**JUDGING THE NEW INTERNATIONAL TAX REGIME**

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Good morning, Mr. Chairman, Ranking Member Wyden, and Members of the Committee. My name is Rebecca Kysar, and I am a professor of law at Brooklyn Law School and will be joining the full-time faculty of Fordham University School of Law later this year. Before joining Brooklyn Law School, I practiced tax law at Cravath, Swaine & Moore in New York, which included advising on cross-border mergers, acquisitions, and restructurings. Thank you for the opportunity to testify on the recent tax legislation.

My primary topic today is the new international tax regime. The recent tax law made significant changes to the way the United States taxes multinational corporations on their cross-border income. The new legislation has, however, fundamentally botched general business taxation in order to "fix" the international system. In fact, the new legislation failed to solve old problems of that system and also opened the door to new perversities. Furthermore, the legislation will deplete government resources and exacerbate growing inequality. To be sure, the title of this hearing is "Early Impressions of the New Tax Law," and, it would be brazen to describe my views as anything but preliminary. My genuine concern, however, is that, with the benefit of hindsight, we will look back at this legislation as a series of tragic policy missteps, which hold the United States back in the 20th century rather than propelling it to be a competitive force and source of general well-being for its citizens in the current one.

Before addressing international taxation, I would like to make a few comments about the legislation generally. One of the most unfortunate aspects of the legislation is its immense cost. By shrinking revenues over the next decade by $1.9 trillion,[2] the tax legislation leaves the country with fewer government resources just as social needs and demographic shifts begin to demand much more of them. This figure, however, is likely to be a low estimate of the legislation's long-term effects. Many of the revenues from the international provisions are front-loaded into the ten-year budget window as a result of the transition tax on the deemed repatriation of old earnings. This is a one-time event that will not be generating revenues going forward, and arguably significantly undertaxed those earnings at windfall rates of 8% and 15.5% given that they were earned in a rate environment of 35%. Moreover, the estimate assumes that

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Much of my testimony here comes from analysis I developed in serving as the primary drafter of the international tax sections of papers discussing the recent tax legislation. *See* Kamin et al., *The Games They Will Play: Tax Games, Roadblocks and Glitches Under the 2017 Tax Overhaul,* 103 MINN. L. REV. (forthcoming 2019); Avi-Yonah et al., *The Games They Will Play: An Update on the Conference Committee Bill* (Dec. 28, 2017) (unpublished manuscript, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423; Avi-Yonah et al., *The Games They Will Play: Tax* Games, Roadblocks, and Glitches Under The New Legislation (Dec. 13 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084187.

[2] Congressional Budget Office, The Budget and Economic Outlook: 2018-2028, p. 106 (April 2018), *at* https://www.cbo.gov/publication/53651.

several far-off tax increases in the international rules will go into effect, a perhaps unlikely event. The $1.9 trillion estimate will also likely be much greater if the law's expiring provisions, or a portion of them, are made permanent.[3] Numerous tax planning opportunities that have been created by the new legislation will lose vast amounts of revenue. Finally, if the new U.S. taxing environment spurs other countries to engage in tax competition, as one would expect, this might reduce the anticipated growth effects of the legislation by decreasing the amount of investment flowing into the United States.

As a result of these deliberate choices, the new tax legislation does not engage our most important fiscal and social problems. On this fiscal side, it fails to provide a stable base on which the economy can grow. On the social side, it will not provide funding for resources to address important public needs, like infrastructure, education, social insurance, the opioid epidemic, healthcare, and military funding. Because of the threat to these programs, low- and middle-income Americans will likely be negatively impacted. Given that the highest income Americans also receive the lion's share of the tax cuts, the legislation not only fails to address the growing inequality in the country, but likely worsens it.

I also believe many features of the new legislation have created a great deal of unnecessary uncertainty. The instability of the new tax landscape comes from the law being enacted through a partisan process, deficit-financing of the cuts, the law's numerous sunset provisions, new gaming opportunities, the privileging of certain industries over others, and the offshoring incentives and other flaws presented by the international rules that I will discuss here.[4] The wobbliness of the new regime will make tax planning challenging. It may also dampen some of the economic growth anticipated by the law's architects.

Finally, the need for international tax reform was the impetus for the legislation but become the proverbial tail wagging the dog. In an attempt to deal with base erosion and profit shifting strategies of multinationals, we have instead created a true mess of business taxation generally. The new "pass-through" deduction, which was aimed at creating parity with the new lower rate available on corporate income, punishes workers and certain industries, substituting congressional judgment for market discipline and allowing for significant tax planning (and revenue-losing) opportunities. Individuals can now also use corporations as tax shelters to avoid the top rate, thereby undermining the individual income tax system.

Given the enormous loss of government resources and gamesmanship the legislation will generate, it is fair to ask a lot of the new international regime. Yet the international provisions fall short, mostly due to avoidable policy choices. Let me say at the outset that the baseline against which I am assessing the international provisions in the new law is not the old, deeply

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[3] CBO estimates that the permanent extension of all expiring tax provisions would reduce revenues by $1.2 trillion over the next decade. *Id.* at 90. Moreover, Congress tends to contort the budget process so that temporary legislation is not subject to its usual rules and may attempt to make such tax cuts permanent without paying for them. *See, e.g.*, Consolidated Appropriations Act, § 601 (exempting the costs of making the tax "extenders" permanent from PAYGO); David Kamin & Rebecca Kysar, *Temporary Tax Laws and the Budget Baseline*, 157 TAX NOTES 125 (2017) (discussing this phenomenon in the Bush tax cuts context); Rebecca Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1030-41 (2011) (critiquing the sunsets of the Bush tax cuts along this axis).

[4] *See* Rebecca M. Kysar & Linda Sugin, *The Built-In Instability of the G.O.P.'s Tax Bill*, N.Y. TIMES (Dec. 19, 2017), https://www.nytimes.com/2017/12/19/opinion/republican-tax-bill-unstable.html. I have elsewhere critiqued the use of the reconciliation process for complex tax reform. Rebecca M. Kysar, *Reconciling Congress to Tax Reform*, 88 NOTRE DAME L. REV. 2121 (2013).

flawed, system because that bar is simply too low.[5] Judged against possible alternative policies that could have been enacted, however, the new international provisions look more problematic. With the benefit of clear-eyed analysis, I am hopeful that the new legislation will serve as a bridge to true reform in the international tax area, rather than a squandered opportunity.

