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Deep Dive, Chicago Style: A Roadmap for Understanding International Tax Reform

Michael J. Veneri Jr.
Cleveland-Marshall College of Law

DEEP DIVE, CHICAGO STYLE: A ROADMAP FOR UNDERSTANDING INTERNATIONAL TAX REFORM

MICHAEL J. VENERI JR.†

ABSTRACT

This Note discusses the potential alternatives for international tax reform and evaluates them based upon the Chicago school of economic theory principles and the ability to eliminate "tax plays." The United States could modify the existing international taxation system with the (1) 2015 Obama Administration proposals, (2) a modified territorial system as proposed by Rep. Dave Camp, (3) a credit system with source-of-income rules without the deferral privilege, or (4) a formulary apportionment system based on either a single-factor or a three-factor system. By eliminating a U.S. multinational corporation's ability to participate in "tax plays," inefficient rent-seeking behavior can be curtailed, which will increase economic efficiency and, thus, overall economic wealth.

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† J.D. Candidate 2016, Cleveland-Marshall College of Law. The author would like to provide special thanks to Professor Deborah A. Geier for her guidance and support throughout the writing of this Note.

I. INTRODUCTION

More than 50 years ago, President Kennedy warned that "more and more enterprises organized abroad by American firms have arranged their corporate structures aided by artificial arrangements ... which maximize the accumulation of profits in the tax haven ... in order to reduce sharply or eliminate completely their tax liabilities." So this problem is not new. But it has gotten worse, far worse. What is the result? Today, U.S. multinational corporations have stockpiled $1.7 trillion in earnings offshore. It is not a pretty picture. It's unacceptable.

–Sen. Carl Levin (D-Mich.)[1]

Washington must make real progress on the critical issues of the day, the most important of which is strengthening the economy. We can, and need, to work together to craft a plan that fixes our broken code and strengthens the economy so there are more jobs and bigger paychecks for hardworking taxpayers.

–Rep. Dave Camp (R-Mich.)[2]

Although Congressional Democrats and Republicans may disagree on many issues, the above quotations demonstrate that one issue garners support from both sides of the political aisle: international tax reform. It has been nearly 30 years since the Tax Reform Act of 1986, the last major piece of tax legislation, was enacted into law. Since that time, the number of U.S. multinational corporations ("MNC") has dramatically increased, significantly changing the typical business model and the composition of annual earnings.[3] In light of this change,

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1 *Statement of Senator Carl Levin (D-Mich) Before U.S. Senate Permanent Subcommittee on Investiations on Offshore Profit Shifting and the U.S. Tax Code* (September 20, 2012). Although Sen. Levin highlights that U.S. multinational corporations have accumulated $1.7 trillion in earnings offshore as of 2012, more recent studies have shown that the offshore earnings have increased to over $2.1 trillion as of 2014. Kevin Drawbaugh & Patrick Temple-West, *Untaxed U.S. Corporate Profits Held Overseas Top $2.1 trillion: Study*, Reuters (Apr. 8, 2014), http://www.reuters.com/article/2014/04/09/us-usa-tax-offshore-idUSBREA3729V20140409.

2 Brendan Buck, *Camp Releases Tax Reform Plan to Strengthen the Economy and Make the Tax Code Simpler, Fairer and Flatter*, Committee on Ways and Means (Feb. 26, 2014), http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987.

3 Between 1998 and 2012, for example, employees of foreign subsidiaries owned by U.S. multinational corporations rose from approximately 8,183,800 employees to 12,115,800 employees, total assets in foreign subsidiaries increased from $3,921,467,000,000 to $21,602,680,000,000, total sales increased from $2,369,990,000,000 to $5,958,048,000,000, and net income increased from $148,357,000,000 to $1,420,679,000,000. Majority-Owned Foreign Corporations: Selected Data for Foreign Affiliates in All Countries in Which Investment Was Reported – Preliminary 2012 Data, BUREAU OF ECONOMIC ANALYSIS (2012), http://www.bea.gov/international/pdf/usdia_2012p/Group%20II%20A1%20to%20A2.pdf; Majority-Owned Foreign Corporations: Selected Data for Foreign Affiliates in All Countries in Which Investment Was Reported – 1998 Data, BUREAU OF ECONOMIC ANALYSIS (1998), http://www.bea.gov/international/di1usdop_archive.htm.

Congressional Democrats and Republicans agree that the current system is outdated and needs to be revamped. The need for reform has also been acknowledged by international committees such as the Group of Twenty ("G20"),[4] which has recently stated that the current international taxation system is inefficient due to its many loopholes and which has endorsed the Organization for Economic Co-operation and Development ("OECD")[5] in its attempt to coordinate modifications to the existing tax systems.[6] Even corporate executives have stressed the need for international tax reform.[7]

If Congress, international committees, and private businesses all agree that there is a need for reform, why has reform stalled? The answer is simple: it is not the "what" that is being debated but rather the "how." In general, Congressional Democrats stress that corporate tax reform should aim to raise revenue to combat the increasing national deficit by closing tax loopholes.[8] They cite facts such as the falling percentage of corporate income tax paid as a portion of the gross domestic product ("GDP"). In 2012, corporate income taxes represented only 2.3% of the U.S. GDP, below the OECD average of 2.9%.[9] One cause for this disparity is that current international tax loopholes cost an estimated $120 billion in lost tax revenue between 2008 and 2017.[10] While recouping the estimated lost tax revenue would not completely solve the

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[4] The G20 includes members of governments and central bank governors from Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States, and the European Union.

[5] The OECD is an organization comprised of representatives from member countries who analyze issues relevant to improving the economic and social well-being of people around the world, including tax policy. For a full list of the members of the OECD, *see* http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm.

[6] *See generally* Tom Bergin & Maya Dyakina, G20 Back Corporate Tax Reform To Eliminate Multinational Loopholes, REUTERS (Jul. 19, 2013), http://www.huffingtonpost.com/2013/07/19/g20-corporate-tax-reform_n_3622276.html.

[7] "The current U.S. tax system puts U.S. companies at a disadvantage." John Lechleiter, CEO of Eli Lilly and Co. Matthew J. Velbedere, *CEOs to Obama: Tax Reform, Not An Inversion Band-Aid*, NIGHTLY BUSINESS REPORT (Jul. 24, 2014), http://nbr.com/2014/07/24/ceos-to-obama-tax-reform-not-an-inversion-band-aid/. "There is no question that a comprehensive, full-blown tax reform in this country is absolutely needed and will absolutely [ ] stimulate growth." Doug Oberhelman, CEO of Caterpillar Inc. *Id.*

[8] Martin A. Sullivan, *Top 10 Reasons There Is No Corporate Tax Reform*, 143 TAX NOTES 45 (2014).

[9] Corporate income taxes again generated 2.3% of the GDP in 2013; however, data is not yet available for certain countries of the OECD and an OECD-Average for 2013 cannot yet be calculated. *Revenue Statistics – Comparative Tables*, OECD STATEXTRACTS (Jan. 1, 2015), http://stats.oecd.org/Index.aspx?DataSetCode=REV.

disparity between the U.S. corporate tax percentage of GDP against the OECD average or cover the entire national deficit, the increase in tax revenue arising from closing these loopholes would contribute towards solving the problem.

Congressional Republicans, unsurprisingly, generally do not share the same goals as Congressional Democrats and believe that tax reform should not aim to raise revenue but should be revenue-neutral.[11] To achieve this result, Congressional Republicans stress that tax loopholes should be closed but that the statutory corporate income tax rate should be simultaneously lowered to 25%,[12] changes that they claim will increase competitiveness with foreign jurisdictions and encourage investment in the United States. Corporate executives typically agree with this position as well. In a 2010 study, the McKinsey Global Institute interviewed senior executives from 26 of the largest U.S. MNCs to discuss the economic impact of U.S. corporate tax policy.[13] Most of the executives stated that current U.S. corporate tax policy creates a disadvantage for U.S. MNCs by discouraging investment in the United States in favor of other countries,[14] citing the U.S. statutory corporate income tax rate of 40% (including average state income taxes) against a global average of 25.5% in 2009.[15] The study concluded that tax policy did factor into a U.S. MNC's decision to invest in the United States, although that factor by itself was not controlling.[16]

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[10] U.S. Department of Treasury, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 11 (2007).

[11] Sullivan, *supra* note 8.

[12] *Id.*

[13] JOHNATHAN CUMMINGS ET. AL., GROWTH AND COMPETITIVENESS IN THE UNITED STATES: THE ROLE OF ITS MULTINATIONAL COMPANIES 35 (McKinsey & Company 2010), *available at* http://www.mckinsey.com/insights/americas/growth_and_competitiveness_in_us.

[14] The executives also cited immigration policy and bureaucratic inconsistencies as reasons for discouraging investment in the United States. *Id.* at 36.

[15] The global average statutory corporate income tax rate has decreased to 23.57% while the U.S. statutory corporate income tax rate has remained at 40.0% as of 2014. For more information regarding the breakdown of corporate income tax rate by country/region, see *Corporate Tax Rates Table*, KPMG (2014), http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx. Although the U.S. corporate income tax statutory rate was higher than the global average, the effective tax rate was calculated to be 12.6% in 2009 and 16.9% in 2010. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, EFFECTIVE TAX RATES CAN DIFFER SIGNIFICANTLY FROM THE STATUTORY RATE 14 (2013), available at http://www.gao.gov/assets/660/654957.pdf.

While a focus of their respective proponents, competition and revenue increases by themselves ignore the underlying reality that the primary issue with respect to the current tax system is that U.S. MNCs are encouraged to focus on what I shall call "tax plays," the ability to consummate transactions with the primary goal of avoiding or reducing taxation without a concomitant change in the underlying economic location of business activities or reducing the underlying economic pre-tax profit of the business. Public finance economists refer to such behavior as rent-seeking behavior – a mere shift in wealth from one to the other without an increase in aggregate wealth – which is economically inefficient.

