Testimony of Stephen E. Shay

United States Senate Committee on Finance

Hearing on The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between

June 26, 2008

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury.[1] The views I am expressing are my personal views and do not represent the views of either my law firm or its clients.

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

I have been invited to discuss possible U.S. international tax reforms. I will limit my comments to U.S. tax rules relating to the taxation of foreign business income, that is, income earned from conducting economic activity outside the United States.[2] I will identify what I view as problems in our current rules for taxation of foreign business income and discuss possible reforms.

The following sections of my testimony (i) discuss the tax policy principles that should guide consideration of U.S. income tax rules generally as well as the rules for taxing foreign business income, (ii) review and evaluate existing U.S. international tax rules, (iii) analyze the difficulties posed by related party income and deductions to administration and enforcement of international tax rules (i.e., transfer pricing issues), (iv) consider possible reforms to the U.S. rules in relation to the defects of current law.

I. U.S. Tax Policy Objectives

The principal function of the U.S. Federal income tax is to collect revenue to maximize U.S. welfare.[3] The correct measure of U.S. welfare is the well being of

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[1] I have attached a copy of my biography to this testimony. I would like to thank Benjamin P. Damsky, a law student at Boston University School of Law and summer law clerk at Ropes & Gray, for his assistance in preparing this testimony.

[2] In September, 2007, I testified before the Committee on Ways and Means regarding the issue of fairness in our international tax rules. I will draw on that testimony today.

[3] Secondary roles of the U.S. income tax system include appropriating public funds, through "tax expenditures," and regulating behavior through tax penalties (which sometimes are sometimes referred to as negative tax expenditures). *See* J. Clifton Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 468–87 (2008); Daniel N. Shaviro,

individual U.S. citizens and residents. Accordingly, the primary focus of U.S. income tax policy should be how to raise revenue in a manner that improves the lives and living standards of U.S. citizens and residents.[4] To best carry out this directive, the federal income tax system is guided by traditional tax policy goals of fairness, efficiency and administrability.[5]

The fairness criterion is based on the accepted notion that a fair tax should take account of a taxpayer's ability to pay. While there may be differences in opinion regarding the ideal tax base or rate structure to employ in taxing income, there is a broad consensus supporting application of fairness criteria to policy analysis of the income tax system. Indeed, fairness has been a principal justification for the income tax in the United States since its inception.[6] One of the reasons to base a tax on a taxpayer's entire income is that income is a reasonable proxy for ability to pay.[7] The source of a taxpayer's income does not affect that taxpayer's ability to pay. Thus, with respect to international taxation, all else equal, there would be no basis to exclude foreign-source income from a resident's ability to pay.

The concept of efficiency generally assumes that the value of society's goods and services can be maximized through the free market. Thus, laws and regulations, when utilized, should try to distort pre-tax economic decisions as little as possible. But, especially in the international context, deploying the concept of efficiency is not a simple task. There is a lack of consensus among economists regarding what neutrality principle (i.e., benchmark of economic efficiency) should guide U.S. tax policy in an open-economy, international setting.[8] I will not review these arguments here.[9] It will suffice to reiterate that the efficiency criterion generally supports rules that distort pre-tax

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Rethinking Tax Expenditures and Fiscal Language, 57 TAX L. REV. 187, 199–206 (2004); David A. Weisbach & Jacob Nussim, *The Integration of Tax And Spending Programs*, 113 YALE L. J. 955, 961 (2004).

[4] *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 284 (2001) [hereinafter Graetz, *Taxing International Income*].

[5] *See* U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13–19 (1984).

[6] There is a rich academic literature about the theoretically appropriate bases on which to evaluate fairness claims and even whether such claims have normative content. *See* J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 301 n. 12 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*] (noting literature). It seems clear, however, that the perception that imposing tax on income is fundamentally fair has played an important role in the continued importance of the income tax as a means of raising revenue in the United States and other developed countries.

[7] I do not consider here issues relating to whether rates of tax on income should be progressive (i.e., increase with income) or flat. Nor do I consider how the distribution of tax burden should be analyzed, e.g., accounting for governmental transfer payments to individuals and subsidies to businesses.

[8] *See Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 680–89 (2006) [hereinafter *ABA Report*] (report authored by task force convened by American Bar Association, Section of Taxation) .

[9] For a summary of the arguments and references, see DAVID L. BRUMBAUGH & JANE G. GRAVELLE, CONG. RESEARCH SERV., REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 4–11 (2007) [hereinafter BRUMBAUGH & GRAVELLE, REFORM OF INTERNATIONAL TAXATION]; *ABA Report*, *supra* note 8, at 680–89.

economic decisions as little as possible. Therefore, granting a tax subsidy, or tax penalty, to one type of investment is disfavored. [10] In the international context, the conventional application of the efficiency criterion would prescribe that the effective tax rate on an item of foreign income, taking into account foreign taxes, should not be materially lower than the effective rate on domestic income. A corollary is that relief should not be given to high foreign effective tax rates through cross-crediting.

The administrability criterion recognizes that the costs of administration and enforcement, to government and taxpayers, are not productive costs and should be kept to the minimum possible. While recognizing that taxpayers with international income are generally sophisticated and able to deal with complex provisions, a system whose complexity fosters wasteful tax planning and which is difficult to administer by tax authorities is undesirable. While tax law uncertainty is undesirable, it is inevitable, and to constrain taxpayers from taking undue advantage of the uncertainty it is necessary and, to the point of marginal return, efficiency enhancing to invest resources in enforcement.