The serious problems created, or left unaddressed, by the new regime, include the following, which I will discuss in more detail along with possible solutions:

- The new international rules aimed at intangible income incentivize offshoring. GILTI is not a sufficient deterrent to profit-shifting because the minimum tax rate is, at most, half that of the 21% corporate rate. Also, the manner in which foreign tax credits are calculated under the GILTI regime encourages profit shifting. Moreover, the GILTI and FDII regimes encourage firms to move real assets, and accompanying jobs, offshore because of the way they define intangible income.
- The new patent box regime will likely not increase innovation, causes WTO problems, and can be easily gamed. Patent box regimes have not been shown to increase R&D or employment. Because the FDII deduction is granted to exports, it likely qualifies as an impermissible export subsidy under our trade treaties. Firms may also be able to take advantage of the FDII deduction by "round-tripping" transactions, disguising domestic sales as tax-preferred export sales.
- The new inbound regime has too generous thresholds and can be readily circumvented. Although strengthening taxation at source is a worthy goal, the new BEAT regime has too high thresholds, allowing multinationals with significant revenues and assets to engage in a great deal of profit shifting. Also, firms can avoid the regime entirely by packaging intellectual property with cost of goods sold, which is exempt from BEAT.
- The new regime falls short of true international tax reform. Rather than aligning taxation with U.S. economic needs and social objectives, the new regime doubles down on archaic concepts that have become malleable and disconnected from economic reality. The regime unwisely retains the place of incorporation as the sole determinant of corporate residency and subscribes to the fiction that the production of income can be sourced to a specific locale. These concepts should be updated, and new supplemental sources of revenue should be seriously explored. A longer-term objective should be to reach international consensus on how to tax businesses selling into a customer base from abroad.

Together, these problems underscore the necessity of continuing to improve the tax rules governing cross-border activity. It would be a grave mistake for the United States to become complacent in this area; in addition to the issues I discuss here, the challenges of the modern global economy will continue to demand dramatic revisions to the system.

Background

By way of background, the former U.S. international tax system has been described as a worldwide system of taxation because it subjected foreign earnings to U.S. taxation (whereas a territorial system of taxation exempts such earnings altogether). In reality, active earnings of

[5] *See, e.g.*, Ed Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 700-01 (2011) (discussing the insufficiency of U.S. tax rules in combatting aggressive profit shifting by multinationals).

foreign subsidiaries could be deferred, even indefinitely. The disparate treatment between foreign and domestic earnings meant that the old system was somewhere between worldwide and territorial.

The new regime has been described as a territorial system because a basic feature is that a broad swath of foreign profits are effectively exempt from U.S. corporate tax since 10% corporate shareholders can deduct the foreign-source portion of dividends from foreign subsidiaries.[6] Here again, however, we see the difficulty of deploying such labels since smaller corporate shareholders and individuals are still subject to taxation on their foreign income. Furthermore, the new minimum tax regime, along with the older subpart F rules, also means that the foreign income of 10% shareholders in certain foreign corporations (controlled foreign corporations or CFCs) is possibly subject to some U.S. taxation, depending on foreign responses.[7]

The new system retained worldwide-type features because Republicans recognized that a move to a pure territorial system would worsen profit shifting incentives by exempting foreign-source income altogether (rather than just allowing it to be deferred, as under the old system). The hybrid nature of both the old and new systems represents an attempt to balance investment location concerns, on the one hand, with concerns over the protection of the revenue base, on the other.[8]

As a general overview, the basic plan of the new tax legislation's international reforms is to: (1) exempt foreign income of certain U.S. corporations from taxation in the United States (the quasi-territorial or participation exemption system); (2) backstop this new participation exemption system with a 10.5% "minimum tax" on certain foreign-source income (the GILTI regime); (3) provide a special low rate on export income (the FDII regime); and (4) target profit-stripping by foreign firms operating in the United States (the BEAT regime). In the remainder of my testimony, I will discuss problems presented by the latter three of these new regimes.

GILTI: New Offshoring and Shifting Incentives

1. New Offshoring and Shifting Incentives

Generally speaking, the existence of a partial territorial system coupled with a minimum tax could be an improvement over the prior system, which often resulted in a zero rate of taxation on

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[6] 26 U.S.C. § 245A.

[7] *See* Mark P. Keightley & Jeffrey M. Stupak, CONG. RESEARCH SERV., R44013, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data* 17 (2015) (discussing the futility of the worldwide and territorial labels); Daniel Shaviro, *The New Non-Territorial U.S. International Tax System* (March 7, 2018) (draft on file with author) (same).

[8] Michael Graetz has described the new system as follows: "Congress confronted daunting challenges when deciding what rules would replace our failed foreign-tax-credit-with-deferral regime. There were essentially two options: (1) strengthen the source-base taxation of U.S. business activities and allow foreign business earnings of U.S. multinationals to go untaxed, or (2) tax the worldwide business income of U.S. multinationals on a current basis when earned with a credit for all or part of the foreign income taxes imposed on that income…Faced with the choice between these two very different regimes for taxing the foreign income of the U.S. multinationals, Congress chose both." Michael J. Graetz, *The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, YALE L.J. FORUM (forthcoming 2018), *draft available at* https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=3157638.

foreign earnings because of deferral and other tax planning maneuvers. It is also preferable to a pure territorial system because of the protections it places on the revenue base. Nonetheless, although a minimum tax can work conceptually, its current GILTI incarnation problematically incentivizes firms to offshore assets and profit shift, as I pointed out early in the legislative process.[9]

First, the minimum tax regime allows a fifty percent deduction of GILTI. At the 21% corporate rate, this amounts to a 10.5% rate on GILTI.[10] Given the wide differential between the domestic rate and the minimum tax rate,[11] there remains substantial motivation to shift profits. Moreover, expenses that support the production of GILTI, like research and development, general and administrative, and some interest, will be deductible at the 21% rate even though the income inclusion occurs at a 10.5% rate.[12] This amounts to a type of tax arbitrage and further incentivizes shifting income abroad.