A study of the recent increase in inversion transactions addressed this issue, stating that the desire to reduce U.S. tax liability combined with the large amount of foreign cash of approximately $1 trillion held offshores superseded the concept of tax competitiveness.[17] The study suggests that U.S. MNCs focus on creating transactions that make it appear as though the focus of their economic activities has moved to low or no-tax jurisdictions in order to capture the benefits of tax savings through the gaps in the international tax system, especially in the absence of anti-abuse rules.[18] Thus, even though the competitiveness argument is used in a theoretical context, the reality of the situation is that "competitiveness" is merely a cover for U.S. MNCs seeking to increase tax benefits to themselves rather than to compete in the global marketplace with respect to their actual businesses. Such rent-seeking encourages behavior changes that would not occur absent the "tax play."

Congress must therefore eliminate "tax plays" in enacting tax reform. Specifically, Congress must adopt a tax system that complies with the Chicago school of economic thought (the "Chicago School"). In structuring the system, Congress must ensure that the tax system would not distort economic behavior away from its most efficient form compared to merely shifting wealth on paper between related taxpayers within the economy. This would allow U.S. MNCs to engage in meaningful transactions that would promote growth and economic wealth. Since there are many proposed systems for Congress to consider in enacting reform, this Note

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[16] The study concluded that the primary factor in a U.S. multinational corporation's investment decision was the pursuit of growth opportunities in fast-growing markets. *Id.* at 50.

[17] Edward D. Kleinbard, *'Competitiveness' Has Nothing to Do With It*, 144 TAX NOTES 1055, 1065 (2014).

[18] *Id.* at 1056.

will provide a framework for understanding these options with a focus on each alternative system's ability to eliminate "tax plays."

Part II will provide a brief explanation of the underlying economic theories that have been attributed to the Chicago School, including a focus on using free-market economics to increase global market efficiencies and a reluctance to use regulation of markets except (1) to avoid inefficient "rents" or monopoly, and (2) to combat negative externalities. Part III will provide a brief explanation of the current U.S. international taxation model (credit system with sourcing-of-income rules and deferral privilege) and will identify the development of existing legislation.

Part IV will explore potential alternatives to the current U.S international taxation model, which include (1) the proposed modifications to the current U.S. international taxation model suggested by the Obama Administration, (2) the current U.S. international taxation model but removing the deferral privilege, (3) the territorial system of taxation, specifically as modified in the proposed Tax Reform Act of 2014 (colloquially known as the "Camp Proposal"), and (4) the formulary apportionment method of international taxation using either a one-factor apportionment method or a three-factor apportionment method. Part V will then analyze the alternatives identified in Part IV under the Chicago School theories. Finally, Part VI will provide a summary for how Congress and the average citizen can use these analyses.

II. BACKGROUND OF THE CHICAGO SCHOOL OF ECONOMIC THOUGHT

The University of Chicago Economics department is heralded as being one of the leading economic departments in the world, yielding 28 Nobel Prize Laureates in the field of Economic Sciences since 1970.[19] The school's rise to prominence began in the 1930s with the work of Jacob Viner, Frank Knight, Henry Simmons, and Aaron Director.[20] However, one of the most recognizable names attributable to the school is Milton Friedman, who has been described as "the most influential economist of the second half of the 20th century [ ], possibly of all of it."[21]

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[19] The University of Chicago, Nobel Laureates (2015), http://www.uchicago.edu/about/accolades/22/.

[20] Milton Friedman, Interview: The Evolution of the Chicago School of Economics, The Chicago Maroon (April 3, 1992), available at http://0055d26.netsolhost.com/friedman/pdfs/other_commentary/Maroon.04.03.1992.pdf.

[21] *A Heavyweight Champ, at Five Foot Two: The Legacy of Milton Friedman, a Giant Among Economists*, THE ECONOMIST (Nov. 23, 2006), http://www.economist.com/node/8313925.

As a leading proponent of the Chicago School, Friedman once described the school as based upon two distinct components. First, there is a scientific component that relies upon empirical evidence to support economic theory rather than the theory being applied in an abstract manner, allowing the evidence to provide guidance for economists to formulate theories that affect the real world. [22] Second, there is a policy component that emphasizes free markets and strongly opposes government intervention.[23] When combined, these two components create a system that views economics as a "practical matter" rather than a "branch of mathematics."[24] Simply stated, the Chicago School focuses on gathering evidence from real-world events to determine how real-world policy should be dictated.

Friedman's explanation of the Chicago School introduces the idea of free market economics, a central concept on which the school is based. Free market economics focuses on economic efficiency as the allocation of money and talent to their most efficient uses, which can be achieved only in the absence of governmental interference.[25] According to the Chicago School, government interference tends to direct the allocation of resources to less efficient uses because this interference modifies market price in a manner that distorts market competitiveness.[26] This in turn leads to a reduction in aggregate societal wealth and harms the economy.

However, the Chicago School states that there are two situations in which governmental interference is tolerable. The first situation is where the interference is used to prevent negative externalities, which are harms imposed on others that are not captured in the market price of goods.[27] A common example of a negative externality is environmental damage caused by a company's products or by the operations of the company. Because the company does not incur the cost of this damage in the manufacturing of the product, interference is tolerated through the

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[22] Friedman, *supra* note 20.

[23] *Id.*

[24] *Id.*

[25] DEBORAH A. GEIER, U.S. FEDERAL INCOME TAXATION OF INDIVIDUALS 99 (CALI eLangdell Press 2015), at http://www.cali.org/books/us-federal-income-taxation-individuals-2015.

[26] *Id.*

[27] *Id.* at 100.

form of taxes and penalties, which quantify the damage caused by the company and requires the company to incur these costs as a form of accountability.[28] Once incurred, the damages will raise the market price of the company's goods, thus forcing the producer to internalize the costs in its market price.[29] The Chicago School will also tolerate interference to prevent rent-seeking behavior as well. Rent-seeking behavior is the manipulation of the economic environment to shift existing wealth from one company to another company which does not create new wealth in the economy.[30] While the entity participating in the rent-seeking behavior may benefit from the transaction, another entity will inevitably be harmed by the behavior, thus offsetting the benefits achieved by the first entity. Absent government interventions, market participants' behavior will be artificially tilted toward such rent-seeking behavior rather than toward behavior that increases overall economic wealth. Thus, the Chicago School states that rent-seeking behavior is inefficient and may be discouraged through government interference.[31]

Government interference is obvious through the imposition of taxes. Because the reality is that taxation will not be eradicated any time soon, the Chicago School stresses that tax policy should be implemented in compliance with the neutrality norm. The neutrality norm states that taxes should be structured in the least invasive way possible with respect to the marketplace and should not encourage or discourage one behavior over another, absent rent-seeking behavior.[32] An example of this concept may be illustrated through the benefits accorded to owner-occupied housing. Imagine that there are two individuals, A and B, who purchase houses of equal value. Assume that A utilizes the house for rental purposes and lives in an apartment. Further assume that the income that A earns from the rental house is equal to the amount of rent that A pays to live in the apartment. Also assume that B utilizes the house for residential purposes. While the net economic impact of utilizing the house is a net zero in both cases, A is required to include the amount of the rental income in A's gross income while not being able to deduct the amount of rent paid for A to live in the apartment, thus creating taxable income in the amount of the rental

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[28] *Id.*

[29] *Id.*

[30] *Id.* at 104.

[31] *Id.*

[32] *Id.* at 99.

income.[33] Conversely, B will not have any taxable income from living in the house. Because tax liability can be altered without incurring an economic impact, the tax benefits associated with owner-occupied housing can encourage the individual's behavior directly, a result which violates the neutrality norm. Alternatively, if the tax benefit was removed from the above example, each option could be determined solely on its economic merits, which would lead to a more efficient result.

III. THE CURRENT INTERNATIONAL TAXATION SYSTEM

A. *Development of the Credit System with Source-Of-Income Rules*

U.S. taxation of international transactions has been contemplated since the enactment of the U.S. federal income tax in 1913, when Congress was given the power to "collect taxes on income, from whatever source derived" under the Sixteenth Amendment.[34] Shortly after, Congress extended Congress' power under the Sixteenth Amendment to collect a tax on the net income of individuals and corporations, including income earned from foreign jurisdictions.[35] Furthermore, Congress allowed taxpayers a deduction for any taxes paid to foreign jurisdictions.[36] Consider the following illustration.

> In Year 1, Domestic Company, a company organized in the United States, establishes a branch in Country A. The branch sells goods to Foreign Company, a company organized in Country A, for $100. Because the income was earned in Country A, Country A imposes a tax of $25 ($100 x 25%) on the sale, which Domestic Company pays to Country A. After the payment, Domestic Company has a net income of $75 ($100 sales income - $25 foreign taxes paid). The United States then imposes a tax of $30 ($75 x 40%) on Domestic Company's net income. Thus, Domestic Company pays a total of $55 in taxes on the $100 sale (effective tax rate of 55%.)

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[33] I.R.C. §§ 61(a)(5), 262(a).

[34] U.S. Const. Amend. XVI.

[35] Revenue Act of 1913, ch. 16, 38 Stat. 114.

[36] *Id.* at 144.

