deferral places tremendous pressure on the determination of transfer prices under [S]ection 482, because the greater the amount of income that can be deferred offshore in a low-tax country, the greater the aggregate benefit of deferral to the taxpayer”); Ilan Benshalom, *Sourcing the “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 646–47 (2007) (“[The] characteristics [of arm's length transfer pricing] render futile the attempt of the transfer pricing rules to determine the reasonable price at which affiliated transactions would have been valued if made with unrelated parties.”).

<sup>150</sup> See, e.g., GOV'T ACCOUNTABILITY OFFICE, U.S. MULTINATIONAL CORPORATIONS: EFFECTIVE TAX RATES ARE CORRELATED WITH WHERE INCOME IS REPORTED 4 (2008) (“Differences in tax rates across countries appear to influence how much income corporations report earning in particular countries, relative to the amount of other activity in those locations.”); STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 32–34; (discussing the “[e]mpirical evidence indicating that U.S. multinationals

A. *The Magnified Challenge of the Arm's-Length Standard with Respect to Intangible Property*

The problems just mentioned have been magnified by the dramatic increase in the commercial importance of intangible property rights, such as patents, know-how, and trademarks, making it more difficult for governments to employ the separate transaction, arm's-length transfer pricing method.<sup>151</sup> This is because intangible property rights inherently exclude unlicensed third parties from using the protected invention, brand mark, or logo, and the conventional view, although evolving, is that a highly valuable intangible right will not be shared with third parties through licensing.<sup>152</sup> This factor, plus the unique nature of intangibles, often means that the independent comparable transactions that are essential to the effective application of the arm's-length standard are non-existent, thus giving taxpayers substantial latitude to determine how the return on a particular intangible will be divided among related parties.

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continue to shift income to low-tax foreign jurisdictions"); U.S. TREASURY DEP'T, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 56–61 (2007) [hereinafter U.S. TREAS. DEP'T, TRANSFER PRICING REP.] (discussing evidence that correlates reductions in foreign effective tax rates of CFCs with income shifting from high nominal tax rate countries to low-tax rate countries); MICHAEL McDONALD, U.S. TREAS. DEP'T., INCOME SHIFTING FROM TRANSFER PRICING: FURTHER EVIDENCE FROM TAX RETURN DATA: OTA TECHNICAL WORKING PAPER NO. 2, at 35 (2008); SHAVIRO, DECODING, *supra* note 6, at 106 ("U.S. tax authorities often have a tough time challenging reported intercompany transfer prices . . ."). This income shifting to low-tax foreign jurisdictions through aggressive transfer pricing "is equivalent to increasing the pre-tax return to the offshore investment [in the low-tax countries]," thus increasing the benefit of deferral and "magnifying the distortion of investment choice" occasioned by deferral. STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 18. Thus, as noted by one commentator, the U.S. transfer pricing regime "creates an incentive to invest abroad and particularly to invest extensively in intangibles . . ." Brauner, *Valuation of Intangibles*, *supra* note 148, at 83. Tax rate differentials also encourage low-taxed foreign parent corporations to transfer profits from U.S. subsidiaries to themselves through aggressive transfer pricing. See generally Michael Overesch, *The Effects of Multinationals' Profit Shifting Activities on Real Investments*, 62 NAT'L TAX J. 5, 20 (2009) ("We can conclude that multinationals gain significant competitive advantages by means of shifting profits if the parent company is located in a lower taxing home country.") This Article, however, focuses on the effects of aggressive transfer pricing when practiced by U.S. resident corporations, i.e., on outbound transfer pricing.

<sup>151</sup> See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 34–35; Brauner, *Valuation of Intangibles*, *supra* note 148, at 156. As stated by Professor Reuven Avi-Yonah: "[I]nformed observers agree that the allocation of income from intangibles is the most important problem in transfer pricing . . ." Reuven S. Avi-Yonah, *Xilinx and the Arm's-Length Standard*, 123 TAX NOTES 1231, 1231 (2009) [hereinafter Avi-Yonah, *Arm's Length*].

<sup>152</sup> There is increased anecdotal evidence in recent years of the licensing of high value intangibles. See, e.g., *Health Care Brief-AstraZeneca PLC: Deal With AtheroGenics Gives Rights to Cardiovascular Drug*, WALL ST. J., Dec. 23, 2005, at B4 (discussing AstraZeneca licensing rights to atherosclerosis medication in late-stage trials for a \$50 million up-front payment and up to \$1 billion if milestones are met).

Intangible property, while not passive when used in a business, nonetheless is particularly mobile property. Moreover, international legal protections for intellectual property have substantially improved in recent decades so that it is feasible as a commercial and legal matter to transfer legal ownership of intangibles to corporations organized in a wide range of countries. Tax law facilitates these transfers through well-developed rules that allow the tax ownership of intangible property to be divorced from legal ownership. These economic and legal features of intangible property make it possible to locate intangible property in low-tax countries within a taxpayer group to earn low-taxed income without materially sacrificing the legal protections and value of the intangible property in question.<sup>153</sup> Indeed, the advent of business restructurings to capitalize on tax and other advantages from shifting functions and locating income in low-tax jurisdictions has attracted the attention of the OECD Committee on Fiscal Affairs and triggered new legislation in Germany.<sup>154</sup>

The fundamental difficulty with administering transfer pricing rules where comparable third-party transactions are unavailable or inexact lies in: (1) the operational flexibility available to a multinational corporate group in planning and executing a transfer pricing strategy, (2) the necessary flexibility of the transfer pricing rules to allow taxpayers to structure their affairs<sup>155</sup> (as well as an arguably excessive electivity of methods), and (3) the information asymmetry and procedural imbalances described below that distort the resolution of transfer pricing controversies.

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<sup>153</sup> See Brauner, *Valuation of Intangibles*, *supra* note 148, at 121 (“[T]he regulations leave the important valuation aspects of intangibles for transfer pricing purposes completely exposed to abuse by taxpayers and their advisors.”).

<sup>154</sup> See ORG. FOR ECON. CO-OPERATION & DEV., TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS: DISCUSSION DRAFT FOR PUBLIC COMMENT (2008); see also Karen E.M. Beck, *Business Restructurings in Germany*, 51 TAX NOTES INT’L 271 (2008).

<sup>155</sup> The Section 482 regulations adopt a taxpayer-generous arm’s-length range rule that treats results within a defined range as “arm’s length” and not subject to adjustment. See Treas. Reg. § 1.482-1(e) (as amended in 2006). This rule “creates an embedded inaccuracy and an advantage to taxpayers.” Brauner, *Valuation of Intangibles*, *supra* note 148, at 159. Thus, the arm’s-length standard under the regulations as applied in practice “leaves substantial room for tax incentives to affect pricing.” STAFF OF JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES, *supra* note 18, at 35. This is only one element of the regulations’ flexibility. Indeed, as noted by one commentator: “[A]t each decision level the law permits almost frictionless flexibility to taxpayers. This flexibility . . . results in significant deviations from the desired accurate result that our transfer pricing rules purport to target.” Brauner, *Valuation of Intangibles*, *supra*, at 157.

Cost sharing for intangible property is one example of where these factors inappropriately favor taxpayers.<sup>156</sup> Treasury regulations have allowed related parties to share the development costs of intangibles since the 1960s. A primary argument made for such cost sharing is that it reduces uncertainty in transfer pricing. Cost sharing is used by taxpayers to increase the future profit that can be allocated to the cost sharer by reason of its deemed joint ownership of the intangible. In many cases, the cost sharer is an affiliate located in a jurisdiction that imposes income tax at a rate substantially lower than that faced by the developer of the intangible. In such a case, cost sharing represents a “bet” that loss from the lower value of deductions for the cost-sharing payments borne by the low-taxed affiliate will be less, on a present value basis, than the savings from earning future intangible income in the lower tax jurisdiction.<sup>157</sup>

In practice, several aspects of cost sharing are problematic and non-arm’s length:

- (1) Cost sharing is elective to the taxpayer—this implicitly permits a substantial degree of “cherry-picking” of intangibles to be cost shared;
- (2) As with all related party transactions, information asymmetry favors the taxpayer and allows it to price favorably the “buy-in” amounts paid for pre-existing intangibles and “platform contributions” and to frame the documentation and supporting “data” in such a way as to reduce its apparent exposure to audit adjustment and penalties;<sup>158</sup> and
- (3) Parties to cost sharing agreements may include affiliates whose interest is purely financial, as distinguished from the interest of a developer or user of the intangible.

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<sup>156</sup> Avi-Yonah, *Arm’s Length*, *supra* note 151, at 1231 (“[C]ost sharing . . . is the principal way in which profits from intangibles get shifted from the United States to low-tax jurisdictions.”); *id.* at 1233 (“Taxpayers have used cost sharing to transfer the majority of their intangible assets overseas without having to do any real research and development outside the United States. Those intangibles then generate income that is eligible for deferral . . .”).

<sup>157</sup> *Id.* at 1233 (“[T]axpayers whose costs are \$1 million to develop a patent worth \$1 billion are happy to risk losing \$800,000 [of deductions] to an 80/20 cost-sharing agreement with an Irish affiliate if they could avoid current U.S. tax on \$800 million when the research succeeds.”).