The new tax legislation also presents more subtle incentives to locate investment and assets abroad. There is an exemption from the GILTI tax in the form of a deemed 10% return on tangible assets held by the CFC, as measured by tax basis. If U.S. firms have or locate tangible assets overseas,[13] then they can reduce their GILTI tax commensurately. This is because the more a U.S. shareholder increases tangible assets held by the CFC, the smaller the income subject to the GILTI regime.[14]

Take for instance, a firm that invests $100 million in a plant abroad through a CFC that will generate $10 million of income. None of that $10 million of income will be subject to U.S. tax because the firm gets to reduce its GILTI by the deemed 10% return on the CFC's assets.[15] In effect, the $10 million of income is reduced by 10% of 100 million, or $10 million, so that it is all tax-free. To compare, consider the tax consequences of the same firm investing in a $100

[9] Rebecca M. Kysar, *The G.O.P's 20th-Century Tax Plan*, N.Y. TIMES (Nov. 15, 2017), https://www.nytimes.com/2017/11/15/opinion/republican-tax-plan-economy.html. Others have discussed the offshoring incentives created by the legislaton. *See* Gene B. Sperling, *How the Tax Plan will Send Jobs Overseas*, THE ATLANTIC (Dec. 8, 2017), https://www.theatlantic.com/business/archive/2017/12/tax-jobs-overseas/547916/; Steven M. Rosenthal, *Current Tax Reform Bills Could Encourage U.S. Jobs, Factories and Profits to Shift Overseas*, TAXVOX (Nov. 28, 2017), http://www.taxpolicycenter.org/taxvox/current-tax-reform-bills-could-encourage-us-jobs-factories-and-profits-shift-overseas; Kimberly Clausing, *How the GOP's Tax Plan Puts Other Countries Before America*, FORTUNE (Nov. 20, 2017), http://fortune.com/2017/11/20/gop-tax-plan-donald-trump-america-first/.

[10] 26 U.S.C. § 250(a)(1). For tax years beginning after 2025, the 50% deduction is reduced to 37.5%, and thus the effective rate on GILTI goes up to 13.125% in those years. 26 U.S.C. § 250(a)(3).

[11] The rate gap with regard to exports is smaller since export income gets the benefit of a 37.5% deduction (producing a tax rate of 13.125%), as I discuss with regard to the FDII regime below.

[12] Thanks to Steve Shay for this point.

[13] The CFC could in theory invest in tangible assets in the United States and have these count for the deemed return, but this investment would be subject to current U.S. tax under 26 U.S.C. § 956.

[14] Note that I am not claiming that the offshoring incentives of the new tax law are worse overall than under the prior regime, which due to the high corporate tax rate created a large disparity between investing here versus abroad. This disparity has been minimized through the lowering of the corporate rate to 21%. *See* Martin A. Sullivan, *Economic Analysis: Where Will the Factories Go? A Preliminary Assessment*, 158 TAX NOTES 570 (2018). Instead, I am pointing out the unfortunate offshoring incentives created by GILTI that could have been avoided through alternative policies, which I discuss below.

[15] In addition to the GILTI exemption, the firm will get depreciation deductions on the assets under § 168(g).

million plant in the United States that will generate $10 million of income. It would pay U.S tax of $2,100,000 (21% of $10 million).[16]

Where there happens to be non-exempt return to tangible assets (return in excess of 10%), this is taxed by the minimum tax regime but at a lower rate than the rate on domestic income.[17] To build on the above example, assume that the $100 million foreign plant generates not $10 million, but $20 million of income. The firm will still get to exempt $10 million of the income through the deemed 10% return, but the other $10 million will be subject to the GILTI regime and given a 50% deduction (i.e., taxed at a 10.5% effective rate). This would produce U.S. tax of $1,050,000 (10.5% of $10 million), as compared to U.S. tax of $4,200,000 (21% of $20 million) on a similar U.S.-based investment.[18]

Investors will, of course, take into account local foreign taxes, and higher taxes abroad will likely sway the decision of where to locate investment. The offshoring incentives of GILTI might then primarily be a problem when low-tax countries are a viable alternative. Although many tax havens have limitations regarding labor supply, legal, and other factors, some low-tax countries, like Ireland and Singapore, are hospitable options for investment.

The structure of GILTI is even more problematic when considering foreign tax credits. The new legislation allows foreign taxes to be blended between low-tax and high-tax countries before offsetting GILTI from those countries (thus constituting a "global" minimum tax), rather than allowing foreign taxes to offset only the GILTI from the country in which they are paid (a "per-country" minimum tax). This structure encourages firms to locate investment in low-tax countries and combine them with income and taxes from high-tax countries, possibly to avoid GILTI liability altogether.[19]

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[16] Note that the rate on the income from the U.S. plant would be lower if such income exceeded a hurdle of a 10% return on the tangible assets and was export income, which is effectively taxed at a 13.125% rate in the new tax legislation. This is the FDII regime, which I discuss below. 26 U.S.C. § 250.

[17] Note that the non-exempt return amount will vary depending on tangible asset intensity. We can thus expect certain industries, like services and technology, to be harmed from this aspect of the formula, whereas other sectors, like non-U.S. manufacturing, to benefit.

[18] If this was export income, the U.S. tax on the U.S.-based investment would be $3,412,500 ($1,312,500 on the $10 million exceeding the exempt return, and $2,100,000 on the other $10 million). Again, I discuss the FDII regime in more detail below.