Is this method of taxation fair? Efficient? If Domestic Company performed the same transaction but sold the goods to another U.S. company instead of Foreign Company, Domestic Company would pay tax of only $40 ($100 x 40%) on the $100 sale (effective tax rate of 40%). This example demonstrates the problem of international double taxation, under which U.S. MNCs that operate in foreign jurisdictions are essentially taxed twice on the same income, once by the foreign jurisdiction and once by the United States. Because U.S. companies that operated solely within the United States are subject to only one tax, U.S. MNCs that operated abroad began to raise concerns about the system.[37]

Congress responded to such concerns in 1918 by adopting the first foreign tax credit system of taxation.[38] Under the credit system, the United States would still tax the worldwide income of the U.S. taxpayer, but the U.S. taxpayer could then directly offset its U.S. tax liability by the taxes paid to foreign jurisdictions on any income earned within that jurisdiction.[39] Consider the previous example under the new credit system.

> In Year 1, Domestic Company's branch sells goods to Foreign Company for $100. Country A still imposes a tax of $25 ($100 x 25%) on the sale, which Domestic Company pays to Country A. The United States then imposes a tax of $40 ($100 x 40%) on the sale. However, Domestic Company can credit the $25 in taxes paid to Country A against its U.S. tax liability and will pay only $15 in taxes to the United States ($40 - $25). Thus, Domestic Company pays a total of $40 in taxes on the $100 sale (effective tax rate of 40%).

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[37] *See generally* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021 (1997). Graetz and O'Hear describe that double taxation may have only been a minor concern of U.S. companies operating abroad upon enactment of the rules in 1913 due to the relatively low tax rates. However, the rapid increase of global tax rates during World War I caused U.S. companies operating abroad to be significantly burdened by the existing regime with the United States applying a base corporate tax rate of 10% and an additional excess profits tax rate between 8%-60%. Due to these increases, double taxation became a larger problem than it had been in 1913 and needed to be resolved. *Id.* at 1045.

[38] Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1918). Competitiveness was also an underlying factor that Congress wanted to address in enacting the credit system. Double taxation may have prevented U.S. businesses from expanding overseas operations due to paying large tax amounts, Congress feared that U.S. businesses would not expand as quickly as foreign businesses and thus harm the U.S. economy. Graetz & O'Hear, *supra* note 37, at 1049-1050.

[39] Revenue Act of 1918, *supra* note 38. As enacted, the U.S. taxpayer was able to credit foreign taxes that the U.S taxpayer actually paid to the foreign jurisdiction. This has become known as the "direct" credit and is currently codified under I.R.C. § 901.

Theoretically, the credit system as enacted in 1918 did not discriminate between a U.S. MNC that operated in foreign jurisdictions and a U.S. company that operates solely in the United States because both companies would pay $40 in taxes on the $100 sale (albeit to different countries). However, it became evident that the credit system was subject to abuse by U.S. MNCs that operated in foreign countries with higher statutory income tax rates than in the United States.[40] Since all foreign taxes paid could be used as a credit against a U.S. MNC's U.S. tax liability, a U.S. MNC could easily "cross-credit" by using excess foreign taxes on high-taxed foreign income to offset its U.S. tax liability on income generated in the United States, leaving the United States unable to collect tax on rightfully taxable income.[41]

Congress soon realized that it needed to protect the United States' ability to collect tax on income that was generated in the United States.[42] Thus, Congress enacted the Revenue Act of 1921, which contained two pivotal features of the current foreign tax credit system.[43] The first feature was a limitation on the foreign tax credit.[44] Under this enactment, a U.S. taxpayer could offset its U.S. tax liability only by the ratio of its foreign-source income over its worldwide income.[45] A key aspect of the legislation was that the limitation was enacted as an "overall" limitation, under which total foreign-source income, regardless of the foreign jurisdiction in which the foreign income was earned, was considered in determining the limitation.[46] This differs from a "per country" limitation, which determines foreign-source income derived in each foreign jurisdiction, calculates a ratio of the individual country foreign-source income over worldwide income, and applies the calculated ratio to the amount of taxes paid to the foreign jurisdiction.

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[40] "[The unlimited foreign tax credit] is subject to this … rather grave abuse: If the foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which fairly belong to this country …" Thomas Sewall Adams, tax advisor to the Treasury Department, *Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245*, 67th Cong. 256 (1921).

[41] Graetz & O'Hear, *supra* note 37, at 1055.

[42] *Id.* at 1056.

[43] Revenue Act of 1921, ch. 136, 42 Stat. 227 (1921).

[44] *Id.* at 258. The limitation rules were originally codified under I.R.C. § 222(a)(5) but are currently codified under I.R.C. § 904(a) and (d).

[45] *Id.*

[46] *Id.* At the time the Revenue Act of 1921 was passed, support for an "overall" limitation was so strong that the Senate Finance Committee did not even discuss the proposal prior to approval. 1921 Hearings, *supra* note 40, at 67.

While the "per country" limitation was enacted in subsequent legislation, it was ultimately repealed and the "overall" limitation is the standard in the current credit system.[47]

The Revenue Act of 1921 also introduced the first codified source-of-income rules, which distinguish between foreign-source income and U.S.-source income.[48] U.S.-source income under the Revenue Act of 1921 was generally defined as income that had a close connection with the United States. However, this connection was further defined depending on the type of income that was generated. Some types of income were considered U.S.-source if they were performed in the United States (ex. compensation for labor or personal services) while other types of income were considered U.S.-source if the income related to property that was physically located in the United States (ex. rents, royalties, and gains or sale of U.S. property).[49] Foreign-source income followed similar rules as U.S.-source income but determined whether income did not have a close connection with the United States.[50] By establishing these rules, the foreign tax credit calculation became clearer and the ability of U.S. MNCs to "cross-credit" was reduced. Consider the following:

> In addition to Domestic Company's branch sale to Foreign Company for a $100 profit, Domestic Company also sells goods to Domestic II Company, a company organized in the United States, for a $900 profit in Year 1. Thus, in addition to the $40 tax that the United States imposed on Domestic Company's branch sale to Foreign Company of $100, the United States imposes an additional tax of $360

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[47] In 1932, Congress passed legislation that required taxpayers to use the lesser of the "overall" limitation or the "per country" limitation. Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 169, 211. Congress then eliminated the "overall" limitation in 1954. Internal Revenue Code Act of 1954 . ch. 736, § 904, 68A Stat. 3, 287-88. However, Congress brought back the "overall" limitation in 1960 and allowed the taxpayer to either use the "per country" limitation or the "overall" limitation at the taxpayer's election. Revenue Act of 1960, § 1(a), 74 Stat. 1010, 1010. Congress amended the limitation again in 1976 by repealing the "per country" limitation. Tax Reform Act of 1976, sec.1031, §904, 90 Stat. 1610, 1620-24.

[48] *Id.* at 243-245. While the Revenue Act of 1918 had relied on terms such as foreign source income and U.S. source income, detailed rules were not included in the Act. Thus, the source rules prior to the Revenue Act of 1921 were determined by the Attorney General through written opinions. Graetz & O'Hear, *supra* note 37, at 1057. However, these written opinions often conflicted with the policy intent of the Treasury Department. Thus, in the Revenue Act of 1921, Congress delegated responsibility of statutory interpretation to the Commissioner of the Internal Revenue Service to avoid further interpretation issues. *Id.* at 1057-1059.

[49] *Id.* at 244.

[50] *Id.*

(\$900 x 40%) on the sale to Domestic II Company. Using this information, Domestic Company then calculates its foreign tax credit limitation as follows:

$$\frac{\$100\ (A)}{\$1{,}000\ (B)} \times \$400\ (C) = \$40\ (D)$$

Where A is the total foreign source income, B is the total worldwide income, C is the U.S. tax liability, and D is the foreign tax credit limitation.

Because Domestic Company paid only \$25 in foreign taxes in Year 1, Domestic Company can credit the \$25 against its total U.S. liability of \$400 and will pay only \$375 in taxes to the United States. Thus, Domestic Company will pay a total tax of \$400 on its \$1,000 of profit (effective tax rate of 40%).

In Year 2, Domestic Company's branch sells goods to Foreign II Company, a company organized in Country B, for a \$100 profit. Country B imposes a tax of \$45 (\$100 x 45%) on the sale, which Domestic Company pays to Country B. The United States also imposes a tax of \$40 (\$100 x 40%) on the sale. Domestic Company also sells goods to Domestic II Company for a \$900 profit, on which the United States imposes a tax of \$360 (\$900 x 40%). Domestic Company calculates its foreign tax credit for Year 2 as follows:

$$\frac{\$100\ (A)}{\$1{,}000\ (B)} \times \$400\ (C) = \$40\ (D)$$

Where A is the total foreign source income, B is the total worldwide income, C is the U.S. tax liability, and D is the foreign tax credit limitation.

Unlike Year 1, Domestic Company has paid \$45 in foreign taxes, which is in excess of the foreign tax credit limitation of \$40. Thus, in Year 2, Domestic Company can credit only \$40 of the foreign taxes paid against its U.S. tax liability and must pay \$360 in taxes to the United States. Thus, Domestic Company will pay a total tax of \$405 on its \$1,000 of sales (effective tax rate of 40.5%).

The foreign tax credit limitation continued to be modified through subsequent legislation to combat a U.S. corporation's ability to "cross-credit." While Congress was concerned with the use of the "overall" limitation and the "per country" limitation,[51] Congress was also concerned

[51] *Supra* note 47.

with the use of excess foreign tax credits on high-taxed foreign income to offset the residual U.S. tax on low-taxed foreign income. Thus, Congress further narrowed the foreign tax credit limitation by applying it separately to different baskets within the foreign-source income categories. By 2004, Congress had enacted legislation that had created nine different limitation "baskets," each basket requiring a separate foreign tax credit limitation: general limitation income, passive income, high withholding tax interest, financial services income, shipping income, dividends from a Domestic International Sales Corporation ("DISC"),[52] taxable income attributable to foreign trade income, certain distributions from a Foreign Sales Corporation ("FSC")[53] or former FSC, IRC §901(j) income, and dividends from each non-controlled foreign corporation.[54] However, Congress felt that the presence of nine baskets had created an overcomplicated system and sought to simplify the baskets without allowing for abuse. In 2004, Congress eliminated seven of the existing baskets and left only two baskets: passive category income and general category income.[55] Passive category income has the same definition as it did since its inception in the Tax Reform Act of 1986 which includes "any income received or accrued by any person which is of a kind which would be foreign personal holding income," although certain exceptions are applicable.[56] General category income, on the other hand, derives its definition from any income that is not considered passive category income.[57] Both of these definitions are present in the current system and have not been significantly modified since 2004.[58]

B. The Deferral Privilege

An important part of the current U.S. international taxation model is the deferral privilege. Although not affirmatively codified in the Internal Revenue Code, the deferral privilege, as it

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[52] A "DISC" is a smaller domestic corporation with a primary activity of export-related business.