<sup>158</sup> See U.S. TREAS. DEP’T, TRANSFER PRICING REP., *supra* note 150, at 48–50. Recent temporary regulations attempt to achieve more complete recognition of and compensation for pre-existing contributions of parties to a cost sharing arrangement. See Temp. Treas. Reg. § 1.482-7T (adopted in T.D. 9441, 2009-1 C.B. 460).

In addition, intercompany services with embedded intangibles present opportunities for hiding the issues of intangible pricing and valuation of intangibles from tax administrators.<sup>159</sup>

*B. Information Asymmetry and the Limits on Enforcement of Any Transfer Pricing Regime*

At the heart of the problem facing government transfer-pricing administrators is the reality that the taxpayer possesses the facts necessary to evaluate the transfer pricing decision.<sup>160</sup> This problem is particularly acute for income from intangible property and unique services. In this context, the effects of practical hurdles to government enforcement are magnified and operate to considerable taxpayer advantage.

Most often, a government trying to evaluate a taxpayer's transfer pricing decision faces a steep information asymmetry.<sup>161</sup> Taxpayers need not routinely disclose relevant facts on either their tax returns or consolidated financial statements.<sup>162</sup> Accordingly, it can be difficult for the IRS to consistently identify potential transfer pricing audit issues.

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<sup>159</sup> U.S. TREAS. DEP'T, TRANSFER PRICING REP., *supra* note 150, at 50–51. While the Treasury has identified these and other issues as allowing scope for income shifting and has documented that income shifting is occurring, the Treasury's remedies have been limited to proposing changes to the rules in the transfer pricing regulations and increasing audit scrutiny of intangibles migration transactions. The IRS has made transfers of intangibles and cost sharing buy-ins a Tier 1 audit issue. See IRS, LMSB DIVISION, TIER I: IRC 482 COST SHARING ARRANGEMENTS WITH BUY-IN PAYMENTS: QUICK REFERENCE GUIDE (2008), available at <http://www.irs.gov/pub/irs-utl/quickref482.pdf>.

<sup>160</sup> See Brauner, *Valuation of Intangibles*, *supra* note 148, at 158–59 (“The system is designed so that taxpayers who take transfer pricing seriously have the advantage of setting the rules of the game and the facts [are] presented in the way they want them to be presented.”).

<sup>161</sup> See Benshalom, *supra* note 149, at 647. The problem of information asymmetry is especially acute in the case of the allocation and apportionment of expenses. It is extremely difficult for the government to readily identify how expenses should be allocated to a category of income or activity. The information asymmetry problem is also acute with respect to IRS efforts to police tax shelters. See David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 337 (2006).

<sup>162</sup> There is required reporting of related party amounts under Section 6038, but these reports do not highlight when the pricing may be inconsistent with the arm's-length standard. Although many taxpayers with large intercompany payments prepare Section 6662 transfer pricing documentation in order to reduce their penalty exposure, this documentation is designed to demonstrate the reasonableness of the taxpayer's method without highlighting major exposures. It remains unclear whether and how the relatively new financial accounting standard known as “FIN 48” (Financial Accounting Standards Board (FASB) Interpretation No. 48 of FASB Statement No. 109) will affect this calculus. For a sampling of the commentary on FIN 48 and its anticipated effects on tax compliance, see Robert H. Aland, Edward W. Trott, Marilyn K. Gerdes, Matthew D. Lerner, C. Chester Abell, Jr. & Robert D. Adams, *FIN 48: Impact on Federal Tax Audits and Litigation*, 86 TAXES 241 (Mar. 2008); Jennifer Blouin, Cristi Gleason, Lillian Mills & Stephanie Sikes, *What Can We Learn About Uncertain Tax Benefits from FIN 48?*, 60 NAT'L TAX J. 521 (2007); Michael J. Donohue & Mark R.



Moreover, if the government does perform a transfer-pricing audit, it must ask the right questions in order to elicit information relevant to the transfer pricing analysis. The government's agents must learn enough about the business and its economics to determine when income and profit margins are out of line. Well-advised and disciplined taxpayers prepare their cases as soon as the audit starts (in addition to prior planning for these issues) and know where the sensitive points are. While a taxpayer must answer an information document request (IDR) truthfully and fully, the taxpayer has no obligation to direct the government to the right question or data absent an IDR. Even for large corporate taxpayers subject to continuous audit, there is a material risk of non-detection of a broad range of inappropriate transfer pricing.<sup>163</sup>

Even if the position taken by an IRS transfer pricing auditor has sufficient merit to support an adjustment of the tax liability, it is frequently the case that the taxpayer can persuade a higher-level IRS reviewer (e.g., an IRS appellate conferee or trial counsel) that the factual and complex nature of the case creates sufficient "hazards of litigation" that the government should accept a taxpayer-favorable settlement, even though the taxpayer has the formal burden of proving both that the government's proposed Section 482 allocation is unreasonable and that the taxpayer's allocation is reasonable. The pressure on the government to compromise is exacerbated by the time and expense required to try a significant transfer pricing case.

Thus, settlements are common in which the government collects less (often substantially less) than one hundred percent of the tax deficiency that was initially proposed by the IRS. Moreover, it is difficult for the IRS to apply a transfer-pricing penalty in the context of a settlement. Even when the IRS prevails at trial, imposing a penalty is problematic unless the taxpayer's conduct was egregious. While there are (relatively rare) transfer-pricing controversies in which penalties are applied, the penalty structure generally is not sufficient to create a significant taxpayer disincentive to taking full

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Martin, *FIN 48 and Transfer Pricing*, 48 TAX MGMT. MEMORANDUM 411 (2007); Darren J. Mills & Kaitlyn M. Bruno, *FIN 48: Where Are We Now and Other Issues to Consider*, 85 TAXES 53 (Aug. 2007).

<sup>163</sup> In addition, when the IRS does propose an adjustment, it is often so excessive that the government suffers a damaging loss of credibility with the trier of fact (whether an IRS appellate conferee or a judge). The taxpayer advantages described in the text are present in other tax controversies as well. What distinguishes transfer-pricing controversies, however, are the factual nature of the issues and the large amounts of potential tax liabilities often at stake.

advantage of the difficulties in enforcement described above (and it is unlikely that such a penalty system could be adopted).<sup>164</sup>

These features of the transfer pricing system make it rational for a taxpayer to take transfer pricing positions that are aggressive (i.e., that push the boundaries of acceptable transfer pricing results),<sup>165</sup> yet within the range of acceptability under the current rules.<sup>166</sup> Failing to do so leaves a tax decision maker open to criticism. How far a taxpayer goes is largely a function of its appetite for tax risk and whether the taxpayer (in particular, a public corporation) can persuade its auditors that either it is not necessary to establish a tax reserve for transfer pricing issues or that a modest reserve is sufficient. None of the preceding discussion is intended to refer to tax positions that are not fully justified from a legal and ethical perspective. Indeed, that is the point—under current law, aggressive transfer pricing positions are often both legally and ethically permissible.

The conclusion to be derived from the preceding analysis of the procedural limitations on the government's ability to enforce transfer-pricing rules, particularly when applied to intangible property, is that the taxpayer has a fundamental and systemic advantage over the government in applying the transfer-pricing regime.<sup>167</sup> Thus, while it is indeed important to improve substantive transfer-pricing rules, it is unrealistic to believe that this alone will bring about robust transfer-pricing compliance and help ensure that the effective tax rate on U.S. taxpayers' foreign-source income under the current international tax rules is not a *negative* amount. Instead, it is clear that other, more fundamental changes to the structure of the U.S. international tax rules need to be made. The most important fundamental changes would be to repeal the deferral privilege and impose current U.S. tax on the foreign-source income of foreign subsidiaries, as well as to tighten the foreign tax credit limitation. These moves would prevent aggressive transfer pricing from being used to artificially increase the amount of income from outbound investments that enjoys the benefit of a low foreign tax rate.

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<sup>164</sup> See generally Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX. REV. 241 (2007) (discussing optimal penalty structures).

<sup>165</sup> See Brauner, *Valuation of Intangibles*, *supra* note 148, at 161 (“[Taxpayers] are allowed, and have all the reason in the world, to be as close as possible to the boundaries of the range of acceptable results in each stage of the analysis. They will always choose the extreme that is most beneficial to them.”).

<sup>166</sup> See *id.* at 108 (“[T]he clear incentive created by the system is to push the envelope and reach the price that is most aggressive, yet still within the very wide margin of reasonability.”).

<sup>167</sup> See *id.* at 157–59.

### C. *Formulary Apportionment Is Not a Panacea*

An alternative to the current arm's-length separate transaction method is a formulary apportionment regime—a method that uses a formula based on inputs such as property, wages, and sales to determine how a multinational corporate group's income is split between the United States and various foreign countries. Substituting formulary apportionment for the current system will not, however, be a panacea for the above-described pressures on transfer pricing. This is principally because income allocated under a formulary apportionment method by the United States to a second taxing jurisdiction likely will be exempted from taxation by the United States as is the case under U.S. state formulary apportionment regimes. Moreover, the present tax rate differentials between countries resulting from tax competition likely will continue to exist. Under those conditions, the taxpayer advantages described above will allow taxpayers to engage in income shifting to the same or a greater extent than under the arm's-length separate transaction method by manipulating the formulary apportionment factors.<sup>168</sup>

To illustrate this point, consider the following Example 4, which is a variation of Example 3.