[19] This example does not take into account the possible allocation of expenses under the preexisting regulations for § 961, which could reduce allowable foreign tax credits perhaps contrary to congressional intent. Martin A. Sullivan, *More GILTI Than You Thought*, 158 TAX NOTES 845 (2018). The expense allocation could have a large effect on the amount of tax owed under GILTI. A host of other taxpayer unfriendly problems exist in the GILTI regime, which others have explored. For no apparent policy reason, assets in CFCs that generate losses are disregarded for purposes of calculating the deemed return on tangible property. *Id.* Additionally, Non-C-corporation shareholders may be unable to take foreign tax credits against liability for GILTI (unless they make an election under § 962). *See* Sandra P. McGill et al., *GILTI Rules Particularly Onerous for Non-C Corporation CFC Shareholders*, MCDERMOTT WILL & EMERY (Jan. 30, 2018), https://www.mwe.com/en/thought-leadership/publications/2018/01/gilti-rules-particularly-onerous-nonc-corporation. Under current law, GILTI deductions in excess of income are permanently disallowed and cannot create NOLs. Similarly, multinationals cannot carryover excess credits within the GILTI basket to future years. Both of these provisions burden businesses with volatile earnings, and may, like other loss limitations in the Code, distort investment away from risky assets. These limitations are undesirable as a policy matter, separate and apart from the appropriate level of minimum taxation of foreign source income. Shaviro, *supra* note 7. Accordingly, they should be eliminated, or, at least, relaxed. These, together with other issues, such as the

For instance, say a corporation earns $1,000,000 of income in Country A, which imposes a 21% rate of taxation. For simplicity's sake, let's ignore the deemed return by assuming there are no assets abroad. And now let's say the corporation is choosing where to locate an additional $2,000,000 in profits (and any associated activity), with the choice being between the United States and a tax haven.

There would be a $210,000 Country A tax and a tentative U.S. GILTI tax on this Country A income of $105,000 ($1,000,000 x 10.5%). But the 80% U.S. credit for the $210,000 Country A tax would reduce the U.S. tax to zero and $63,000 of excess credit would remain ($105,000-[$210,000 x .8] = -$63,000).

If an additional $2,000,000 were earned in the United States, the 21% U.S. tax thereon would be $420,000 and the $63,000 of excess credit for Country A tax could not be used to reduce this liability. Thus, the corporation's total tax liability (both U.S. and foreign) would be $630,000 ($210,000 Country A tax + zero post-credit U.S. tax on the first $1,000,000 of Country A income + $420,000 U.S. tax on the additional $2,000,000 of U.S. income).

Suppose instead that the corporation earned the additional $2,000,000 in a tax haven, Country B, which imposes no local taxes. In that case, the total foreign taxes imposed would be $210,000 (those from Country A), 80% of which ($168,000) are creditable against the 10.5% tax on GILTI. The GILTI regime produces a U.S. tax liability of $147,000 [(10.5% x $3,000,000)-168,000)] (in contrast to $630,000 if the additional investment was located in the United States). This brings down the total tax liability (both U.S. and foreign) to $357,000 (as opposed to $630,000 if the investment was made in the United States).

Note that, through this blending technique, a firm can also shield profits in tax havens by choosing to invest in high-tax countries.[20] A firm may even prefer to invest in countries with *higher* tax rates than the United States since income and taxes from such countries can be used to blend down the U.S. minimum tax to zero. If a firm has profits in tax havens, then the effective tax rate of investing in a high-tax country, say Sweden, which has a 22% statutory corporate rate, might only be 4.4% (20% of 22%) since 80% of those taxes can be used to blend down GILTI completely. This puts the United States at a competitive disadvantage, making it more likely that jobs and investment go to countries like Sweden.

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uncertainty over whether the foreign tax credit gross-up goes into the GILTI basket and questions over whether GILTI should be a separate basket from branch income, will continue to challenge tax planners.

[20] In front of this Committee, Kim Clausing explained this dynamic in the following manner: "If you earn income in Bermuda, say, where the tax rate is zero, that per country minimum tax would tax the Bermuda income right away . . . . If you have a global minimum tax you could use taxes paid in Germany to offset the Bermuda income and then you have an incentive to move income to both Bermuda and Germany." *International Tax Reform before the S. Comm. on Fin.*, 115th Cong. (2017) (testimony of Kim Clausing); *Senate Convenes International Tax Hearing*, DELOITTE (Oct. 6, 2017), https://www.taxathand.com/article/7596/United-States/2017/Senate-convenes-international-tax-reform-hearing. Ed Kleinbard has similarly warned, "[c]ompanies will double down on tax-planning technologies to create a stream of zero-tax income that brings their average down to that minimum rate." Lynnley Browning, *One Sentence in the GOP Tax Plan Has Multibillion-Dollar Implications*, BLOOMBERG (Oct. 2, 2018), https://www.bloomberg.com/news/articles/2017-10-02/trump-plan-aims-new-foreign-tax-at-apple-other-multinationals.

Finally, as a general matter, the structure of the minimum tax allows multinationals to blend their high profits from intangibles with their low profits from tangibles, thereby falling below the deemed 10% rate of return on tangible investments, and escaping the GILTI regime. This ability to blend high return with low return income will further encourage offshoring and profit shifting.[21]

In summary, the deemed rate of return and global minimum features of the GILTI regime run contrary to Congress's pronounced intention to keep investment in the United States.

2. Reform Possibilities

There are several options to remove or reduce GILTI's offshoring incentives, all of which would require legislation. First, the deduction for GILTI income should be reduced so that the gap between the domestic corporate rate and the minimum tax rate is not so large. Decreasing the rate differential will lessen the motivation to earn income abroad. It is true that too high of a tax burden on foreign income will cause corporations to simply locate their residence abroad, thereby escaping outbound base erosion rules. With the new lower 21% corporate rate and inbound base erosion regime, however, this is now much less of a concern. Additionally, the inbound rules can be strengthened, as I discuss below. Congress should also explore the haircutting of deductions that are allocable to GILTI to equalize the treatment between foreign and domestic income further.

Congress should also eliminate the exempt return on foreign tangible assets, and instead apply the minimum tax to all foreign source (non-subpart F) income. This would seek to address one of the GILTI regime's conceptual flaws: only seeking to reduce the incentive to offshore intangible assets while doing nothing to reduce the incentive to offshore operations.

If policymakers are wedded to the idea that a minimum tax should only target multinationals' intangible assets, an option would be to rethink the deemed rate of return. The 10% rate is arbitrary, does not necessarily correlate to the market return on tangibles, and seems quite high, given that the average rate of return on low-risk or risk-free assets has been much lower, especially in recent years.[22] Instead, the rate could be pegged to a dynamically adjusting market interest rate[23] or something closer to the risk-free return on Treasury yields.[24] Finally, another way to close the gap between foreign income and domestic income would be to keep the 10%

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[21] Sperling, *supra* note 9.