[53] A "FSC" is a foreign company that is controlled by a U.S. person and is created to promote U.S. exports.

[54] Revenue Act of 1962, 76 Stat. 960; Tax Reform Act of 1976, 90 Stat. 1610, 1620-24; Tax Reform Act of 1986, (P.L. 99-514), 100 Stat. 2085, 2521.

[55] American Jobs Creation Act of 2004 (P.L. 108-357), Sec. 404, 118 Stat. 1418, 1494.

[56] *Id.*; Tax Reform Act of 1986, 100 Stat. 2085, at 2521.

[57] American Jobs Creation Act of 2004, *supra* note 55. From a practical view, general category income can be thought of as any income that is related to an active trade or business (i.e., sales or services income.)

[58] I.R.C. § 904(d).

relates to the U.S. international taxation model, allows for net income earned by foreign subsidiaries of U.S. MNCs to escape current taxation until a an actual or deemed repatriation occurs.[59] If repatriation does not occur, the earnings of the foreign subsidiary will never be subject to U.S. taxation, even though the U.S. individual or U.S. MNC owns the foreign subsidiary.[60]

The deferral privilege developed as a result of two features in the Internal Revenue Code. First, in enacting the U.S. federal income tax, Congress created separate tax regimes for individuals and corporations.[61] In reconciling these two regimes, Congress included the rule that, although business profits of the corporation were taxable to the corporation when earned, business profits of the corporation were only taxable to the individual when distributed by the corporation.[62] Thus, undistributed earnings of the corporation could remain at the corporate level and not be subjected to the individual level of taxation. The inclusion of this rule had the effect of treating a corporation as a separate taxpayer from an individual, a rule that conforms to the traditional business law rule that a corporation is a separate entity from an individual for legal liability purposes.[63] Second, in enacting the federal income tax, Congress included a provision that only taxes the worldwide income of a "U.S. person."[64] However, a foreign person is not subject to U.S. taxation on its worldwide income and will be liable to the United States for tax imposed only on the foreign

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[59] OFFICE OF TAX POLICY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS, ix (Department of the Treasury 2000), available at http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf.

[60] A different result would occur if the foreign subsidiary is not a "regarded" entity for U.S. tax purposes. In general, a foreign entity will be considered a "regarded" entity if the owner or owners of the foreign entity have limited legal liability. Treas. Reg. §301.7701-3(b)(2). Thus, a foreign entity with unlimited legal liability is classified as a "disregarded" entity (also referred to as a pass-through entity) and is not considered to be a taxpayer for U.S. tax purposes. In this case, even though the foreign entity may only have foreign-source income, the foreign-source income would be deemed to have been earned by the U.S. MNC and immediately taxable in the United States. The same result occurs if the owners of the foreign entity make an election to treat the foreign entity as a "disregarded" entity under the "check-the-box" rules. Treas. Reg. §301.7701-3. Under these rules, the owners of the foreign entity can elect the business entity classification as either "regarded" or "disregarded" as long as the entity is considered to be an eligible entity (i.e., owners have limited liability and the foreign entity is not a per se corporation that is listed under Treas. Reg. §301.7701-2(b)). *Id.* Thus, owners of foreign entities maintain some ability to arbitrarily determine whether the foreign entity's income will be subject to the deferral privilege or not.

[61] Revenue Act of 1913, *supra* note 35.

[62] *Id.* The rules governing distributions from a corporation to a shareholder are currently codified in I.R.C. §§ 301-318.

[63] Office of Tax Policy, *supra* note 59, at 2.

[64] Revenue Act of 1913, *supra* note 35.

person's U.S.-source income.[65] This allows a foreign person to escape U.S. taxation on its foreign-source income. By combining these two features in the context of a foreign corporation, a foreign corporation will qualify as a foreign person because it is not incorporated within the United States and will thus not be taxed on undistributed earnings.

The deferral privilege is subject to high levels of abuse because a U.S. person has the discretion to incorporate an entity in either the United States or a foreign jurisdiction, with only the latter having the benefit of the deferral privilege. Thus, Congress has enacted legislation commonly known as the anti-deferral rules to combat abuse. The first appearance of the anti-deferral rules is in the Revenue Act of 1913, which targeted abuse of the deferral privilege by U.S. individuals. While recognizing that a corporation was a separate taxpayer from its shareholder, the Revenue Act of 1913 contained a provision that required U.S. shareholders to include in income their proportionate share of the corporation's net income, whether distributed or not, if the corporation was "created or organized, formed or fraudulently availed of for the purpose of" avoiding individual taxation.[66] This rule was further modified in 1921 to allow for shareholders to have the additional tax imposed on the corporation itself and not to the shareholders individually.[67] Additional anti-deferral rules targeted towards U.S. individuals were enacted during the 1930s, including taxation on the transfer of appreciated property from a U.S. corporation to a foreign subsidiary[68] and taxation on income derived by a foreign personal holding company.[69]

While U.S. individuals were traditionally targeted as potential abusers of the deferral privilege, Congress began to focus on U.S. MNCs following World War II due to the increase in foreign business, lower foreign tax rates, and the existence of tax havens.[70] Congress and the

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[65] *Id.*

[66] *Id.* at § II.A., Subdivision 2.

[67] Revenue Act of 1921, supra note 43, at § 220.

[68] Revenue Act of 1932, ch. 209, 47 Stat. 169. While codified as I.R.C. § 112(k) in 1932, this provision was the predecessor to I.R.C. § 367 in the current version of the Internal Revenue Code.

[69] Revenue Act of 1937, ch. 815, 50 Stat. 813. A foreign personal holding company was defined under the Act as a foreign corporation that had more than 50 percent of its stock owned by not more than five individuals who were citizens or residents of the United States if at least 60 percent of its gross income was derived from dividends, interest, annuities and other specified passive income.

[70] Office of Tax Policy, *supra* note 59, at 8.

Kennedy Administration both recognized that the U.S. international taxation rules should not impede legitimate foreign operations but should discourage foreign investments that were done solely for tax-avoidance purposes.[71] To achieve this result, Congress enacted the anti-deferral measures known as the Subpart F rules.[72] The Subpart F rules apply to controlled foreign corporations ("CFC")[73] and state that certain types of income arrangements will not be granted the deferral privilege, making the resulting income immediately taxable in the United States as "Subpart F income" despite not being distributed by the CFC.[74] Congress originally identified two general types of income that would qualify as Subpart F income, with the most common type of income being foreign base company income.[75] Foreign base company income was further defined as containing three categories of income: foreign personal holding company income, foreign base company sales income, and foreign base company services income.[76] While the technical rules regarding each of these categories are complex, the underlying motivation for the income arrangement is "to avoid either U.S. tax or tax imposed by the foreign country" by exploiting a "multiplicity of foreign tax systems."[77]

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[71] *Id.* at 120.

[72] I.R.C. §§ 951-964.

[73] A controlled foreign corporation is defined as "any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned [ ] [either directly, indirectly, or constructively] by United States shareholders on any day during the taxable year of such foreign corporation." I.R.C. § 957(a). A "United States shareholder" means "a United States person [ ] who owns [ ] [either directly, indirectly, or constructively] 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation." I.R.C. § 951(b).

[74] I.R.C. § 951(a).

[75] I.R.C. § 952(a). Congress also originally identified insurance income in 1962 as another form of Subpart F income. *Id.* It later expanded the definition of Subpart F income to include income generated from an agreement to participate in an international boycott of certain countries and income equal to the amount of any illegal bribes, kickbacks, or other payments to any governmental employee. Tax Reform Act of 1976, P.L. No. 94-455, 90 Stat. 1520 (1976).

[76] I.R.C. § 954(a). Foreign base company oil related income was also added to the definition of foreign base company income in 1982 following concerns of abuse by multinational oil companies. Tax Equity and Fiscal Responsibility Act of 1982, P.L. No. 97-248, 96 Stat. 324 (1982).

[77] Office of Tax Policy, *supra* note 59, at 129.

C. The Role of Transfer Pricing

While the focus thus far has been expansion of operations of a U.S. MNC into foreign jurisdictions, it is important to also explore the underlying expansion of operations through different business functions. There are many types of business functions, with common functions including, but not limited to, manufacturing of goods, sales of goods, and performance of services related to the goods.[78] To facilitate these processes in the most efficient manner, it is common practice for a U.S. MNC to create multiple subsidiaries that will each have a specific business function. From a supply chain management perspective, by assigning the different functions to the subsidiaries, the U.S. MNC is able to achieve vertical integration of the supply chain which increases the efficiency and quality of the product produced.[79]

While this may be desirable from an operational perspective, there is an inherent taxation issue when different business functions in the same production path are assigned to subsidiaries in multiple jurisdictions. Absent rules to the contrary, a U.S. MNC could manipulate the price at a variable rate during the different stages of the production path to maximize income in low-tax jurisdictions and minimize income in high-tax jurisdictions, a result that could not be as easily achieved if the sales were made to a third-party company. To prevent this result, Congress enacted I.R.C. § 482, under which the Treasury Department has promulgated extensive and detailed "transfer pricing"[80] rules.[81] The purpose of the rules was to "ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions."[82] This led to the adoption of the "arm's-length standard," which states that

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[78] Other common functions may include warehousing, distribution, financing, holding of intellectual property or stock of another subsidiary, research and development, and more.