#### EXAMPLE 4

The DP-FS corporate group consists of DP, a U.S. corporation, and FS, its wholly owned foreign corporate subsidiary, which is resident in Tropicana, a low-tax foreign country. Assume that the United States has replaced its arm's-length transfer pricing system with a formulary apportionment approach that utilizes three equally weighted apportionment factors—sales revenue (assigned in accordance with the location of the buyers),<sup>169</sup> payroll (assigned in accordance with the location of the workers),<sup>170</sup> and assets (assigned

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<sup>168</sup> It is possible that under formulary apportionment methods, income (particularly from intangibles) would be allocated away from low-tax countries where little economic activity involving property, payroll, or sales takes place. That will depend, of course, on the specifics of the rules adopted. Experiences of U.S. states suggest that these rules remain subject to taxpayer manipulation. Moreover, if income is allocated under unilateral U.S. rules to higher-tax foreign countries, it could encourage such countries to adopt rules that would allow them to tax such income.

<sup>169</sup> This is the way that sales revenue is usually allocated under the formulary apportionment systems used by the states of the United States. See Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 207 (2008).

<sup>170</sup> See ARNOLD & MCINTYRE, *supra* note 135, at 78.

in accordance with the location of production assets).<sup>171</sup> Income allocated to a foreign country under this formula is not taxed by the United States.<sup>172</sup> DP makes widgets in the United States at a cost of \$50 each and sells 100 percent of them to FS. FS sells these widgets for \$100 each in Tropicana. FS's sales cost is \$2 per widget. Obviously, every widget manufactured by DP produces \$48 of profit (\$100 - \$50 - \$2 = \$48).

Because all of the widget sales are made to Tropicana buyers, the sales factor in the three-factor U.S. formula will effectively allocate one-third of the \$48 profit per widget to Tropicana.<sup>173</sup> This means that \$16 of profit inherent in each widget that is sold to FS for resale into the Tropicana market will be allocated to low-tax Tropicana and will be free of U.S. income tax regardless of the small economic contribution of FS's sales activity to the overall profit.<sup>174</sup> The same exemption from U.S. tax will be obtained with respect to each widget that is sold to FS for resale into other foreign countries. Moreover, DP will also have a strong incentive to avoid U.S. tax by finding a truly independent Tropicana reseller through which to route sales back into the United States. Of course, the United States may attempt to assert taxing jurisdiction over the profits on sales into the U.S. market by an independent reseller, but such jurisdiction cannot be effectively exercised under prevailing U.S. law if the Tropicana reseller's U.S. activities are limited to delivering widgets to a U.S. location.<sup>175</sup>

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<sup>171</sup> See *id.* Thus, the portion of the total net income of the DP/FS group that would be allocated to Tropicana would be determined by the following formula: (Tropicana sales/Total DP-FS sales × DP-FS income/3) + (Tropicana assets/Total DP-FS assets × DP-FS income/3) + (Tropicana payroll/Total DP-FS payroll × DP-FS income/3).

<sup>172</sup> See KIMBERLY A. CLAUSING & REUVEN S. AVI-YONAH, *THE BROOKINGS INST., REFORMING CORPORATE TAXATION IN A GLOBAL ECONOMY: A PROPOSAL TO ADOPT FORMULARY APPORTIONMENT 12* (2007), available at [http://www.brookings.edu/papers/2007/06corporatetaxes\\_clausing.aspx](http://www.brookings.edu/papers/2007/06corporatetaxes_clausing.aspx). Thus, the typical formulary apportionment system is actually a type of exemption or territorial regime that uses an allocation formula, instead of source rules, to identify exempt foreign income. For discussions of the deficiencies of exemption or territorial regimes, see the authorities cited *supra* note 17.

<sup>173</sup> See *supra* note 171.

<sup>174</sup> Measured on a cost-of-inputs basis, the FS sales activity accounts for only 3.8% (2/52) of the \$48 per widget profit.

<sup>175</sup> If Tropicana has a typical bilateral income tax treaty with the United States, the United States cannot tax the reseller's profits on these facts because the reseller will not have a U.S. permanent establishment. See U.S. TREASURY DEP'T, *UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006*, art. VII, available at <https://treas.gov/offices/taxpolicy/library/model006.pdf>. If Tropicana is a non-treaty country, the result should be the same because the reseller will not be carrying on a trade or business within the United States. See generally Treas. Reg. § 1.864-4(b), ex. 3 (as amended in 2005).

At the end of the day, it is quite likely that the U.S. formulary apportionment scheme described in Example 4 will cause the one-third of the DP/FS widget profit assigned to the sales factor to be allocated entirely to Tropicana (and not taxed by the United States).<sup>176</sup> Moreover, DP will have a powerful incentive to relocate the widget factory and the related payroll to Tropicana. If this relocation occurs, the other two-thirds of the profit inherent in each widget, or most of it, will also be allocated to Tropicana and not taxed by the United States.<sup>177</sup> Finally, these allocations of profit to Tropicana will occur even if Tropicana imposes a very low income tax. Thus, formulary apportionment, like territorial taxation, results in residence countries surrendering taxing jurisdiction to source countries that then attract investment away from the residence countries by forgoing use of the taxing jurisdiction that was surrendered to them by the residence countries.<sup>178</sup>

This example illustrates that because formulary apportionment is subject to manipulation and has incentives that distort taxpayer decisions, it is not a particularly attractive cure for the ills of the arm's-length transfer pricing system. As we have argued in other works, a much better cure with respect to outbound transactions is to repeal deferral of U.S. tax on income earned through U.S.-controlled foreign corporations.<sup>179</sup>

Finally, no precedent exists for employing formulary apportionment in a system with worldwide taxation and a foreign tax credit.<sup>180</sup> In order for a formulary apportionment regime to work in the context of a foreign tax credit, the two taxing jurisdictions would have to coordinate their income allocation formulas so that the income apportioned by the residence state to the other

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<sup>176</sup> One recent formulary apportionment proposal would rely exclusively on the sales factor to allocate income between the United States and Tropicana. See CLAUSING & AVI-YONAH, *supra* note 172, at 12. If this single-factor approach were not remediated, one hundred percent of the profit inherent in each widget would be allocated to Tropicana regardless of the fact that production occurred entirely in the United States.

<sup>177</sup> A recent formulary apportionment proposal would prevent this result by relying exclusively on the sales factor to allocate income between the United States and Tropicana. For a brief evaluation of this approach, see *supra* note 176.

<sup>178</sup> See authorities cited *supra* note 17.

<sup>179</sup> See Peroni, *Back to the Future*, *supra* note 6, at 986–94; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 17, at 508–14; see also Fleming, Peroni & Shay, *Consider Ending It*, *supra* note 22, at 837–38. Two proponents of a properly designed exemption system, Grubert and Altshuler, admit that adoption of a burden neutral worldwide system (which would include a repeal of the deferral privilege) “promises broader benefits” than adoption of a dividend exemption system so long as it is accompanied by a cut in the corporate tax rate to twenty-eight percent and an elimination of expense allocations. See Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 352.

<sup>180</sup> For a brief discussion of this possibility, see Peroni, *Back to the Future*, *supra* note 6, at 1002–03.

(i.e., source) state bears substantial resemblance to the income actually subject to tax in the other state.<sup>181</sup> Otherwise there will be substantial risk of highly distortive double taxation and double non-taxation in everyday business transactions that are handled adequately, if not perfectly, under the arm's-length separate transaction method that is the subject of the international consensus described above. In today's world, the likelihood of achieving the necessary coordination seems remote.

It might be possible to develop a new international transfer-pricing consensus around a common formulary apportionment method that could be adopted on a global basis and the preceding issues surmounted. Such a process, however, likely would take a decade or more and success would be uncertain at best.

#### *D. The Deferral Privilege Is Enhanced by Aggressive Transfer Pricing*

The policy implication of the preceding analysis is that, in the face of the inherent inability of governments to effectively monitor and enforce any transfer-pricing regime and the unlikelihood that formulary apportionment can be an effective alternative, it is important that there be legislative reform that places structural limits on the ability of taxpayers to take advantage of effective tax rate differentials through aggressive transfer-pricing strategies. The most obvious reforms are (1) to repeal the deferral privilege and impose a current U.S. tax on the foreign-source income of foreign subsidiaries, and (2) to tighten the foreign tax credit limitation to reduce cross-crediting opportunities for U.S. taxpayers. Such reform measures would dramatically reduce the effectiveness of aggressive transfer pricing and thereby lessen the importance of the inherent limits to transfer-pricing enforcement.<sup>182</sup> By contrast, under the current system, aggressive transfer pricing is encouraged because it enhances the likelihood of worse-than-exemption outcomes by magnifying the deferral privilege and the opportunities for taxpayers and their advisers to obtain negative effective tax rates on deferred foreign-source income.

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<sup>181</sup> *Id.* at 1003.

<sup>182</sup> See also Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 337 ("Burden neutral worldwide taxation removes all incentives for income shifting by US companies abroad except for any possible role of continuing excess credit positions."); McDaniel, *Territorial vs Worldwide*, *supra* note 6, at 293 (concluding that a properly designed worldwide system could reduce the pressure on the transfer pricing rules).