[22] Center on Budget and Policy Priorities, *New Tax Law is Fundamentally Flawed and Will Require Basic Restructuring* 17 (April 9, 2018), at https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring. In April 2018, a ten-year Treasury bond yielded about 2.8% interest. The average yield on ten-year Treasury bonds over the past twenty years is approximately 3.69%. Over thirty years, the average is approximately 4.87% and over ten years it is approximately 2.57%. I constructed these averages from data on the Fred Economic Data site. See Federal Reserve Bank of St. Louis,10-Year Treasury Constant Maturity Rate, *at* https://fred.stlouisfed.org/series/WGS10YR.

[23] Shaviro, *supra* note 7; *see also* Rebecca M. Kysar, *Dynamic Legislation*, 167 U. PENN. L. REV. __ (forthcoming 2019) (discussing dynamically adjusting fiscal legislation).

[24] Kamin et al., *supra* note 1. Conceptually, the exempt return should be the "normal" return on investment, but that is firm specific and nearly impossible to design as a matter of tax policy.

exempt return but subject the excess to the normal corporate rate of 21% (rather than the 10.5% rate).[25]

The problem of blending foreign tax credits could be addressed by moving to a per-country minimum tax rather than one done on a global basis.[26] Critics of a per-country approach argue that it would be too complex administratively, but that is disputed. The primary targets of GILTI are sophisticated multinational corporations that can effectively deal with the challenge of computational complexity. Moreover, the blending technique itself requires significant resources and complex tax planning, and a global minimum tax would eliminate the need for such inefficient maneuvering. Additionally, a per-country approach is even more necessary if the other offshoring incentives in the GILTI regime are maintained.[27]

FDII: New Offshoring Incentives, WTO Issues, and Gaming Opportunities

1. New Offshoring and Shifting Incentives

If GILTI is the stick for earning income from intangibles abroad, then FDII is the carrot for earning such income here. To this end, FDII provides a 37.5% deduction on so-called foreign-derived intangible income, which amounts to a 13.125% effective tax.[28] A domestic corporation's FDII represents its intangible income that is derived from foreign markets. Although this income slice is defined as "intangible income," as is the case with the GILTI regime, the intangible aspect, as is also the case with GILTI, comes only from the excess over the deemed return on tangible investment, rather than from intellectual property in the traditional sense of the word. This also distinguishes FDII from other patent box regimes, which apply to patents and copyright software, because it instead includes branding and other market-based intangibles.[29]

Like GILTI, the intangible slice of income is calculated by deeming a 10% return on tangible assets (but those of the domestic corporation as opposed to the CFC). Unlike GILTI, a taxpayer wants to *reduce* this deemed return amount because doing so increases the amount available for the FDII reduction. In contrast, in the GILTI regime, the taxpayer wants to increase their deemed return amount because this reduces the amount of income subject to the minimum tax. Unfortunately, this again creates perverse incentives. Because we are dealing with domestic assets, the FDII regime pushes taxpayers towards minimizing their investment in such assets.

[25] Reuven S. Avi-Yonah, *How Terrible is the New Tax Law? Reflections on TRA17?* 5 n. 4 (Feb. 12, 2018 draft), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095830; *see also* J. Clifton Fleming et al., *Incorporating a Minimum Tax in a Territorial System*, 157 TAX NOTES 76, 78 (2017).
[26] *Id.* at 77; Keightly & Stupak, *supra* note 7, at 17-18. In the above example on blending, for instance, under a per-country GILTI tax, if the corporation made the additional investment in Country B, this investment would be subject to the full U.S. minimum tax of $210,000 [(10.5% x 2,000,000)], with no offset for the local taxes paid in Country A. Those taxes would only be able to offset Country A income, which would result in a U.S. tax liability of zero on that investment [(10.5% x 1,000,000)-168,000). The per-country approach thus yields U.S. taxes of $210,000, as opposed to only $147,000 under the current global minimum tax.
[27] Proponents of the global approach might argue that the per-country approach punishes multinationals that naturally conduct integrated production in high- and low-tax countries for non-tax reasons. I believe that the national welfare objective implicated in cross-crediting for non-tax purposes likely outweighs this concern. An alternative to the per-country approach, however, would be to raise the rate on GILTI.
[28] For tax years beginning after 2025, the 37.5% deduction is reduced to 21.875%, and thus the effective rate on FDII goes up to 16.406% in those years. 26 U.S.C. § 250(a)(3).
[29] Stephanie Soong Johnson, *EU Finance Minister Fires Warning Shot on U.S. Tax Reform*, TAX ANALYSIS (Dec. 12, 2017), http://www.taxanalysts.org/content/eu-finance-ministers-fire-warning-shot-us-tax-reform.

For instance, assume a U.S. corporation has income of $3,000,000, $2,500,000 of which is derived from sales abroad. Further assume the corporation has a basis in tangible assets of $30,000,000. To calculate FDII, the taxpayer would calculate the ratio that the corporation's exports bears to its income ($2,500,000/$3,000,000), or 83.33%. FDII is that percentage times the income after the deemed 10% return. Here since 10% return on $30,000,000 is $3,000,000, the taxpayer would take 83.33% of 0 ($3,000,000-$3,000,000). In this case, none of the income gets the benefit of the FDII reduction.

If the corporation instead had zero basis in tangible assets in the United States, it would have a higher FDII deduction. The taxpayer would calculate the above export ratio (83.33%). FDII is that percentage times the $3,000,0000 income less the deemed 10% return ($0 since there are no assets), or $2,500,000 (83.33% of $3,000,000). The taxpayer then gets to deduct 37.5% of FDII ($937,500), which, with the 21% corporate rate, amounts to a tax savings of $196,875 over our base case with U.S. tangible assets. As always, add as many zeroes as you would like.