[79] "Vertical integration" refers to a company being able to consolidate the various business functions in the same production path under common ownership. *Definition of 'Vertical Integration'*, INVESTOPEDIA (last visited March 20, 2015), http://www.investopedia.com/terms/v/verticalintegration.asp.

[80] Transfer pricing can generally be described as "[t]he price at which divisions of a company transact with each other." *Definition of 'Transfer Pricing'*, INVESTOPEDIA (last visited March 20, 2015), http://www.investopedia.com/terms/t/transferprice.asp.

[81] I.R.C. § 482. Although the legislative history of the transfer pricing rules has its origins in the Revenue Act of 1918, the current version of the rules finds its origins in the Revenue Act of 1928. Robert N. Lent, *New Importance for Section 482 of the Internal Revenue Code*, 7 WM. & MARY L. REV. 345, 346 (1966), available at http://scholarship.law.wm.edu/wmlr/vol7/iss2/12.

[82] Treas. Reg. § 1.482-1(a)(1).

an allocation of profits and losses on an intercompany transaction will be respected if "the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."[83] If the transaction does not meet the arm's-length standard, the IRS has the authority to reallocate the profits and losses from the transaction to conform the transaction to the standard.[84]

D. Criticism of the Current International Tax System

> *The important thing about tax reform is you make the tax code less complicated, easier for people to understand.*
>
> –Grover Norquist[85]

As legislative history demonstrates, when U.S. MNCs become more creative in their tax planning efforts, Congress is forced to pass legislative responses in a reactionary capacity. A result of this legislation is that the development of the current U.S. international tax system has been an arduous and complicated process with legislation often aimed at preventing specific abuse rather than creating overall systemic change. Thus, in addition to the issues of revenue generation and competitiveness focused upon by Congressional Democrats and Republicans respectively, critics of the current system also argue that the system is far more complex than it should be.[86] According to these critics, the complexity of the current system leads to increased compliance costs for U.S. MNCs and the IRS.[87] Furthermore, the complexity of the system

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[83] Treas. Reg. § 1.482-1(b)(1).

[84] I.R.C. § 482.

[85] *Tax Reform Quotes*, BRAINYQUOTE (2015), http://www.brainyquote.com/quotes/quotes/g/grovernorq453743.html?src=t_tax_reform.

[86] A common structure for many Internal Revenue Code sections is to state a general rule and then provide numerous exceptions to that general rule. Furthermore, many of the sections will state exceptions to the exceptions, creating a convoluted set of rules that an average person may not be able to comprehend. Even further, the Internal Revenue code sections are often not self-contained and rely heavily on reference to other Internal Revenue Code sections to properly communicate the correct treatment of a transaction. Thus, even to those with a considerable amount of tax expertise, certain sections are difficult to understand.

[87] MARK P. KEIGHTLEY & MOLLY F. SHERLOCK, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM 22 (Congressional Research Service 2005), available at http://fas.org/sgp/crs/misc/R42726.pdf. Compliance costs (ex. the filing of federal, state, local, and international returns) are often a separate expense from the expenses incurred in connection with tax planning (e.g. the structuring of transactions to achieve a more favorable tax treatment.) As the Internal Revenue Code encompasses a vast amount of topics and information, tax professionals often specialize in one field rather than have general knowledge in all fields. Thus, U.S. MNCs are

creates a divide between U.S. MNCs who are able to expend resources on highly trained tax professionals and U.S. MNCs who have limited resources.[88] Because highly trained tax professionals are more likely to have the requisite knowledge in terms of tax strategy and planning, the U.S. MNC that is able to hire these professionals is more likely to maximize its use of the tax benefits to which it is legally entitled.[89] Conversely, U.S. MNCs with limited resources may not be able to expend resources on highly trained tax professional and maximize its tax benefits, even if the operations of the U.S. MNC with fewer resources are similar to the U.S. MNC with more resources.[90] Because tax benefits can often be reinvested in the economic business of the U.S. MNC, the ability to achieve maximum tax benefits translates into an even greater advantage to the U.S. MNC that is able to expend the resources on tax professionals.[91]

The concept that the complexity of the current system is able to influence the economic landscape of U.S. MNCs with similar operations does not comply with Chicago School principles. Through the need for highly specialized professionals to interpret and comply with the current system, it not only permits "tax plays" but heavily encourages them through its many loopholes. As the current tax system creates the opportunity to artificially create transactions that shift income,[92] U.S. MNCs are more likely to allocate resources to hiring tax professionals who can take advantage of these loopholes (and thus participate in rent-seeking behavior) than to allocate resources in a more-efficient manner that would increase the society's aggregate economic wealth.[93] Thus, the current international tax system contains an inherent flaw and

often required to hire a large number of specialists to cover the numerous fields and subfields of taxation, significantly increasing costs depending on the complexity of the U.S. MNC's operations.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.* at 22-23.

[92] "Tax arbitrage" is a commonly used example to illustrate this point and is often described as the ability of a U.S. MNC to allocate deductions generated in a low-tax or no-tax jurisdiction to offset income generated in a high-tax jurisdiction. Under the sourcing rules, deductions that can be used to offset income are allocated based on certain methodologies to determine the potential taxable income of the U.S. MNC between the U.S.-source and foreign-source income by basket. Treas. Reg. §§ 1.861-8, -8T, -10, -10T, -14, -14T, -17. However, since the current "overall" limitation does not differentiate between countries within the baskets, a U.S. MNC has the ability to blend many foreign countries' income and deduction items.

should be modified to facilitate allocation of financial and human capital to their most efficient use rather than to rent-seeking behavior.

IV. Alternatives to the Current System

A. The 2015 Obama Administration Proposals

The Obama Administration released its fiscal year 2015 budget on March 4, 2014, which contained a series of revenue proposals that affect the international tax system.[94] According to budget, the international tax proposals would generate an additional $118.9 billion in total tax revenue within the next five years and $276.3 billion in total tax revenue within the next ten years.[95] The proposals target various aspects of the international tax system, including the foreign tax credit limitation. While the current limitation separates foreign-source income into a passive category and a general category for calculation purposes, the Obama Administration believes that the existence of these two categories increases the potential for abuse through "cross-crediting."[96] As a remedy, the Obama Administration proposes that the two categories should be eliminated and the foreign tax credit limitation should be applied to all foreign-source income on which a foreign tax credit (either actual or deemed) would be allowed.[97] Although the method for calculating the limitation would change, the taxpayer's ability to carry forward disallowed tax credits due to the limitation would not be modified.[98]

The proposals also attempt to update the Subpart F rules. One of the proposals relates to expanding the definition of foreign base company income to include a new category for transactions involving digital goods or services.[99] The Obama Administration claims that the

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[93] This is not to say that U.S. MNCs should not hire highly trained tax professionals in an attempt to reduce its tax liability. On the contrary, U.S. MNCs who have the resources available should be given the autonomy to allocate its resources as it wishes, even if it decides to hire tax professionals to reduce its overall tax liability. However, the expertise of the tax professionals should be focused on modifying economic operations rather than arbitrarily creating the transactions that shift income between high-tax and low-tax jurisdictions.

[94] General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, (Department of Treasury 2014), available at http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx.

[95] *Id.* at 280.

[96] *Id.* at 44.

[97] *Id.* This proposal would essentially return the foreign tax credit limitation method to its pre-2004 format.

[98] *Id.*

[99] *Id.* at 58-59.

current provisions are inadequate to capture digital transactions in a consistent manner. As a result, taxpayers have the ability to characterize a transaction involving digital products in a variety of ways (lease, sale, or services), each of which have different tax treatment under the Subpart F rules.[100] Because this creates a high potential for taxpayer manipulation and abuse, the Obama Administration proposes that foreign base company income should include "foreign base digital income," which would include income derived from sale of copyrighted material by a CFC which did not substantially contribute to the development of the copyrighted material.[101] The proposals further note that the same-country exception would still apply.[102]

B. Eliminating the Deferral Privilege

While the current international tax system intertwines a credit system with source-of-income rules with the deferral privilege, a credit system with source-of-income rules can exist without the deferral privilege. In fact, the concept of separating the two aspects is not new. Prior to the enactment of the Subpart F rules in 1962, the Kennedy Administration proposed to eliminate the deferral privilege entirely, stating that the international tax system favored U.S. investment in foreign jurisdictions over U.S. investment in the United States.[103] Without the deferral privilege, a foreign corporation's income would be immediately taxable in the United States as a deemed dividend to the U.S. shareholder of the foreign subsidiary as long as certain ownership requirements were met, regardless of whether or not the earnings were distributed or undistributed.[104] The credit system rules would still apply to the deemed dividend, and the U.S. shareholder would receive a foreign tax credit for any foreign taxes paid to the foreign

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[100] *Id.*

[101] *Id.* "Substantial contribution" is currently used under the manufacturing exception to foreign base company sale income. Some activities which are evidence of substantial contribution in the manufacturing context include oversight and direction over the manufacturing process, performance of some manufacturing activities, material selection, vendor selection, management of costs or capacities, control of manufacturing related logistics, quality control, and developing certain intangible property. Rev. Rul. 75-7. Although not explicitly stated in the Obama Administration proposals, it is likely that "substantial contribution" under the proposals would follow the same definition.

[102] Department of Treasury, *supra* note 55, at 59. For the definition of the same-country exception, see I.R.C. § 954(c)(3).