#### IV. OVERLY GENEROUS CROSS-CREDITING: ELIMINATING THE SHRUNKEN RESIDUAL TAX AND ACHIEVING A NEGATIVE TAX RATE

##### A. *The Basic Effects of Cross-Crediting*

As discussed above, the United States grants U.S. citizens, resident aliens, and domestic corporations a foreign tax credit<sup>183</sup> in order to mitigate international double taxation<sup>184</sup>. The foreign tax credit is in the form of a dollar-for-dollar offset of qualifying foreign taxes (so-called creditable taxes) against the taxpayer's pre-credit U.S. tax liability, but it has long been subject to various types of limitations. Under the overall limitation in Section 904(a), the taxpayer's foreign tax credit for the year is limited to the taxpayer's pre-foreign tax credit U.S. tax liability on the taxpayer's foreign-source taxable income (i.e., foreign-source gross income minus the allowable deductions that are allocable and apportionable to such income, as discussed earlier in this Article<sup>185</sup>). The purpose of the overall limitation is to protect the U.S. tax base from erosion by preventing the foreign tax credit from offsetting U.S. tax liability on U.S.-source taxable income.<sup>186</sup> Section 904(d) of current law separates this overall limitation into two categories, or "baskets," which prevent the excess foreign tax credits from one basket of foreign-source taxable income from being offset (cross credited) against the U.S. residual tax liability on low-taxed foreign-source taxable income in the other basket.<sup>187</sup> Note, however, that this basket limitation system allows a taxpayer to freely

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<sup>183</sup> See I.R.C. §§ 901–903 (2009).

<sup>184</sup> See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 3, at 277; ELISABETH A. OWENS, THE FOREIGN TAX CREDIT 2–3 (1961).

<sup>185</sup> See *supra* text accompanying notes 106–107.

<sup>186</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 3–4, 18; U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 63, at 45; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 372; OWENS, *supra* note 184, at 198. The foreign tax credit limitations in Section 904, including the overall limitation, conflict with a strict application of efficiency objectives because these limitations may discourage U.S. persons from investing in high-tax foreign countries. Stated differently, an unlimited foreign tax credit would more completely implement the economic efficiency model of capital export neutrality. See, e.g., U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 18; Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 12, 27–28 (Assaf Razin & Joel Slemrod eds., 1990). However, concern with preservation of the U.S. tax base from inappropriate erosion overrides these efficiency objectives, see *supra* note 6, and, accordingly, Congress has imposed some form of limitation on the foreign tax credit since 1921. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60.

<sup>187</sup> See 2 BITTKER & EUSTICE, *supra* note 32, at ¶¶ 15.21[3]–[4]; 3 BITTKER & LOKKEN, *supra* note 36, at ¶ 72.7; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 34, 377–87; 2 ISENBERGH, *supra* note 31, at ch. 57; 1 KUNTZ & PERONI, *supra* note 36, at ¶ B4.16.

cross credit the foreign tax credits generated on high-taxed foreign-source income against the U.S. residual tax on low-taxed foreign-source income within the same limitation category or basket.<sup>188</sup>

Because the income tax system is based on transactions and the fundamental purpose of the foreign tax credit is to mitigate international double taxation, a theoretically pure foreign tax credit limitation would be applied on an item-by-item (i.e., transaction-by-transaction) basis.<sup>189</sup> An item-by-item foreign tax credit limitation would ensure that a taxpayer's foreign tax credit is limited to the actual amount of foreign income tax imposed on the taxpayer's foreign-source income and would greatly minimize, if not completely eliminate, cross-crediting opportunities under the foreign tax credit regime.<sup>190</sup> Any foreign tax credit limitation other than the per-item approach allows some degree of cross-crediting, which reduces the residual U.S. tax on low-taxed, foreign-source income falling within the same limitation category and in effect subsidizes a U.S. taxpayer's business and investment activities in low-tax foreign countries.<sup>191</sup> Congress has not adopted a per-item approach,

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<sup>188</sup> See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 18; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 373–75, 383–85; MYRON S. SCHOLÉS, MARK A. WOLFSON, MERLE ERICKSON, EDWARD L. MAYDEW & TERRY SHEVLIN, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 318–22 (3d ed. 2005); Ault & Bradford, *supra* note 186, at 18. Proponents of cross-crediting typically argue that the U.S. tax system should allow liberal cross-crediting because such cross-crediting enhances the competitiveness of U.S. multinational corporations in the global economy. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 22; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 375–76; 1 NAT'L FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME TAX PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY—PART TWO: RELIEF OF INTERNATIONAL DOUBLE TAXATION 301–09 (2001), available at [http://www.nftc.org/default/tax/fip/NFTC1a%20Part%20Volume1\\_part2Chap1-5.pdf](http://www.nftc.org/default/tax/fip/NFTC1a%20Part%20Volume1_part2Chap1-5.pdf). Typically, however, there is little or no empirical data offered in support of such an argument. See also *supra* Section I.E. of this Article.

<sup>189</sup> See, e.g., U.S. TREASURY DEP'T, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 386 (1985) [hereinafter U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS], available at <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/pres85index.shtml> (“Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income.”); AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION—PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 318–21 (1987) [hereinafter ALI, INTERNATIONAL TAX STUDY]; Peroni, *Back to the Future*, *supra* note 6, at 996; see also AULT & ARNOLD, *supra* note 6, at 362; Kingson, *Foreign Tax Credit*, *supra* note 6, at 17. But see McClure & Bouma, *supra* note 91, at 1403 n.192.

<sup>190</sup> See, e.g., U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 386–88; ALI, INTERNATIONAL TAX STUDY, *supra* note 189, at 318–19.

<sup>191</sup> See, e.g., U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 386–87 (“Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.”); ALI, INTERNATIONAL TAX STUDY, *supra* note 189, at 318–19.



however, because the substantial administrative costs on both taxpayers and the government would exceed its benefits.<sup>192</sup> Instead, Congress has over the years used an overall limit, a per-country limitation, or an income category or basket limitation with varying numbers of categories or baskets. Between 1986 and 2004, a nine-basket limitation system was used. Then the American Jobs Creation Act of 2004 changed the system into the present two-basket limitation system, which became effective in 2007.<sup>193</sup> Under this system, there is a passive category income limitation basket and a general category income limitation basket, which means that unlimited cross-crediting is essentially allowed, except with respect to foreign-source income and foreign taxes falling within the passive income basket.<sup>194</sup> It should be noted that even the nine-basket system enacted as part of the Tax Reform Act of 1986<sup>195</sup> allowed a good deal of cross-crediting because the general or residual income basket of that system contained a significant majority of the foreign-source income earned by U.S. persons.<sup>196</sup>

Cross-crediting operates as a subsidy for foreign investment by allowing a U.S. person to credit foreign taxes higher than the U.S. rate on some types of foreign-source income against the U.S. residual tax on other types of low- or zero-taxed foreign-source income, which is the equivalent of the U.S. government giving the U.S. person a grant in the amount of the U.S. residual tax eliminated.<sup>197</sup> Moreover, cross-crediting enhances the benefit of the

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<sup>192</sup> See U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 388; ALI, INTERNATIONAL TAX STUDY, *supra* note 189, at 319–20; Brauner, *Crystallization*, *supra* note 4, at 286.

<sup>193</sup> Pub. L. No. 108-357, §§ 403–04, 118 Stat. 1492-97 (2004).

<sup>194</sup> See I.R.C. § 904(d)(1) (amended by the American Jobs Creation Act of 2004); see also STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 8 (stating that “the current [foreign tax credit limitation] system allows for a significant amount of cross-crediting”). For a critique of the foreign tax credit limitation changes made by the 2004 legislation, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax—What's ETI Repeal Got to Do with It?*, 104 TAX NOTES 1393, 1406 (2004) [hereinafter Fleming & Peroni, *ETI Repeal*].

<sup>195</sup> Pub. L. No. 99-514, § 1201, 100 Stat. 2085 (1986).

<sup>196</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 20 (stating that “approximately 75 percent of all foreign source income falls within the general limitation category” of former Section 904(d)(1)(I), before its amendment in 2004).

<sup>197</sup> As two of the authors of this Article discussed in an earlier publication, cross-crediting remains a serious problem notwithstanding the nominal worldwide decline in corporate tax rates. See Fleming & Peroni, *ETI Repeal*, *supra* note 194, at 1403–04; see also Simeon Djankov, Tim Ganser, Caralee McLeish, Rita Ramalho & Andrei Shleifer, *The Effect of Corporate Taxes on Investment and Entrepreneurship* (National Bureau of Economic Research, Working Paper No. 13756, 2007), available at <http://www.nber.org/confer/2007/pef07/shleifer.pdf> (graph entitled “Effective Corporate Tax Rate on Business Density” identifies approximately twenty countries with effective corporate tax rates higher than that of the United States). For a contrary view arguing that cross-crediting should probably be ignored by U.S. tax policymakers and that an

deferral privilege discussed in Section I of this Article by eliminating or reducing the U.S. residual tax on a CFC's foreign-source income when the income is eventually repatriated.<sup>198</sup> To the extent that the U.S. residual tax is eliminated, the U.S. system of worldwide taxation with deferral is converted into a "self-help" elective exemption system, which is more generous to taxpayers and economically distortive than a properly designed, non-elective exemption system for taxing foreign business income.<sup>199</sup>

These points about the effects of cross-crediting in eliminating, or at least substantially reducing, the shrunken U.S. residual tax remaining after the effects of the deferral privilege can be illustrated by returning to Example 1 presented earlier in this Article involving DC, a U.S. resident multinational corporation. In Column (3) of Table 3 below, the facts are the same as for Column (2) of Table 1, except that DC is allowed to eliminate U.S. tax on repatriated Country A income by cross crediting high foreign taxes on manufacturing income earned in Countries B and C, two developed foreign countries with income tax systems that have applicable tax rates above the top U.S. rate. In Column (4) of Table 3, the new factory is located in Country A and the United States employs an exemption (territorial) tax system for foreign-source active business income.