Also note that the FDII regime essentially applies effective rates between 21% if there is no income above the exempt return, and 13.125% if there is. The GILTI regime applies effective rates between 0% if there is no income above the exempt return, and 10.5% if there is. These rate disparities privilege GILTI in comparison to FDII and incentivize U.S. corporations to produce abroad for foreign markets instead of producing exports in the United States.[30]

2. WTO Issues

One significant problem with the FDII regime is that it threatens to reignite a three-decades long trade controversy between the United States and the European Union that was thought to have been resolved in 2004.[31] As I pointed out immediately after the release of the Senate bill, which originated FDII, the regime likely violates WTO obligations because it is an export subsidy.[32] This is because the more the U.S. taxpayer's income comes from exports, the more of its income gets taxed at the FDII 13.125% effective rate (after taking into account the 37.5% deduction), which is a subsidy in comparison to the normal 21% corporate rate.

Because the FDII regime benefits exports, it likely violates Article 3 of the Agreement on Subsidies and Countervailing Measures (SCM), which prohibits (a) subsidies that are contingent, in law or fact, upon export performance and (b) subsidies that are contingent upon the use of domestic over imported goods.[33] Article 1 of the Agreement on Subsidies and Countervailing

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[30] The conference report states the lower minimum tax rate under GILTI is justified because only 80% of the foreign tax credits are allowed to offset the minimum tax rate. (13.125% equals the effective GILTI rate of 10.5% divided by 80%.) This justification, however, does not hold if no or low foreign taxes are paid.

[31] It is worthwhile to note that the history of the export subsidy controversy is tortured, beginning in 1971 with the Domestic Sales Corporation or "DISC" provisions. After a GATT panel ruled against DISC, the United States replaced that system with the Foreign Sales Corporation ("FSC") rules in 1984. The WTO would later rule against the FSC system. In 2000, Congress enacted the Extraterritorial Income ("ETI") exclusion, which was also held to be an illegal export subsidy by the WTO. Congress finally repealed the last of the export subsidy measures—the ETI—in the American Job Creation Act of 2004. David L. Brumbaugh, CONG. RESEARCH SERV., RL31660, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy* (2004).

[32] Rebecca Kysar, *The Senate Tax Plan Has a WTO Problem*, MEDIUM (Nov. 12, 2017), https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99.

[33] Agreement on Subsidies and Countervailing Measures, Art. 3.1.

Measures defines a subsidy as a financial contribution by a government, including the non-collection or forgiveness of taxes otherwise due.[34]

Although the United States may contend that intangible income lies outside the scope of the WTO agreements,[35] the intangible income in the legislation is simply an arbitrary slice (determined through the 10% deemed return) of the income from the sale of tangible goods. Exports of tangible goods fall within the scope of the agreements, and likely so will the FDII regime since it amounts to the non-collection or forgiveness of taxes otherwise due on an export. Accordingly, our trading partners may seek to impose sanctions, either unilaterally or after consent from the WTO's Dispute Resolution Body.[36] The U.S. will then have to choose between abandoning the FDII regime or continuing it and paying the sanctions.

To summarize, the low rate on FDII is intended to encourage firms to keep and develop intangible property in the United States. Given its serious legal uncertainty, however, firms may be unwilling to rely upon it in making their decisions of where to place IP. It is therefore doubtful that the FDII regime will accomplish its stated purpose.

3. Gaming Opportunities

The FDII regime also presents new gaming opportunities. Under some interpretations of the statute, the taxpayer may be able to get the FDII deduction by "round-tripping" transactions—that is, selling to independent foreign distributors, who then resell back into the United States. In this manner, domestic sales can masquerade as tax-advantaged export sales. The new legislation requires that taxpayers must establish to the satisfaction of the Treasury Secretary that the goods are sold for use abroad. Some taxpayers, however, will likely take the position that the intent of an initial sale to a foreign business is sufficient (like in a VAT regime). Ultimately, it will be difficult for the IRS to meaningfully patrol round-tripping transactions given the legal and factual ambiguity inherent in determining the meaning of "foreign use."

4. Reform Possibilities

In light of the troubling incentives for offshoring, the likely incompatibility with WTO rules, and the potential for round-tripping strategies, the best course of action is to repeal FDII entirely. This is more emphatically the case considering the mixed evidence as to whether even better designed patent boxes increase R&D or employment and the inefficiencies resulting from privileging exports.[37] Note however, that with the repeal of FDII, there would be a wider

[34] *Id.* at Art. 1.1(a)(1)(ii).
[35] This argument was briefly raised by GOP Senators in markup.
[36] Reuven S. Avi-Yonah, *The Elephant Always Forgets: Tax Reform and the WTO* (Univ. of Mich. Law & Econs. Working Paper No. 151, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095349.
[37] Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 113 COLUM. L. REV. 347, 375 (2013) (reviewing the literature to conclude that the effectiveness of patent boxes is mixed, only affecting the location of IP ownership and income rather than R&D in some countries); Shay, Fleming & Peroni, *R&D Tax Incentives – Growth Panacea or Budget Trojan Horse?* 69 TAX LAW REV. 501 (2016) (critiquing patent boxes). *See also* Pierre Mohnen et al., *Evaluating the Innovation Box Tax Policy Instrument in the Netherlands, 2007-13*, 33 OXFORD REV. OF ECON. POL'Y 141 (2017) (finding that the patent box in the Netherlands has a positive effect on R&D but that the average firm only uses a portion of the tax advantage for extra R&D investment); Annette Alstadsaeter et al., *Patent Boxes Design, Patents Location and Local R&D* (IPTS Working Papers on Corp. R&D and Innovation, No 6/2015, 2015), https://ec.europa.eu/jrc/sites/jrcsh/files/JRC96080_Patent_boxes.pdf (finding that patent boxes tend to deter local

differential between the domestic rate on exports (which would then be 21%) and GILTI (10.5%), which could increase incentives for profit shifting. If FDII is repealed, Congress should strongly consider raising the rate on GILTI, which I am in favor of for other reasons previously discussed.