[103] Office of Tax Policy, *supra* note 59, at 112.

[104] *Id.* The ownership requirements were substantially the same as ownership requirements for the subsequently enacted definition of a CFC. *See* note 73.

jurisdiction.[105] Although the proposal was presented to Congress in 1962, Congress rejected the complete elimination of the deferral privilege[106] and modified the proposal to eliminate the deferral privilege only on certain transactions, which led to the adoption of the Subpart F rules.[107]

More recent proposed legislature has also contemplated eliminating portions of the deferral privilege. The proposed United States Job Creation and International Tax Reform Act of 2012 recommended creating an exception to the deferral privilege for "low-taxed income."[108] The proposed law would amend I.R.C. § 952 by immediately including any "low-taxed income" earned by a CFC in the gross income of the U.S. shareholder through the Subpart F rules.[109] However, "qualified business income" earned by the CFC would still be subject to the deferral privilege and not subject to immediate taxation in the United States.[110] Furthermore, the determination of whether income was "qualified business income" or "low-taxed income" would be performed on a country-by-country basis, with the CFC unable to blend earnings derived from different countries to achieve a more desirable result.[111] While these rules target the deferral privilege in a limited capacity, Congress has not responded to the proposed bill since 2012.[112]

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105 Office of Tax Policy, *supra* note 59, at 112.

106 Opponents of eliminating the deferral privilege unanimously cited competitiveness as one of the deciding factors. At the time, other jurisdictions did not have a tax regime that would tax foreign operations outside of its respective jurisdiction. If the United States were to adopt such a regime, investors would likely invest in foreign jurisdictions over the United States due to tax concerns. Furthermore, opponents claimed that investment in foreign jurisdictions actually stimulated the U.S. economy. In their opinion, a U.S. MNC that invested abroad would earn a return in excess of the foreign investment, which the U.S. MNC would then use to expand operations in the United States. *Id.* at 121-122.

107 *Id.* at 113-116.

108 112th Congress (2011-2012), S.2091.IS Sec. 201. According to the proposal, "low-taxed income" is defined as "the entire gross income of the controlled foreign corporation unless the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax [] opposed by a foreign country in excess of one-half of the highest [U.S. corporate income tax rate.]" *Id.* at Sec. 201(b).

109 *Id.* at Sec. 201(a).

110 *Id.* at Sec. 201(b). Income could qualify as "qualified business income" if three conditions were met: (1) the income was attributable to an active trade or business, (2) the corporation maintains a fixed place of business in the foreign country, and (3) the officers and employees located in the fixed place of business conducted the active trade or business. *Id.*

111 *Id.*

Many who believe that the removal of the deferral privilege would constitute a significant improvement in the international tax model state that treating each foreign entity as a pass-through entity for U.S. tax purposes would effectively simplify the international system.[113] Because one of the largest areas of complexity in the Internal Revenue Code comes from the anti-deferral measures of the Subpart F regime, elimination of a need for the regime would render these provisions useless and could be repealed.[114] Furthermore, because the worldwide operations of a U.S. taxpayer would immediately be taxable in the United States, the taxpayer would not need to consider the tax impact of structuring operations.[115] In particular, the transfer pricing rules, which are incredibly difficult to administer effectively, would become almost irrelevant. Proponents who believe in the removal of the deferral privilege believe that this would lead to taxpayers conducting business in a more economically efficient manner.[116]

C. Territorial System and the Camp Proposal

The most cited alternative to the current international tax system is the territorial system, also known as the "participation exemption" system. A territorial system is fundamentally different from the current credit system because it does not focus on taxation of worldwide income as a starting point. Instead, the territorial system focuses on taxation of business operations that are located only within the jurisdiction itself, and income that is generated by a resident corporation in foreign jurisdictions will be subject to tax only in the foreign jurisdiction. A common exception to this rule is that the territorial system can be modified to allow for taxation of a small amount of easily movable foreign income, such as passive investment

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112 The proposed bill was last referred to the Committee on Finance on February 9, 2012, but has not since been acted upon. *Bill Summary & Status, 112th Congress (2011-2012) S.2091*, THE LIBRARY OF CONGRESS (last visited on March 20, 2015), http://thomas.loc.gov/cgi-bin/bdquery/z?d112:SN02091:@@@X.

113 *See* Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 S.M.U. L. REV. 455 (199) at 512.

114 *Id.*

115 *Id.*

116 *Id.* at 515. In their study, Peroni, Fleming, and Shay note that there would still be a few issues with enacting a pure pass-through proposal, such as the need to retain and modify many of the existing Internal Revenue Code sections. However, the complexities that the new regime would create would be offset by the benefits that elimination of the deferral system would simultaneously create. *Id.*

income.[117] However, regardless of whether or not all of the active business income is exempted from taxation under the system, foreign tax credits are entirely disallowed.

Use of the territorial system has become more common since the turn of the millennium. As of 2012, 28 of the 34 current OECD members have adopted some version of a territorial tax system, with 14 of these countries adopting the territorial system since 2000.[118] Of these 28 countries, twenty of the countries have a territorial system that exempts 100 percent of eligible foreign subsidiary dividends while the other eight countries have a territorial system that exempt 95 percent or more of eligible foreign subsidiary dividends.[119] This shift in tax systems has also shifted the location of the world's largest OECD-based companies of the Forbes 500 list. As of 2000, only 85, or approximately 17%, of these companies were located in territorial tax system jurisdictions.[120] However, as of 2012, 261, or approximately 61%, of the world's largest OECD-based companies were located in territorial tax system jurisdictions.[121] After removing any U.S.-based companies on the Forbes 500 list from this percentage, an overwhelming 91% of non-U.S. OECD companies are located in territorial tax system jurisdictions.[122]

The United States has considered a moving to a territorial system. The leading proponent of the territorial system is Rep. Dave Camp (R-Mich.), who introduced a discussion draft of his proposal to adopt the territorial system through the Ways and Means Committee in 2014 (the "Camp Proposal").[123] The Camp Proposal recommends that the United States adopt a territorial system that exempts 95 percent of eligible foreign subsidiary dividends, similar to the systems adopted by members of the OECD, and would be effective for tax years beginning after 2014.[124]

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[117] Partial participation exemption systems traditionally use an exemption rate of 95%.

[118] PRICEWATERHOUSECOOPERS, *Evolution of Territorial Tax System in the OECD* 3, 7 (April 2, 2013), available at http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf. The only OECD members that still utilize a credit system are Chile, Ireland, Israel, the Republic of Korea, Mexico, and the United States. *Id.* at 3.

[119] *Id.*

[120] *Id.* at 12.

[121] *Id.*

[122] *Id.* at 13.

[123] Tax Reform Act of 2014, 113th Congress (2015-2015) H.R.1.

[124] *Id.* at 142.

However, modified elements of the foreign tax credit system would remain in place for the 5 percent of eligible foreign subsidiary dividends that would be subject to U.S. taxation, such as the foreign tax credit limitation, source-of-income rules, and Subpart F rules.[125] The Camp Proposal also addresses the transition from the current international tax system to the territorial system with respect to the currently non-taxed foreign income that was earned under the deferral privilege through a one-time "repatriation holiday." According to the proposal, the historic foreign deferred earnings will be immediately taxable in the United States by the U.S. shareholder at special rates based upon certain criteria.[126] The historic foreign deferred earnings would first be categorized as either earnings retained in the form of cash, cash equivalents, or certain other short-term assets or as earnings reinvested in the foreign subsidiary's business in the form of property, plant, and equipment.[127] After classification, the portion of earnings classified as retained in the form of cash, cash equivalents, or certain other short-term assets would be subject to a tax rate of 8.75% while the earnings classified as reinvested in the foreign subsidiary's business in the form of property, plant, and equipment would be subject to a tax rate of 3.5%.[128]

The Camp Proposal is structured with the goal of allowing U.S. corporations to compete more efficiently with foreign corporations.[129] As Rep. Camp stated in a hearing on international tax reform:

> *There is no doubt that the global marketplace is changing. Today it doesn't even slightly resemble the marketplace that America once dominated. As the world economy changes, America must also change and adapt. That begins with transforming our Tax Code so that America can be a more vibrant competitor abroad and a more attractive place to invest and create the jobs we need here at home.*[130]

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[125] *See generally id.* at 145-151.

[126] *Id.* at 143.

[127] *Id.*

[128] *Id.*

[129] *Id.* at 142.

[130] COMMITTEE ON WAYS AND MEANS, *Camp Announces Hearing on How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market and Create Jobs*, (May 24, 2011). http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=275739.

To achieve this result, the Camp Proposal also lowers the corporate statutory tax rate to 25 percent through a phase-out program.[131] This reduction would "not only increase America's ability to compete internationally, but also would ensure that American corporations have more resources here in the United States to invest, hire and grow their businesses."[132] The Camp Proposal quantifies this assertion by estimating that this reduction would add approximately 581,000 jobs annually and increase the GDP growth by approximately 1 to 2 percent.[133]

Proponents of a territorial system laud the creation of domestic jobs and increase in domestic wages. According to these proponents, U.S. MNCs are more likely to invest in foreign jurisdictions when the business decision is not affected by U.S. taxation.[134] Although increasing investment in foreign jurisdictions may be seen as a way for U.S. MNCs to move existing domestic jobs overseas, proponents of the territorial system believe that any loss of direct labor positions, such as jobs related to manufacturing, would be offset by the creation of domestic jobs related to the overhead of the products, such as procurement, finance, and legal activities.[135] Furthermore, because of the economic expansion of the U.S. MNC, wages for these positions increase as the U.S. MNC has increased capital to allocate to employee wages.[136]

Although the most popular alternative suggested in tax reform discussions, the territorial system does not have universal support. Critics state that moving from a credit system to a territorial system would create more incentives for U.S. MNCs to invest offshore, both economically and artificially through income shifting.[137] Similar to the competitiveness argument raised by Congressional Republicans and private businesses, critics argue that lower-

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[131] Tax Reform Act of 2014, *supra* note 123 at 49.