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overall foreign tax credit limitation should be adopted, see AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW*, *supra* note 1, at 158–62.

<sup>198</sup> See, e.g., STAFF OF JOINT COMM. ON TAX'N, *INTERNATIONAL TAX REFORM*, *supra* note 12, at 64 (“[B]ecause excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for cross-crediting (if effective foreign tax rates vary across years or across jurisdictions) by not deeming high foreign taxes to be paid until a year when the U.S. taxpayer chooses also to repatriate low-taxed foreign source income.”); James R. Hines, Jr. & R. Glenn Hubbard, *Coming Home to America: Dividend Repatriations by U.S. Multinationals*, in *TAXATION IN THE GLOBAL ECONOMY*, *supra* note 186, at 161, 178 (“[T]he combination of the credit system and deferral can diminish substantially the revenue raised by the United States from the taxation of overseas operations of U.S. multinationals.” (footnote omitted)); see also Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1270 (1981) (“[E]nding deferral without changing the overall foreign tax credit limitation might have only limited revenue impact.”).

<sup>199</sup> See HARRY GRUBERT & JOHN MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM* 12–13, 27–28, 42 (2001) [hereinafter GRUBERT & MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME*]; Peroni, *The Proper Approach*, *supra* note 22, at 1586; Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 153; see also U.S. TREASURY DEP'T, *APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY* 57 (2007) (describing how the current U.S. international tax system allows U.S. multinational corporations to engage in “self-help territoriality”).

Table 3

	<u>Column (3)</u> Same as Column (2) of Table 1, But with Cross-Crediting	<u>Column (4)</u> Country A Location, U.S. Exemption System
Year 1 Net Profit	\$2,000,000	\$2,000,000
Year 1 U.S. Tax @ 35%	<u>- 0 -</u>	<u>- 0 -</u>
Invested in Year 2 @ 10%	\$2,000,000	\$2,000,000
Year 2 Return	+ 200,000	+ 200,000
Year 2 35% U.S. Tax on Year 2 Return	<u>- 0 -</u>	<u>- 0 -</u>
Distribution to DC Headquarters	\$2,200,000	\$2,200,000
Dividend Tax @ 35%	<u>- 0 -</u> <sup>200</sup>	<u>- 0 -</u> <sup>201</sup>
After-Tax Net to DC	\$2,200,000	\$2,200,000

Note that because cross-crediting eliminated the dividend tax in Column (3), Columns (3) and (4) produce identical bottom-line results. Stated differently, as mentioned earlier in this Article, loosely restrained cross-crediting—as is commonly allowed under the present U.S. system of worldwide taxation with deferral and an unrestrictive foreign tax credit limitation—effectively converts the U.S. international tax system into a poorly designed and elective exemption regime that is more generous, and economically distortive, than a traditional exemption system.

Finally, note that the difference between DC's after-tax net income in Column (1) of Table 1 and in Columns (3) and (4) of Table 3 is not merely the \$45,500 difference between Columns (1) and (2) of Table 1. Instead, it is a

<sup>200</sup> In this example, cross-crediting effectively eliminates the U.S. dividend tax.

<sup>201</sup> Under a hypothetical U.S. exemption system that follows the pattern of the exemption systems of the major trading partners of the United States, both dividend distributions from a foreign subsidiary's foreign-source active income and repatriations from a foreign branch's foreign-source active income likely would be exempt from U.S. tax. See generally Fleming & Peroni, *Exploring the Contours*, *supra* note 17.

much larger amount of \$815,500.<sup>202</sup> The explanation is quite simple. In order to make the \$700,000 Year 1 U.S. tax in Column (1) of Table 1 comparable to Year 2 amounts in Columns (3) and (4) of Table 3, the \$700,000 Year 1 tax must be “grown” for one year at 10% (we are using a 10% interest assumption) so that it becomes \$770,000<sup>203</sup> at the end of Year 2. When we add this \$770,000 amount to the \$45,500 Year 2 tax in Column (1) of Table 1, the sum is \$815,500, which equals the difference between DC’s after-tax net in Column (1) of Table 1 and in Columns (3) and (4) of Table 3. In other words, the effect of the U.S. taxing regimes in Columns (3) and (4) of Table 3 is to relieve DC’s foreign-source income from *both* the Year 1 tax and the Year 2 tax that DC would have incurred if it had built the factory in the United States.

Stated differently, the U.S. regimes of deferral with very loosely restrained cross-crediting (Column (3)) and exemption (Column (4)) provide DC with a tax incentive (i.e., subsidy) of \$815,500 over Years 1 and 2 for building the new factory in Country A instead of in the United States. This subsidy can be enjoyed in future years in different amounts depending on DC’s profits and reinvestment decisions for Year 3 and beyond, as is illustrated in Table 2 presented earlier in this Article.

*B. Export Sales Income That Is Effectively Tax-Exempt under the Current U.S. International Tax System*

Under current U.S. tax law, income from the sale of purchased inventory is treated as arising in (i.e., sourced to) the place of sale.<sup>204</sup> In addition, under the regulations<sup>205</sup> and case law,<sup>206</sup> the place of sale is treated as the place where the rights, title, and interest of the seller of the inventory passes to the buyer (often referred to as the “title passage test”). In cases where the U.S. seller is also the

<sup>202</sup> \$2,200,000 – \$1,384,500 = \$815,500.

<sup>203</sup> \$700,000 + (\$700,000 × 0.10) = \$770,000.

<sup>204</sup> See I.R.C. §§ 861(a)(6), 862(a)(6), 865(b) (2009).

<sup>205</sup> See Treas. Reg. § 1.861-7(c) (1957). The regulations, however, provide that the place where the substance of the sale occurs, instead of the place where title passes, will be treated as the place of sale if the “sales transaction is arranged in a particular manner for the primary purpose of tax avoidance.” *Id.* This “tax avoidance” exception promises more than it delivers in preventing manipulation of the inventory source rules because the government has been generally unsuccessful when litigating the application of this exception. See 3 BITTKER & LOKKEN, *supra* note 36, at 73-42, 73-43; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 90; 1 PHILIP F. POSTLEWAITE & SAMUEL A. DONALDSON, INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL 46 (4th ed. 2003). Accordingly, the title passage test essentially determines the place of sale for inventory property, with few exceptions. See, e.g., I.R.C. § 865(e)(2).

<sup>206</sup> See, e.g., A.P. Green Exp. Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960); Liggett Group, Inc. v. Comm’r, 58 T.C.M. (CCH) 1167 (1990).

manufacturer of the inventory, the income is treated as partially production/manufacturing income and partially sales income,<sup>207</sup> with the production component sourced to the location of the seller's production assets<sup>208</sup> and the sales component generally sourced under the title passage test.<sup>209</sup> The current regulations allocate the income between the production and sales functions by applying an arbitrary formula that treats 50 percent of the income from an export sale as sales income, which generally will be characterized as foreign-source income if title to the inventory is passed to the purchaser outside the United States.<sup>210</sup> Stated differently, the current export sales source rule does not attempt to actually associate the source of export sales income with the economic activity giving rise to the income.<sup>211</sup> Nor does it attempt to prevent inappropriate cross-crediting by treating income from an export sale as having a U.S. source if that income is free of foreign tax. Instead, this rule arbitrarily allows at least 50 percent of the U.S. manufacturer's income from the export sale to be treated as foreign-source income even when it bears no foreign tax and even though most of the taxpayer's economic activity giving rise to the income (the production and sale of the goods that are the subject of the export sale) may take place within the United States.<sup>212</sup>

The result is that 50 percent of the U.S. seller/exporter's income from the export sale of inventory manufactured in the United States can be treated as foreign-source income without regard to whether the U.S. seller/exporter has a sales office or sales employees abroad, without regard to whether the purchaser of the inventory is a controlled foreign corporation in which the U.S. exporter/seller owns a significant interest, and without regard to whether any

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<sup>207</sup> See I.R.C. §§ 863(b), 865(b); Treas. Reg. §§ 1.863-3(a)–(b) (as amended in 2006).

<sup>208</sup> See Treas. Reg. § 1.863-3(c)(1) (as amended in 2006).

<sup>209</sup> See I.R.C. §§ 861(a)(6), 862(a)(6), 863(b), 865(b); Treas. Reg. §§ 1.863-3(c)(2) (as amended in 2006), 1.861-7(c) (1957).