If FDII is maintained, new legislation or regulation should tighten limitations on round-tripping. Treasury could turn to the foreign base company sales rules that determine the destination of a sale. Problems with those rules, however, illustrate just how difficult it is to police the line between foreign and domestic use.[38]

BEAT: Matters of Threshold and Gaming Opportunities

1. Matters of Threshold

One of the more interesting provisions in the new legislation is the base erosion and anti-abuse tax (BEAT), which significantly strengthens U.S. source-based taxation. The BEAT applies to certain U.S. corporations that excessively reduce their U.S. tax liability by making deductible payments, such as interest or royalties, to a 25% owned foreign affiliate ("base erosion payments"). Importantly, the BEAT applies to all multinationals with U.S. affiliates, whether a U.S. or foreign parent owns them. Accordingly, it is a step towards equalizing the treatment between U.S. and foreign multinationals, the latter of which could reduce their U.S. tax liability through earnings stripping in a way that was unavailable to U.S. multinationals.

Problematically, the scope of BEAT allows many multinationals with significant base shifting activity to avoid it. This is because the regime only applies to corporations that have average annual gross receipts in excess of $500 million over three years. BEAT is also not triggered until there are base erosion payments over a specified threshold, where deductions related to base erosion payments exceed 3% (2% for financial groups) of the overall deductions taken by the corporation (with some enumerated exceptions).[39]

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innovation activities unless such regimes impose local R&D conditions). Note also that, as an export subsidy, FDII provides an inefficient incentive to sell to foreign rather than domestic customers. Moreover, if it succeeds, the U.S. dollar will appreciate and undermine its purported benefits.

[38] These regulations allow the corporation to determine the country of use "if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination." See Treas. Reg. 1.954-3(a)(3)(ii). This leaves firms with flexibility to make this determination. Treasury should use its authority to impose an interpretation of the FDII statute that requires U.S. taxpayers to do a true inquiry into whether the foreign recipient will sell the product back into the United States. The adequacy of any such approach, however, is uncertain given the fact-intensive nature of the inquiry.

[39] 26 U.S.C. § 59A(c)(4). In other respects, BEAT is arguably over-inclusive. For instance, BEAT captures routine transactions such as repurchase agreements and posted collateral, as well as certain debt instruments required by regulators. Davis Polk, *The New 'Not Quite Territorial' International Tax Regime* 13 (Dec. 20, 2017), https://www.davispolk.com/files/2017-12-20_gop_tax_cuts_jobs_act_preview_new_tax_regime.pdf. As a result, non-abusive transactions may fall within BEAT's ambit. There is also the question as to whether Congress intended that GILTI be included in the BEAT tax base but without regard for foreign tax credits. There are numerous other technical problems and unanswered questions left open by BEAT, particularly with regard to services, as others have explored. *See, e.g.*, Laura Davison, *Most Wanted: Tax Pros' Technical Corrections Wish List*, BLOOMBERG (Apr. 13, 2018) (discussing ambiguity regarding which payments are included and how to aggregate income); Martin A. Sullivan, *Marked-Up Services and the BEAT, Part II*, 158 TAX NOTES 1169 (2018); Manal Corwin et al., *A Response to an Off-BEAT Analysis*, 158 TAX NOTES 933 (2018); Martin A. Sullivan, *Can Marked-Up Services Skip the BEAT?*, 158 TAX NOTES 705 (2018). More generally, as Ed Kleinbard has noted, "[BEAT's] application to

Assume for instance, a U.S. corporation makes base erosion payments to its foreign affiliate producing deductions in the amount of $300,000. Further assume other deductions amount to $9,700,000 (so total deductions are $10,000,000). In this case, the corporation would be subject to the BEAT since it meets the 3% threshold. But if it were to reduce its base erosion deductions by just $1, or increase its other deductions by the same amount, it would entirely escape BEAT.

Both of these features have the unfortunate consequence of creating a cliff effect. Multinationals with $499 million in average annual gross receipts avoid BEAT altogether, as do such companies with a base erosion percentage of 2.99%. This has implications for horizontal equity, since two similarly situated taxpayers will be taxed very differently.[40] It also produces efficiency losses since cliff effects push the marginal tax rate on the activity in question very high.[41]

Another problem with cliff effects is that they reward taxpayers who are resourceful enough to create structures so that they fall just on the right side of the line. For instance, taxpayers may check the box with regard to foreign affiliates so that they become disregarded entities and payments to them are disregarded. Although the taxpayer would lose out on deductibility for purposes of their regular tax liability, the cliff effect in the BEAT may mean such a tax increase is outweighed by the avoidance of BEAT liability.[42]

2. Gaming Opportunities with Cost of Goods Sold

Importantly, base erosion payments generally do not include payments for costs of goods sold (unless the company inverted). If a foreign affiliate incorporates the foreign intellectual property into a product and then sells the product back to a U.S. affiliate, the cost of the goods sold does not fall within BEAT. Even if the U.S. subsidiary pays a royalty to the foreign parent for the right to use a trademark on goods purchased by the subsidiary from the parent, the royalty must be capitalized into the costs of goods sold under pre-existing regulations, and therefore the royalty payments skip the BEAT entirely.[43] This gap in the law creates significant planning opportunities, allowing a large amount of base shifting to escape BEAT liability.[44]

3. Reform Possibilities

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services . . . is just plain perverse. Example: SAP America lands a contract on behalf of the SAP group with Ford to manage some global IT databases. Ford wants one SAP contact, pays SAP America, which 'hires' local SAP affiliates around the world to perform services in their jurisdictions. Big BEAT problem. If, instead, SAP Germany enters into the [worldwide] contract and hires SAP America to do the US part, then no BEAT issue at all." E-mail from Ed Kleinbard, Robert C. Packard Trustee Chair in Law, USC Gould School of Law, to the author (April 16, 2018) (draft on file with author).

[40] *See* Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931, 955-56 (2016) (discussing equity concerns of income-based cliff effects). *See also* Lily L. Batchelder et al., *Effficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 30-31, 50 (2006) (discussing cliff effects in the context of non-refundable credits and other tax incentives).

[41] *See* Viswanathan, *supra* note 35, at 958-59.

[42] Shaviro, *supra* note 7.