[132] *Id*. at 50.

[133] *Id.*

[134] *See generally* Curtis S. Dubay, *A Territorial Tax System would Create Jobs and Raise Wages for U.S. Workers*, BACKGROUNDER (Sep. 11, 2013), available at http://report.heritage.org/bg2843.

[135] *Id.*

[136] *Id. But see* Chye-Ching Huang, Chuck Marr, and Joel Friedman, *The Fiscal and Economic Risks of Territorial Taxation*, CENTER ON BUDGET AND POLICY PRIORITIES (January 31, 2013), http://www.cbpp.org/cms/?fa=view&id=3895 (arguing that U.S. wages would actually decrease as a result of a territorial system).

[137] *Id*. at 2-3.

tax jurisdictions are more attractive than investment in the United States due to the United States high statutory tax rate.[138] Because a territorial system would essentially transform the deferral privilege into a complete forgiveness privilege, U.S. MNCs could book profits overseas and never pay U.S. tax on the transactions, even if the cash were later repatriated to the United States.[139] This favorable treatment, critics argue, would decrease the tax base in the United States and increase already high budget deficits.[140] To avoid the reduction in tax revenue, Congress would then be pressured to raise taxes on domestic investment, which may consist of small businesses and purely domestic businesses that do not have the ability to operate overseas.[141]

D. Formulary Apportionment

A seemingly overlooked alternative to the international tax system is perhaps the most familiar to U.S. tax practitioners: formulary apportionment. Under a formulary apportionment system, worldwide income of a U.S. MNC is apportioned among countries based upon a set formula, and each jurisdiction has exclusive taxing rights to its apportioned amount. Because each jurisdiction is able to tax only the apportioned amount, the threat of double taxation is eliminated.[142] There are two versions of the apportionment formula that are commonly asserted: a single-factor apportionment method and a three-factor apportionment method. The single-factor apportionment method focuses solely on sales income and can be expressed as follows:

$$\text{Taxable Income} = \frac{\text{Sales Within Jurisdiction}}{\text{Total Sales}} \times \text{Total Profit}$$

The single-factor apportionment method is easier to calculate compared to the three-factor apportionment method, which focuses on sales income, payroll, and property and can be expressed as follows:

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[138] *Id.*

[139] *Id.* For a more in-depth discussion of the application of this criticism to the Camp Proposal, see Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 2013 WTD 199-12, available at http://taxprof.typepad.com/files/72ti0155.pdf.

[140] HUANG ET AL., *supra* note 136 at 4-6.

[141] *Id.* at 6.

[142] The reduction of double-taxation risk in a formulary apportionment system assumes that all jurisdictions adopt the system at the same time. If there is a mismatch in the taxing regime methodology (e.g. one jurisdiction adopts the formulary apportionment methodology while another jurisdiction adopts the territorial methodology), there is an increased risk that more than one jurisdiction will claim taxing rights to the same income.

$$\text{Taxable Income} = \frac{\text{Jurisdiction Sales}}{\text{Total Sales}} \times \frac{\text{Jurisdiction Payroll}}{\text{Total Payroll}} \times \frac{\text{Jurisdiction Property}}{\text{Total Property}} \times \text{Total Profit}$$

Neither the single-factor apportionment method nor the three-factor apportionment method have been adopted yet by any country in the international context, although multiple proposals have been presented in the past to both the European Union and the United States.[143]

If there has not been any country that has adopted formulary apportionment in the international context, why should it look familiar to U.S. practitioners? The answer is that the United States uses formulary apportionment in determining state and local tax. Similar to the international context, states found problems with taxing the activities of U.S. corporations because U.S. corporations are legally located only in at most two jurisdictions (the jurisdiction where the corporation is incorporated and the jurisdiction in which the corporation maintains its principal place of business.) However, U.S. corporations perform activities in a variety of states outside of these jurisdictions, causing the outside states to run into issues with taxing the activities that occurred within their respective jurisdictions. In response to this issue, the Supreme Court announced that outside states could tax the interstate commerce of U.S. corporations located outside the taxing state's jurisdiction if certain tests were met.[144] Two of these tests are that the corporation's activity has a substantial "nexus"[145] with the outside state and that the tax is fairly apportioned to the U.S. corporation's activity.[146] Many states adopted the "Massachusetts formula," another name for the three-factor apportionment method, to comply with these standards, focusing on sales, payroll, and property factors. As of 2013, 29 states use the Massachusetts formula while 12 states use a single-factor sales apportionment method.[147]

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[143] *See generally* JOANN M. WEINER, FORMULARY APPORTIONMENT AND GROUP TAXATION IN THE EUROPEAN UNION: INSIGHTS FROM THE UNITED STATES AND CANADA (European Union 2005), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/2004_2073_EN_web_final_version.pdf. *See also* KIMBERLY A. CLAUSING & REUVEN S. AVI-YONAH, REFORMING CORPORATE TAXATION IN A GLOBAL ECONOMY: A PROPOSAL TO ADOPT FORMULARY APPORTIONMENT (The Brookings Institution 2007), available at http://www.brookings.edu/~/media/research/files/papers/2007/6/corporatetaxes%20clausing/200706clausing_aviyonah.pdf.

[144] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[145] "Nexus" in the state and local taxation context means a seller's minimum level of physical presence within a state that permits the state to tax the activity of the seller.

[146] *Id.* at 279.

Formulary apportionment systems have been praised by proponents who believe that the system more accurately reflects the economic realities of U.S. MNCs.[148] Advocates of the system state that in systems where sales factors are considered, the economic transaction controls the tax aspects instead of the other way around.[149] Furthermore, even in formulary apportionment systems where payroll and property are considered, the factors are directly related to actual economic operations. Thus, if a U.S. MNC desired to manipulate its apportionment factors, it would be required to move *real* economic operations to achieve the goal.[150] This directly reduces the ability of U.S. MNCs to artificially create transactions that make it appear as if economic operations moved without actually moving the operations, thus reducing the incentive to attempt these type of transactions without considering other business impacts.[151]

Conversely, the formulary apportionment system is criticized by some as a system that is "likely to be incapable of living up to [its] billing, especially as time passes and taxpayers become more familiar with its limitations."[152] Specifically, critics of the system state that unless formulary apportionment is adopted by all jurisdictions, there is still a large potential for U.S. MNC income to remain untaxed through the use of artificial tax planning among jurisdictions.[153] Furthermore, even if each jurisdiction were to agree to implementation, the coordination and maintenance of the system would result in a significant amount of compliance costs worldwide.[154] While U.S. MNCs would see traditional compliance costs rise, such as the costs needed to structure their internal operations to facilitate the change, political administrations would also have to restructure existing tax treaties and other systems to facilitate the new

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[147] JOHN C. HEALY & MICHAEL S. SCHADEWALD, 2013 MULTISTATE CORPORATE TAX GUIDE, 5007-5014 (CCH 2012). The remaining nine states do not impose a corporate income tax.

[148] *See* Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

[149] *Id.* at 507.

[150] *Id.*

[151] *Id.*

[152] Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 238 (2008).

[153] *Id.* at 222-229.

[154] Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593. 632-33 (2010).

universal system.[155] Thus, critics believe that the change to a formulary apportionment system would have implicit costs that outweigh any of the potential benefits.

V. ANALYSIS OF ALTERNATIVES TO THE CURRENT SYSTEM UNDER THE CHICAGO SCHOOL ECONOMIC PRINCIPLES

A. The 2015 Obama Administration Proposals

The 2015 Obama Administration proposals do not comply with Chicago School principles. While the proposals would close a few of the loopholes that U.S. MNCs have engaged in to perform "tax plays," the proposals do not do enough to eliminate the ability for U.S. MNCs to conduct "tax plays" in the aggregate. First, the Obama Administration's proposal to eliminate the distinction between the general category and passive baskets of income still does not contemplate that transactions can be artificially manufactured to mismatch income and deductions between U.S.-source and foreign-source income. Second, the proposal to create a separate type of Subpart F income for digital goods and services does not do enough to prevent a U.S. MNC from reducing the taxable income of the CFC with potential Subpart F income through the use of paper transactions without modifying the underlying economic transactions. In particular, shifting intellectual property rights to low-tax countries so that the U.S. parent can pay deductible royalties succeeds in artificially shifting profits from high-tax to low-tax countries. Because unique intellectual property rights are extremely difficult to value under the arm's-length standard, transfer pricing has been particularly difficult to police in this area.[156] Thus, although these proposals are a step in the right direction, the slight reduction of the ability to perform "tax plays" does not achieve its desired goals and thus still permits significant rent-seeking behavior.

B. Territorial System and the Camp Proposal

The Camp Proposal also does not comply with Chicago School principles. Although the Camp Proposal is ambitious and more developed than the other alternatives, the territorial system

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[155] *Id.* In her analysis on a destination sales formulary apportionment model, Morse claims that incremental reform may be more advantageous than an immediate complete shift to ease the implicit compliance costs and to facilitate coordination between jurisdictions. *Id.* at 639-640.

[156] For examples of the difficulties associated with transfer pricing and the valuation of intellectual property rights, see Veritas Software Corporation & Subsidiaries v. Commissioner, 133 T.C. 14 (2009) and Xilinx Inc. and Subsidiaries v. Commissioner, 125 T.C. 4 (2005).

as proposed still allows significant opportunities for U.S. MNCs to engage in "tax plays" due to the differing tax rates and intransigent transfer pricing problems, thus not adhering to the neutrality norm. By subjecting only U.S.-source income, but not all income, to taxation in the United States, the Camp Proposal creates an incentive for U.S. MNCs to modify their operations to take advantage of lower tax rates in jurisdictions without any consequences, thus leading to rent-seeking behavior in the form of reducing tax liability and increasing "tax" profits that do not reflect business profits.