<sup>210</sup> See Treas. Reg. § 1.863-3(b)(1) (as amended in 2006). A taxpayer may instead elect to determine the amount of production income by using the so-called "independent factory or production price" if the taxpayer can establish that such an independent factory or production price exists. See Treas. Reg. § 1.863-3(b)(2) (as amended in 2006). A third, rarely used alternative allows a taxpayer to allocate the income from export sales between the production and sales function based on the taxpayer's books of account, but only if the taxpayer has received the IRS district director's advance permission and if certain other requirements in the regulations are met. See Treas. Reg. § 1.863-3(b)(3) (as amended in 2006).

<sup>211</sup> See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 31, 32 (concluding that the export sales source rule of current law "can reach results that depart significantly from the 'economic nexus' principle"); I ISENBERGH, *supra* note 31, at ¶¶ 16.5, 19.15, 19.29.

<sup>212</sup> 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 60, at 365–67; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 399.

foreign country is likely to impose any tax on the sales income.<sup>213</sup> In fact, income from export sales of inventory by a U.S. seller/exporter usually bears little or no foreign income tax,<sup>214</sup> unless the U.S. seller/exporter has a sales office, other fixed place of business, or sales employees in the foreign country of sale.<sup>215</sup> This means that if a U.S. seller/exporter manufactures inventory and sells it to a foreign customer, which may be the seller's controlled foreign corporation, and passes title to the goods abroad, the result is zero-foreign-taxed income, half of which is characterized as foreign-source sales income for foreign tax credit limitation purposes.<sup>216</sup> This result occurs even though most (or all) of the income producing activity occurred in the United States.

The export sales source rule, thus, enhances the deferral and cross-crediting defects in the current U.S. international tax rules by artificially creating foreign-source income, which is typically subject to little or no foreign taxes.<sup>217</sup> This increases a U.S. exporter's cross-crediting opportunities by increasing the numerator of the foreign tax credit limitation fraction, thereby permitting a U.S. exporter to reduce or eliminate the U.S. residual tax on export sales income by cross crediting high foreign taxes on other foreign business income (including dividends received from controlled foreign corporations operating in high-tax foreign jurisdictions) against the U.S.

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<sup>213</sup> See Treas. Reg. § 1.863-3(b)(1) (as amended in 2006).

<sup>214</sup> Most foreign countries would not tax inventory sales income merely because title to the inventory property sold passes within the country. U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 399; U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 32; ALI, INTERNATIONAL TAX STUDY, *supra* note 189, at 354. Thus, the title passage test for determining the source of the sales portion of the income from the export sale effectively allows a U.S. taxpayer to artificially create zero-taxed foreign-source sales income that expands the taxpayer's foreign tax credit limitation and increases the opportunities for cross-crediting. See 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 60, at 365; U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 350–51, 399–400; ALI, INTERNATIONAL TAX STUDY, *supra* note 189, at 354. This enhances the opportunities for worse-than-exemption results from a public policy point of view. See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 153.

<sup>215</sup> See, e.g., U.S. TREASURY DEP'T, REPORT TO THE CONGRESS ON THE SALES SOURCE RULES 1 (1993); see also 2 U.S. TREAS. DEP'T, TAX REFORM, *supra* note 60, at 365–67; see also U.S. TREAS. DEP'T, PRESIDENT'S 1985 TAX PROPOSALS, *supra* note 189, at 399.

<sup>216</sup> See, e.g., Donald J. Rousslang, *The Sales Source Rules for U.S. Exports: How Much Do They Cost?*, 62 TAX NOTES 1047 (1994) [hereinafter Rousslang, *Sales Source Rules*]. For a defense of the title passage source rule for inventory sales, which argues that the rule is really a risk of loss rule that properly reflects the economic activity generating the income, see Linda Galler, *An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property*, 52 U. PITT. L. REV. 521 (1991).

<sup>217</sup> See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 32; ALI, INTERNATIONAL TAX STUDY, *supra* note 189 at 32; Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (And Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 768–69 (2006).

residual tax on the low- or zero-taxed export sales income.<sup>218</sup> Stated differently, because of cross-crediting, a U.S. exporter may be effectively tax-exempt with respect to export sales income that is not subject to any foreign taxes.<sup>219</sup> In fact, the export sales source rule, when combined with the substantial cross-crediting opportunities in the general category income limitation basket, may create a negative effective U.S. tax rate on the foreign-source income from an export sale of inventory property under certain circumstances.<sup>220</sup> To be precise, by allowing a U.S. taxpayer to treat one-half of such export sales income as foreign-source income even though the income is not attributable to any active business in a foreign country, this rule effectively allows U.S. exporters to credit foreign taxes against U.S. income tax on what should be properly characterized as U.S.-source income, thus potentially creating a negative effective U.S. tax rate on the taxpayer's foreign-source income.<sup>221</sup> The following example illustrates the effects of the export sales source rule:

#### EXAMPLE 5

Assume that DC, a U.S. multinational corporation, has a marginal effective U.S. income tax rate of 35% and a marginal effective tax rate of 45% on its active foreign business income earned in Country C, a high-tax foreign country. During the current year, DC has total worldwide taxable income of \$1,000, \$500 of which is U.S.-source income from transactions occurring entirely within the United States. DC earns \$300 of foreign-source business income in Country C and pays income tax of \$135 to Country C. DC also produces inventory in the United States and sells the inventory to independent foreign distributors in low-tax Country A. Title to the inventory passes from DC to the foreign distributors at the time that the distributors receive the inventory in Country A. DC has \$200 of taxable income on these inventory sales during the current year. None of that income is taxed by Country A because DC has no office or fixed place of business in Country A.

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<sup>218</sup> See, e.g., U.S. TREAS. DEP'T, INTERIM REP., *supra* note 60, at 32; Peroni, *Back to the Future*, *supra* note 6, at 1007; see also U.S. TREAS. DEP'T, BACKGROUND PAPER, *supra* note 63, at 48.

<sup>219</sup> See, e.g., *International Task Force Report*, *supra* note 16, at 703-05; Kingson, *Foreign Tax Credit*, *supra* note 6, at 20-22; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 118 (2003). The effect of cross-crediting in reducing U.S. income tax is illustrated with Example 1 and Table 3 in the text above.

<sup>220</sup> See Rousslang, *Sales Source Rules*, *supra* note 216; see also U.S. TREAS. DEP'T, DEFERRAL STUDY, *supra* note 22, at 46; see also PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note 15, at 104.

<sup>221</sup> See, e.g., Lokken, *supra* note 217, at 769.

Under the current export sales source rule, DC may treat one-half (i.e., \$100) of this inventory sales income as foreign-source income even though it is not subject to tax in any foreign country and, in terms of economic connection, should properly be characterized as entirely U.S.-source income. Thus, DC has total foreign-source income of \$400—\$300 earned in Country C and \$100 artificially created by the export sales source rule with respect to transactions with Country A distributors. This latter \$100 of foreign-source income falls within the general category income limitation basket, where the high foreign taxes on DC's active foreign business income in Country C can be cross credited against the zero-foreign-taxed \$100 of export sales income to the extent permitted by the foreign tax credit limitation. DC's foreign tax credit limitation for the general category income limitation basket is \$140 (i.e.,  $\$400/\$1,000 \times \$350 = \$140$ ), so that all \$135 of the foreign taxes paid by DC can be credited in the current year. In effect, DC's total "real" foreign-source income for the current year of \$300 (excluding the \$100 of export sales income that is improperly treated as foreign-source income under current law) bears an effective U.S. tax rate of *negative* 10% because the foreign tax credit of \$135 eliminates all \$105 of U.S. tax on that \$300 of income that is properly characterized as foreign-source income and also reduces the U.S. tax on the \$100 of export sales source income that should be treated as U.S.-source income from \$35 to \$5—a \$30 reduction.

Thus, this export sales source rule, combined with a loosely restrictive foreign tax credit limitation, creates a tax result that is considerably more generous to the taxpayer than would be a properly designed exemption system.<sup>222</sup> Under a properly designed exemption system, a U.S. taxpayer's income from an export sale that is not connected with an active business in a foreign country would not qualify for exemption, and the export sales source rule of current law would lose its relevance.<sup>223</sup> Thus, such income would be subject to the full U.S. income tax and no longer be effectively tax-exempt or

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<sup>222</sup> See GRUBERT & MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME*, *supra* note 199, at 46–47; Grubert, *Enacting Dividend Exemption*, *supra* note 136, at 812; Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 343 (stating that in a dividend exemption system, "[t]he current 'sales-source' rules that provide a tax benefit for export income for companies in excess credits would no longer have any impact").

<sup>223</sup> Graetz & Oosterhuis, *supra* note 135, at 776 (concluding that "income from export sales not attributable to an active foreign business" should not be eligible for exemption under a properly designed exemption system); GRUBERT & MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME*, *supra* note 199, at 10; Grubert, *Enacting Dividend Exemption*, *supra* note 136, at 814. *But see* Lokken, *supra* note 217, at 769–70 (arguing that the current export sales source rules likely "would operate equally mischievously" under the exemption proposals by the Joint Committee Staff and President Bush's Advisory Panel on Tax Reform).



subject to a negative tax rate, as is true under the current U.S. international tax system.