[43] 26 C.F.R. 1.263A-1(e)(3)(ii)(u). There is a question as to whether Congress intended such royalties to escape BEAT. One government official has indicated that this was not the intent of Congress and that the outcome may be changed through a technical correction. Jasper L. Cummings, *Selective Analysis: The Beat,* TAX NOTES TODAY 69-10 (April 10, 2018).

[44] Kamin et al., *supra* note 1.

The BEAT thresholds established by the legislation should be revisited. It may be reasonable to exempt some smaller corporations from its scope since such companies may not be able to profit shift as effectively and BEAT poses a greater challenge for them as an administrative matter. Instead of a cliff effect, however, the BEAT could be phased in at different income levels. This would reduce the loss in social welfare by lowering the marginal tax rate below 100%.[45]

Separate and apart from the cliff effect, however, a separate criticism of the $500 million threshold is that it is simply too high. In the section 385 regulations, which also focus on base erosion, large multinationals are defined as having either $50 million in annual revenues or assets exceeding $100 million. These levels are much more appropriate for identifying multinationals with sufficient base shifting activity, and the BEAT threshold should be lowered to similar amounts.[46]

The 3% threshold for the base erosion percentage should simply be eliminated since it is unclear why a certain degree of base erosion is tolerated. If administrative concerns are the motivation, then the efficiency and equity costs of the cliff effect likely outweigh them.

Even if the 3% base erosion percentage is maintained for administrative reasons, it should be restructured to use a threshold of base erosion payments as a percentage of taxable income rather than total deductions. A small percentage of total deductions could be a large percentage of taxable income, thereby representing a significant degree of base erosion in relation to the company's overall operations.

Solving the cost of goods sold issue is not so easy. This is because there is no proven method of separating out the intangible component of a tangible sale.[47] Additionally, the inclusion of cross-border sales of inventory would present trade and tax treaty issues, similar to those presented by the originally proposed House excise tax.[48] Indeed, the inherent difficulties in designing an inbound regime like BEAT raises the argument about whether more fundamental changes to business taxation may be necessary. I discuss this in the following section.

<u>Going Forward: True International Tax Reform</u>

Going forward, it is not only necessary to deal with the flaws in the recent tax legislation that I have raised, but also to manage larger challenges. Taxing corporate income will continue to be formidable given the global nature of today's economy, the mobility of capital and intellectual property, and strategic responses from other nations. Because of these pressures, corporate income tax revenues are likely to shrink. In fact, if one ignores the one time repatriation tax, the new international tax provisions lose revenue going forward.[49]

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[45] Cliff effects based on income impose a marginal tax rate exceeding 100%. This will induce taxpayers to reduce their income so that they fall under the cliff, thereby discouraging socially desirable work. Viswanathan, *supra* note 40, at 959-60.
[46] *See* Bret Wells, *Get With The Beat*, 158 TAX NOTES 1023 (2018).
[47] Itai Grinberg, *The BEAT is a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule* 7 (draft Dec. 6, 2017), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3069770.
[48] *See* Reuven Avi-Yonah and Nir Fishbien, *Once More, With Feeling: The 'Tax Cuts and Jobs' Act and the Original Intent of Subpart F* 12 n. 32 (Univ. of Mich. Law & Econs., Working Paper No. 143, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074647 (discussing the WTO problems presented by the House excise tax).
[49] Joint Comm. on Taxation, *supra* note 2.

A badly needed reform is to strengthen rules governing corporate residence. Rather than follow the place of incorporation as the sole determinant of corporate residency, a notoriously artificial and gameable definition, corporate residency could account for factors such as the location of a company's headquarters or be linked to the residency of its shareholders.[50] Our source rules also fall far short in reflecting modern economic reality, and should be thoroughly reexamined. For instance, the rules might be revised to reflect a more destination-based approach, perhaps assigning income to the jurisdiction of the customer base.[51]

Given the nation's bleak fiscal outlook and tax competition from other countries,[52] it may also be necessary to explore other sources of revenue. Destination-based taxes, which tax where goods are consumed are of particular interest given the relative immobility of the customer base. Origin-based taxes, like our current corporate income tax, instead levy taxes based on where income is produced or earned, an artificial, manipulable, and mobile construct.

Other developed nations have increasingly relied on consumption taxes, like value-added taxes (VATs), as supplements to traditional business income taxes. A VAT would not only raise badly needed revenues, but it could apply to the sale of inventory without causing trade or tax treaty issues, therefore helping with inbound base erosion.[53] We typically dismiss a VAT as a political non-starter in the United States, but the destination-based cash flow tax proposal of the House, which operates very similarly to a VAT, went surprisingly far in the reform process.

Finally, the international system of taxation is predicated on divisions of taxing jurisdiction that have no bearing in the modern global economy. A longer-term objective should be to work with other nations, developing a consensus as to how to tax remote businesses selling into markets from abroad. This should include serious re-examination of our double tax treaty regime, which reinforces archaic conceptions of how income should be allocated among nations.

## Conclusion

Although there are reasons to like some aspects of the new international tax regime, it also has several serious flaws, as I have discussed. Moreover, the international tax regime will continue to be challenged by base erosion and tax competition. If the U.S. rules on international tax remain stagnant, then the recent legislation will have been a wasted chance to tackle serious problems posed by the modern global economy. If instead the new provisions are an incremental step on the path to true reform, the international provisions in the act can be judged more leniently. Only time will tell.

I welcome any questions from the Committee.

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[50] For discussion of a shareholder-based approach, see J. Clifton Fleming et al., *Defending Worldwide Taxation With a Shareholder-Based Definition of Corporate Residence*, 1016 BYU L. REV. 1681, 1702-09 (2017).

[51] Paul Oosterhuis & Amanda Parsons, *Destination-Based Income Taxation: Neither Principled Nor Practical?* (Oct. 27, 2017) (unpublished manuscript) (draft on file with author).

[52] There is already evidence that other countries are considering lowering their tax rates in response to recent tax legislation. Laura Davison, *U.S. Tax Overhaul Spurs Others to Re-Evaluate Rates: Tax Counsel*, BLOOMBERG (Feb. 22, 2018) (quoting a key drafter of the tax legislation, who has met with representatives from other countries who are pursuing such changes).

[53] See Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2011) for a compelling justification of the VAT.