Empirical evidence supports this assertion. In 2011, a study was performed with the focus of determining whether corporations domiciled in a country using a territorial system shifted more income to foreign countries than corporations domiciled in a country using a worldwide credit system.[157] The study gathered financial statement and ownership date for MNCs domiciled in a total of 34 countries,[158] including all of the MNCs' subsidiaries, between 2004 and 2008.[159] Based on the data, the study concluded that MNCs located in jurisdictions that utilize a territorial system shift more income to foreign jurisdictions than do MNCs when the tax incentives and opportunities are the same.[160] Furthermore, the study concluded that this difference in income shifting was related solely to income shifting from the MNC's domiciled country to a foreign country and that there was no statistical evidence that the income shifting was due to income shifting among foreign subsidiaries.[161]

The presence of the repatriation holiday also violates the principles of the Chicago School creating an opportunity for rent-seeking behavior instead of preventing it. The Camp Proposal is not the first time that a repatriation holiday has been used in the United States. In 2004, the American Jobs Creation Act of 2004 created a similar "one-time" repatriation holiday

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[157] Kevin Markle, *A Comparison of the Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries*, SOCIAL SCIENCE RESEARCH NETWORK (September 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1764031. The study assumed that the territorial system was a 95 percent exemption system, similar to the system proposed in the Camp Proposal.

[158] Of the countries sampled with multinational parents, 21 of the countries had adopted a territorial system while the remaining 13 countries had adopted a worldwide credit system. In total, the study contained analysis for 42 countries with 8 countries only containing subsidiaries of foreign multinational corporations.

[159] *Id.* at 3.

[160] *Id.* at 20.

[161] *Id.* at 21-22.

that U.S. MNCs used to repatriate approximately $362 billion, with $312 billion being subject to a reduced income tax rate of 3.7%.[162] While Congress imposed restrictions on the permissible uses for the repatriated earnings, multiple studies found that U.S. MNCs did not use the funds to increase wages or create jobs. Instead, the U.S. MNCs often repurchased their outstanding shares or increased payouts to shareholders.[163] Furthermore, U.S. MNCs actually reinvested the repatriated earnings in foreign operations, with a significant average increase of $1.32 billion a year between 2006 and 2008 compared to an average increase of $342 million a year between 1994 and 2004.[164] Using this evidence, it is clear that a repatriation holiday would still allow for significant tax play opportunities since U.S. MNCs would repatriate only to receive a tax benefit. Because the U.S. MNCs would reinvest the repatriated earnings in foreign jurisdictions to avoid reinvesting the earnings in the United States, which could create additional taxable income, the repatriation holiday violates the neutrality norm.

C. Eliminating the Deferral Privilege

The elimination of the deferral privilege from the current system is a viable option for international tax reform when considering its ability to eliminate "tax plays." By eliminating the deferral privilege, foreign income would immediately be taxable in the United States, whether the income was actually repatriated or not. This modification to the system complies with the neutrality norm by eliminating the incentive to shift income to foreign jurisdictions with lower tax rates. Significantly, it also reduces or eliminates intransigent transfer pricing abuse because the income, whether booked in the United States or abroad, would be currently taxed to the United States. In other words, U.S. MNCs would no longer benefit from artificial transfer prices. Although a foreign tax credit would still be allowed to the extent of the foreign taxes paid on the foreign income, the United States would still have one of the highest statutory income tax rates.

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[162] Chuck Marr & Brian Highsmith, *Tax Holiday For Overseas Corporate Profits Would Increase Deficits, Fail To Boost the Economy, and Ultimately Shift More Investment and Jobs Overseas*, CENTER ON BUDGET AND POLICY PRIORITIES (June 23, 2011), available at http://www.cbpp.org/files/4-8-11tax.pdf. The effective rate was originally projected to be 5.25% where the first 85% of repatriated earnings would be tax free and the remaining 15% of repatriated earnings would be taxed at the top corporate rate of 35%. *Id.* However, in reality, approximately 30% of the remaining tax liability was ultimately offset by foreign tax credits, causing the actual effective rate to be closer to 3.7%. *Id.*

[163] *Id.* at 4-5.

[164] *Id.* at 8.

Thus, regardless of the amount of foreign tax credit that could be used on a yearly basis, a U.S. MNC's worldwide effective rate would consistently remain at the U.S. statutory rate, although the taxes would be paid to a multitude of jurisdictions. As this rate could not be manipulated through permanently reinvesting earnings offshore, U.S. MNCs would be less inclined to engage in transactions for tax purposes.

In 2013, Grubert and Altshuler analyzed the effects of alternative systems, including the elimination of the deferral privilege (referred to as the "full inclusion" system) on the ability of MNCs to shift income between jurisdictions.[165] As a testing model, the study utilized the effective tax rate and tax revenue as indicators of this ability.[166] According to the model, the effective tax rate of a MNC was unaffected by outside changes when eliminating the deferral privilege.[167] Furthermore, overall tax revenue was unaffected by outside changes when eliminating the deferral privilege, although the proportion of U.S. tax revenue versus foreign tax revenue would vary depending on investment.[168] Due to these results, the study concluded that repealing deferral would provide no incentive to shift income from a higher-tax jurisdiction to a lower-tax jurisdiction.[169]

D. Formulary Apportionment

The adoption of a formulary apportionment system is also a viable option for international tax reform with the preferred method being a single-factor system based upon destination sales. Under the single-factor system, tax would be imposed solely on the location of destination sales or services, an item which is driven primarily by market demand. Because the destination of the sales or services would be used rather than the location from which the goods would be shipped or the service provider's home country, the ability to incorporate in

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[165] Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NATIONAL TAX JOURNAL 671 (2013). The study assumed a statutory rate of 30% and tested each alternative system with respect to two foreign options: a low-tax investment with a statutory rate of 5% and a high-tax investment with a statutory rate of 25%.

[166] *Id.* at 686, 691.

[167] *Id.* at 687, 689.

[168] *Id.* at 692.

[169] *Id.* at 689. The study noted that an incentive may arise if a U.S. corporation entered into an excess credit situation. However, this would be difficult to do under current statutory rates.

jurisdictions to take advantage of low-tax rates would be diminished. Instead, the market would dictate where the MNC pays taxes, not the MNC through manipulation of incorporation destinations and arbitrary income shifting on paper. Thus, the single-factor system would comply with the neutrality norm, as taxes would not materially affect the market demand for a product.

A three-factor formulary apportionment system would also achieve this effect to a degree. However, although it may be considered, the three-factor system should not be adopted in lieu of the single-factor system. Because the three-factor system utilizes wages and property within a jurisdiction in addition to destination sales, there is more potential for tax-play-driven transactions. For example, a U.S. MNC could relocate highly compensated individuals to low-tax jurisdictions and locate lower compensated individuals in high-tax jurisdictions while continuing to consummate sales based solely on market demand. As the location of the administrative employees may not relate to the sales function, this would distort the apportionment factor for each jurisdiction from marketplace demand and demonstrate rent-seeking behavior in favor of low-tax jurisdictions.

Kimberly Clausing provides support for these assertions in her 2014 study of formulary apportionment system used among the individual U.S. states.[170] In the study, Clausing gathered sales, employment, capital expenditure, corporate tax revenue, and other relevant data for each of the fifty states spanning from 1986-2012.[171] The study proceeded to test each of the apportionment factors separately against constant explanatory variables to determine each factor's impact on the economic activities generated in each state.[172] In each instance, the test determined that the apportionment factor did not have a significant impact on the economic activity of the U.S. states.[173] Clausing finally concludes that the formulary apportionment system does not incentivize income shifting but also states that concerns of apportionment manipulation through distortion of formula factors is a valid concern.[174]

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[170] Kimberly Clausing, *Lessons for International Tax Reform from the US State Experience Under Formulary Apportionment*, INTERNATIONAL CENTRE FOR TAX AND DEVELOPMENT (March 2014), available at http://ssrn.com/abstract=2437362.

[171] *Id.* at 26-27.

[172] *See generally id.* at 6-14.

[173] *Id.* at 20.

VI. CONCLUSION

International tax reform is long overdue. As long as Congress allows U.S. MNCs to operate in the current system, U.S. MNCs will continue to manipulate the system through loopholes to obtain the highly favorable effective tax rates through the use of overly complex transactions and structures. Because the ability to consummate tax plays exists, there is an inherent economic inefficiency under Chicago School analysis that must be cured. However, Congress must be careful to adopt an international tax system that does not distort marketplace behavior by encouraging one practice over another due to tax benefits. Furthermore, Congress must adopt an international tax system that encourages the creation of aggregate societal wealth instead of the mere shifting of wealth from one entity to another entity by allowing resources to naturally allocate to their most efficient use.

As Part V discussed, the two viable options for international tax reform are (1) the credit system with source-of-income rules without the deferral privilege and (2) a single-factor formulary apportionment system based upon destination sales. Using these models as a base, Congress can collaborate with economists, policy makers, and practitioners familiar with administrative difficulties to determine a viable application of these systems without some of the potential pitfalls identified with each system. Furthermore, Congress can coordinate with foreign jurisdictions to determine how to implement these types of systems worldwide, thus eliminating the ability for MNCs to take advantage of inconsistent regimes. Average citizens can also use the analyses performed in Part V. By understanding an otherwise complex area, citizens will have the ability to inquire about a potential representative's position on international tax reform and elect a representative accordingly. This will in turn protect the citizen from potential additional taxes arising from MNCs artificially shifting their tax base to other countries.

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[174] *Id.* at 24-25.