*C. Possible Zero U.S. Taxation of Foreign-Source Royalties under the Current U.S. International Tax System*

Under look-through rules in Section 904(d)(3) of current law, the low- or zero-taxed foreign-source royalties received by a U.S. corporation from a subsidiary that is a controlled foreign corporation may be placed in the same general category foreign tax credit limitation basket that contains high-foreign-taxed dividends paid to the U.S. corporation by another controlled foreign corporation and other high-foreign-taxed active foreign business income.<sup>224</sup> Accordingly, through cross-crediting, the U.S. residual tax on the foreign-source royalties may be substantially reduced or even eliminated, thus making such royalties effectively tax-exempt in many situations under current law.<sup>225</sup> This is the result even though the royalties frequently bear no foreign tax at any level because the foreign subsidiary is allowed to deduct the royalties paid to its U.S. parent under the corporate tax laws of the foreign country in which it is resident and the U.S. parent is simultaneously exempted from a foreign withholding tax on the royalties under a treaty between the foreign country and the United States. This result encourages U.S. corporations to exploit intellectual property in foreign countries through controlled foreign corporations.<sup>226</sup> The following example illustrates these points:

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<sup>224</sup> See, e.g., Lokken, *supra* note 217, at 764–67.

<sup>225</sup> See STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 8 (“According to one study, almost two-thirds of royalties were sheltered by excess foreign tax credits in 2000.”); STAFF OF JOINT COMM. ON TAX'N, OPTIONS, *supra* note 8, at 188; GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME, *supra* note 199, at 35 (“In 1994, this flow of excess credit royalties reduced the U.S. tax liabilities of U.S. parents by \$2.7 billion, of which \$2.0 billion was in manufacturing.”); Graetz & Oosterhuis, *supra* note 135, at 774; Grubert, *Enacting Dividend Exemption*, *supra* note 136, at 812; Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 327 (estimating that almost two-thirds of royalty payments received by U.S. multinational corporations in 2000 were shielded by excess credits arising from dividends and that such royalty payments of \$45.1 billion “only yielded additional taxes of \$5.8 billion”); see also Chorvat, *supra* note 83, at 854 (“These [royalty] payments increase the foreign tax credit limit of the U.S. MNE [multinational enterprise] and allow any excess foreign tax credits to reduce or eliminate the U.S. tax on these payments.”).

<sup>226</sup> See Chorvat, *supra* note 83, at 854; Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 327.

## EXAMPLE 6

Assume that DC, a U.S. multinational corporation, has a marginal effective U.S. income tax rate of 35%. During the current year, DC has total worldwide taxable income of \$1,000, \$500 of which is U.S.-source income from transactions occurring entirely within the United States. DC owns all of the stock of FS1, a controlled foreign corporation operating an active manufacturing business in Country D, a high-tax foreign country. (FS1 has post-1986 foreign income taxes of \$450,000 (all of which are creditable taxes within the meaning of Sections 901 and 903) and post-1986 undistributed earnings of \$550,000, all of which arise from FS1's active foreign manufacturing business.) During the current year, FS1 pays DC a dividend of \$220, which is exempt from Country D withholding tax but which carries with it deemed foreign taxes of \$180 under Section 902 ( $\$220/\$550,000 \times \$450,000 = \$180$ ). Thus, DC's total dividend income is \$400, as grossed up by the Section 902 deemed paid taxes under Section 78 of the Code. Under the look-through rules in Section 904(d)(3), this dividend income and the associated foreign taxes fall within the general category income limitation basket, rather than the passive category income limitation basket.

DC also owns the stock of FS2, a controlled foreign corporation operating in Country E, a low-tax foreign country. Country E has entered into an income tax treaty with the United States under which royalties paid to a U.S. resident are exempt from the Country E income tax unless the royalties are attributable to a permanent establishment maintained by the U.S. resident in Country E. DC licenses a Country E patent to FS2, which FS2 uses in connection with its manufacturing business. (All of FS2's income comes from an active foreign business in Country E.) FS2 pays DC royalties of \$100 under its license for the Country E patent, which is treated as foreign-source income under Section 862(a)(4). Country E allows FS2 to deduct these royalties in computing its taxable income for purposes of the low-rate Country E business income tax. DC is exempt from Country E income tax on the royalties by reason of the Country E income tax treaty with the United States. Under the look-through rules in Section 904(d)(3), DC's royalty income falls within the general category income limitation basket, rather than the passive category income limitation basket. FS2 does not pay any dividends to DC in the current year.

Thus, for the current year, DC has total foreign-source income of \$500—\$400 of dividend income from FS1, the Country D subsidiary, and \$100 of royalty income from FS2, the Country E subsidiary—all

of which falls within the general category income limitation basket. DC's foreign tax credit limitation for the general category income limitation basket is \$175 (i.e.,  $\$500/\$1,000 \times \$350 = \$175$ ), so that \$175 of the \$180 of foreign taxes deemed paid by DC can be credited in the current year (with the remaining \$5 of foreign taxes subject to the carryback and carryforward provisions of Section 904(c)). In effect, DC is allowed to use \$140 of the \$175 foreign tax credit to eliminate the \$140 of U.S. tax on the \$400 of dividend income from FS1; then DC is allowed to cross credit excess foreign taxes of \$35 on the high-foreign-taxed Country D dividend income against the zero-foreign-taxed Country E royalty income, thus eliminating the entire \$35 of residual U.S. income tax on such income. This means that the \$100 of royalty income is completely tax-exempt, having borne no tax in either the United States or Country E, a worse-than-exemption result that is inconsistent with sound international tax policy.

In most cases, there is no need for double taxation relief for these foreign-source royalties because they bear no foreign tax for the reasons explained above. Thus, under an exemption system of the type proposed by the Joint Committee Staff and President Bush's 2005 Advisory Panel on Tax Reform, foreign-source royalties paid by a foreign subsidiary to its domestic parent corporation that are deductible abroad would be fully subject to U.S. income taxation in the hands of the domestic parent corporation.<sup>227</sup> Such royalties would not qualify for exemption under such a territorial system and the ability of U.S. taxpayers to shield foreign-source royalties from U.S. taxation through cross-crediting would be eliminated.<sup>228</sup> Consequently, the effectively tax-exempt treatment of royalties under the current U.S. international tax system is considerably more favorable to taxpayers than would be the treatment of such royalties under a properly designed exemption system.<sup>229</sup>

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<sup>227</sup> See STAFF OF JOINT COMM. ON TAX'N, OPTIONS, *supra* note 8, at 191; PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note 15, at 134; *see also* Graetz & Oosterhuis, *supra* note 135, at 774 n.4 (concluding that an exemption system should not apply to foreign-source royalties received by a U.S. corporate parent payee that are deductible by the foreign corporate payor and not subject to substantial foreign withholding taxes). However, these exemption proposals would allow a foreign tax credit for any foreign withholding taxes imposed on foreign-source royalties not eligible for exemption treatment.

<sup>228</sup> GRUBERT & MUTTI, TAXING INTERNATIONAL BUSINESS INCOME, *supra* note 199, at 36; Graetz & Oosterhuis, *supra* note 135, at 776; Grubert, *Enacting Dividend Exemption*, *supra* note 136, at 813; Grubert & Altshuler, *Corporate Taxes in the World Economy*, *supra* note 137, at 343.

<sup>229</sup> See STAFF OF JOINT COMM. ON TAX'N, OPTIONS, *supra* note 8, at 189, 195; Grubert, *Enacting Dividend Exemption*, *supra* note 136, at 815-16.

*D. Other Types of Effectively Tax-Exempt, Foreign-Source Income under Current Law*

The purpose of an exemption system is to provide residence countries with a method for discharging their obligation to mitigate double taxation of foreign-source income earned by their residents that is subject to source taxation in a foreign country but that also comes within a residence country's taxing jurisdiction.<sup>230</sup> Therefore, logic dictates that a properly designed exemption system should not apply to any foreign-source income that, like royalties, is typically subject to little or no foreign taxes.<sup>231</sup> Such income should default into the residence tax base because it is not exposed to any meaningful threat of double taxation. Examples include space and ocean income, international communications income, shipping income, and certain types of transportation income, which are treated in whole or in part as foreign-source income under the current U.S. statutory rules.<sup>232</sup> Another example is income from personal services performed by a U.S. person outside the United States<sup>233</sup> but not attributable to a fixed base in any foreign country and, therefore, unlikely to be subject to taxation by any foreign country.<sup>234</sup> Such income is often effectively exempt from U.S. income tax under the current U.S. international tax system because of the cross-crediting opportunities provided by an only loosely restrictive foreign tax credit limitation in Section 904(d).<sup>235</sup> Accordingly, the current U.S. international tax system arguably provides an inappropriately more generous tax result for taxpayers for such types of income than would obtain under a properly designed exemption system.

V. DEDUCTING FOREIGN LOSSES AGAINST U.S.-SOURCE INCOME: CLEARLY A WORSE-THAN-EXEMPTION RESULT

The general pattern under an exemption system is that only domestic business losses are deductible. Foreign business losses are treated as occurring outside the system and are, therefore, not deductible against taxable domestic-

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<sup>230</sup> See *supra* text accompanying notes 4-8.

<sup>231</sup> See, e.g., Graetz & Oosterhuis, *supra* note 135, at 776.

<sup>232</sup> See I.R.C. § 863(c)-(e) (2009).

<sup>233</sup> Such personal service income would be treated as foreign-source income under the place-of-performance rule in Sections 861(a)(3) and 862(a)(3) of current law.

<sup>234</sup> See, e.g., Graetz & Oosterhuis, *supra* note 135, at 776.

<sup>235</sup> See Shay, Fleming & Peroni, *Source Rules*, *supra* note 1, at 152-53.

source income.<sup>236</sup> To do otherwise would create the possibility of a negative tax on foreign operations that would aggravate the exemption system's inherent distortive effect on the choice between locating business operations in the taxpayer's residence country or in a low-tax foreign country. The following example illustrates this point:

#### EXAMPLE 7

XCo, a corporation resident in exemption system Country A, is debating whether to build a new manufacturing facility in Country A or in Country B, a tax haven with no business profits tax, no withholding tax regime, and no branch profits tax. Country A imposes a tax on domestic corporate profits at an effective rate of 25 percent. When XCo thinks about the upside of its new facility—i.e., potential profits—it will recognize that Country A's exemption system provides a clear incentive to locate the facility in Country B in order to shield those profits from the 25-percent Country A tax. When XCo then considers the downside of the new facility—loss years in the start-up phase and during business cycle downturns—XCo will understand that if Country A allows losses from the Country B facility to be deducted from XCo's Country A income, each dollar of Country B loss will save 25 cents of Country A tax on Country A domestic-source income, even though the Country A income is not generated by the Country B operation. Thus, these tax savings would amount to a 25-percent negative Country A tax on the Country B operation during loss years and would increase the exemption system's powerful incentive for XCo to build the new facility in tax haven Country B.

Consequently, it is no surprise that exemption systems typically prohibit the deduction of foreign losses.

The U.S. federal income tax system purports to tax foreign-source business income at the same rates that apply to U.S.-source business income, which suggests that foreign-source business losses should be deductible against U.S.-source business income. As explained above,<sup>237</sup> however, the U.S. system gives preferred treatment to foreign-source business income that causes it to be

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<sup>236</sup> See AULT & ARNOLD, *supra* note 6, at 376–77. France and the Netherlands have limited exceptions. See Lee A. Sheppard, *Cross-Border Use of Losses of Subsidiaries and Branches*, 54 TAX NOTES INT'L 711, 712 (2009). In principle, however, there should be no exceptions. See *International Task Force Report*, *supra* note 16, at 726.

<sup>237</sup> See *supra* Section I.

taxed at lower effective rates than U.S.-source business income, thus providing a strong incentive to locate business operations in low-tax foreign countries. If losses from these low-taxed foreign operations are deductible against non-preferred U.S.-source business income, the result would be to magnify the U.S. system's tax incentive to locate operations in tax havens instead of in the United States. The following example illustrates this point:

#### EXAMPLE 8

Assume that DC, a U.S. resident multinational corporation, is debating whether to build a new manufacturing facility in the United States or in low-tax Country B, a tax haven with no business profits tax, no withholding tax regime, and no branch profits tax. Accelerated depreciation and other tax preferences result in a 25-percent effective rate of U.S. federal income tax on DC's U.S.-source income. Because of deferral and other aspects of the U.S. system, however, the effective rate of U.S. federal income tax on the profits of a Country B factory operated through DC's Country B controlled foreign corporation will be only 5 percent (and the Country B effective tax rate will be zero). Obviously, the U.S. system provides a strong incentive for DC to locate the new facility in Country B. Assume further, however, that DC expects the new factory to be a loss operation for the first five years regardless of where it is located. If DC locates the factory in Country B, operates the factory as a branch during the loss period, and is allowed to deduct the branch losses against U.S.-source income, each dollar of Country B loss will save 25 cents of U.S. tax on U.S.-source income even though the Country B branch generates no U.S.-source income. Thus, these tax savings will effectively be a 25-percent negative U.S. tax on the Country B branch during the initial loss years. This subsidy for loss operations in Country B will magnify the incentive for DC to locate the new factory in Country B initially as a branch operation<sup>238</sup> that will later be transferred to a Country B controlled foreign corporation (to gain the benefit of deferral, aggressive transfer pricing, and other defects in the current U.S. international tax system) when it becomes profitable.

A comparison of Examples 7 and 8 shows that the allowance of a deduction for foreign branch losses against U.S.-source income will create much the same policy problem for the United States as the allowance of a deduction for

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<sup>238</sup> See generally STAFF OF JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 18, at 60.

foreign losses would create for an exemption system country. Exemption system countries, of course, avoid this problem by prohibiting foreign loss deductions.

In recognition of this issue, the U.S. federal income tax system has a rule providing that a taxpayer's foreign-source branch losses cannot be deducted against U.S.-source income except to the extent that they exceed foreign-source income generated by the taxpayer's profitable foreign branches,<sup>239</sup> if any. An overall foreign-source loss is, however, deductible against U.S.-source income, thus producing the incentive-enhancing effect illustrated in Example 8.<sup>240</sup> This exception for overall foreign-source losses is highly significant. Such losses are quite likely to occur because the passthrough characteristic of a foreign branch<sup>241</sup> and the separate taxpayer and deferral characteristics of a controlled foreign corporation<sup>242</sup> mean that U.S. taxpayers are encouraged to (1) concentrate loss-generating activities in foreign branches, where the losses are passed through directly to the U.S. owner without any absorption by the controlled foreign corporation's profits, and (2) once foreign activities become profitable, to transfer them to controlled foreign corporations in order to defer U.S. tax on the foreign-source income and to employ aggressive transfer pricing.

The U.S. tax system attempts to block the preceding maneuver by adding a foreign branch's prior losses to the U.S. owner's income when the branch's assets are transferred to a controlled foreign corporation under the so-called "branch loss recapture rules."<sup>243</sup> However, because the resulting tax increase occurs in a year later than the years in which tax savings were realized from the deduction of branch losses, a time value of money analysis<sup>244</sup> indicates that the strategy of operating through a foreign branch during the start-up loss

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<sup>239</sup> See I.R.C. § 904(f)(5) (2009); GUSTAFSON, PERONI & PUGH, *supra* note 3, at 616–17.

<sup>240</sup> See 3 BITTKER & LOKKEN, *supra* note 36, at 71-27–71-29. Granted, the overall foreign-source loss is "recaptured" by recharacterizing an appropriate amount of foreign-source income as U.S.-source income in later years for foreign tax credit limitation purposes, see I.R.C. § 904(f)(1), but, because of the time value of money, this recharacterization does not eliminate the advantage of deducting an overall foreign loss against U.S.-source income.

<sup>241</sup> As noted in *supra* note 26, for U.S. income tax purposes, a foreign branch is treated as lacking a legal personality separate from its corporate owner.

<sup>242</sup> See *supra* Section I.A.

<sup>243</sup> See I.R.C. § 367(a)(3)(C); Temp. Treas. Reg. § 1.367(a)-6T (1986); 2 BITTKER & EUSTICE, *supra* note 32, at ¶ 15.81[1][c]; 3 BITTKER & LOKKEN, *supra* note 36, at 71-27–71-29; GUSTAFSON, PERONI & PUGH, *supra* note 3, at 769–72; 3 ISENBERGH, *supra* note 31, at ¶ 92.10; 1 KUNTZ & PERONI, *supra* note 36, at ¶ B2.04[4][g][ix].

<sup>244</sup> See, e.g., DODGE, FLEMING & GEIER, *supra* note 76, at 23–26.

period and then switching to a controlled foreign corporation operation when profits begin to flow remains an attractive approach. Thus, this additional feature of the current U.S. international tax system provides an incentive for U.S. taxpayers to locate business operations in low-tax foreign countries and obtain tax results that are inappropriately more generous (and distortive) than those that may be attained in a properly designed exemption system.

### CONCLUSION

In this Article, we have discussed how various defects in the current U.S. international tax system—deferral, defective income-sourcing and cost-allocation rules, generous transfer-pricing rules, generous cross-crediting, the export sales source rule, the effectively tax-exempt treatment of many types of foreign-source royalties, and the deduction of foreign losses against U.S.-source income—can be combined to make the present U.S. system as generous as, and in some important respects more generous than, a properly designed exemption or territorial system for taxing foreign-source income of U.S. resident corporations. In other words, when judged from a public policy standpoint, the current U.S. system can produce worse-than-exemption results. Because of this, the U.S. multinational corporate community largely has shifted its lobbying efforts away from support for an exemption or territorial system and toward support for changes in the current incoherent international tax system that would further reduce the effective U.S. income tax rate on U.S. corporations' foreign-source income by magnifying the worse-than-exemption results. In our view, reform efforts in the international tax area should be directed toward comparing the strengths and weaknesses of a properly designed worldwide system with the strengths and weaknesses of a properly designed exemption system, and then proceeding to enact one of those two coherent systems for taxing the international income of U.S. persons. Based on our prior work<sup>245</sup> in the international tax area, we believe that such an analysis will lead to a conclusion that a strengthened and properly designed worldwide system is superior to a properly designed territorial system and is definitely superior to our defective and incoherent current U.S. international tax system.

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<sup>245</sup> See authorities cited *supra* note 17.