The policy criteria of fairness, efficiency and administrability conflict. The critical point is that when an inefficient tax situation is present, the total costs and benefits of that rule – including fairness, and administrability – are all considered. Only then can the rule be properly evaluated.

I will next briefly outline the current U.S. rules for taxing U.S. persons' foreign business income, make observations about how these rules operate in practice and evaluate the current rules under the preceding tax policy criteria.

II. An Evaluation of Current U.S. Rules For Taxing International Income

A. Overview of Current U.S. Rules

Worldwide taxation subject to a limited tax credit for foreign income taxes. The United States taxes the worldwide income of U.S. citizens, resident aliens and domestic corporations. Generally, the United States allows a taxpayer to elect to credit foreign income taxes paid or deemed paid. The credit for the foreign income tax paid is allowed against U.S. tax subject to a limitation that the credit may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign-source net income in the same limitation category as that on which the foreign tax is paid. Today, there are only

[10] The President's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another that should be applied to evaluate proposals to tax foreign income more or less favorably than domestic income:

> Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment *only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers*.

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, FINAL REPORT xiii (Nov. 1, 2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter PRESIDENT'S ADVISORY PANEL REPORT] (emphasis added).

two foreign tax credit limitation categories, one for passive income and another "general" category that includes all non-passive income.

U.S. source taxation of a foreign corporation. In contrast to the taxation of U.S. persons, foreign persons are taxed by the United States only on a source basis on certain U.S.-related income. Foreign persons that carry on a U.S. trade or business are taxed on their net income effectively connected with that trade or business. If resident in a treaty country, the foreign person's income must be attributable to a so-called "permanent establishment" in the United States. Foreign persons earning U.S. source income not connected with a U.S. trade or business are taxed on U.S.-source interest, dividends, royalties and other fixed or determinable, annual or periodical ("FDAP") income at a rate of 30% (or lower treaty rate) on the gross amount of the income. A foreign corporation's earnings that are effectively connected to the U.S. are subject to a second level branch profits tax that also may be reduced or eliminated by treaty.[11] A foreign corporation is not taxed by the United States on foreign income unless the foreign income is effectively connected with a U.S. trade or business.

U.S. shareholder taxation of income earned through a foreign corporation. Most active foreign business income earned by a foreign (non-U.S.) corporation is not taxed to its U.S. shareholders until distributed. In international tax, this concept is referred to as "deferral." If and when the foreign corporation's earnings are distributed (or deemed to be distributed), the United States will allow a U.S. corporate shareholder who owns 10% or more of the voting power of the foreign corporation a credit for foreign income taxes paid.[12] This "indirect" or "deemed paid" credit mitigates double corporate taxation of the foreign dividend.[13] An individual U.S. taxpayer may (through 2010) treat certain dividends from publicly traded foreign corporations (and foreign corporations qualifying for the benefits of a comprehensive income tax treaty with the United States) as qualified dividend income ("QDI") eligible for the 15% tax rate on long-term capital gain, provided that the foreign corporation was not a passive foreign investment company in the current or preceding year.

Anti-deferral rules. A series of so-called anti-deferral rules are intended to discourage use of foreign corporations as mechanisms to avoid U.S. tax on certain passive and other "base company" income. The two principal anti-deferral regimes today are the controlled foreign corporation rules and the passive foreign investment company

[11] The determination of whether a corporation is domestic or foreign is essentially elective. A corporation is domestic if it is incorporated under the laws of the United States, one of the states of the United States or the District of Columbia or is a business entity that is otherwise organized under such laws and elects to be taxable as a corporation.

[12] Because the U.S. tax on foreign income earned by a foreign corporation is deferred until the earnings are repatriated, rules are required to associate the foreign taxes to the earnings that are repatriated, either as an actual dividend or as income inclusions under subpart F. In addition, to permit the foreign tax credit limitation to operate effectively, the limitation categories are applied on a look-through basis to income of a controlled foreign corporation and a non-controlled section 902 corporation.

[13] A dividends received deduction is not allowed with respect to a dividend from a foreign corporation of earnings that were not effectively connected with a U.S. trade or business.

rules.[14] The tax rules relating to a United States shareholder's share of income earned by a controlled foreign corporation, in addition to limiting deferral for passive income, also end deferral for certain active business income that is earned through the use of "base companies" and is subject to an effective rate of foreign tax that is lower than the U.S. rate. The investment in U.S. property rules generally are designed to prevent earnings of a controlled foreign corporation that have not been taxed to a U.S. shareholder from being made available, directly or indirectly, to a U.S. shareholder.

A United States shareholder's gain on the sale of stock in a controlled foreign corporation generally will be treated as a dividend to the extent of the shareholder's share of the controlled foreign corporation's earnings. What was once considered a negative provision for taxpayers that recaptured the benefits of deferral, is in many cases favorable or neutral. The dividend income will carry foreign tax credits to a 10% corporate shareholder and may constitute qualified dividend income eligible for the 15% rate (until 2010) to an individual shareholder.

A U.S. shareholder in a passive foreign investment company ("PFIC"), that is not also a U.S. shareholder in a controlled foreign corporation, is subject to the rough equivalent of current taxation of the foreign corporation's earnings (or appreciation in value) under one of several alternative taxing regimes. As currently designed, the PFIC rules are intended to cause taxable U.S. shareholders in foreign investment companies to elect to be taxed in a manner that is comparable to the tax that would be imposed on a shareholder in a U.S. mutual fund (a "QEF election") or, if the foreign shares are marketable, to elect mark-to-market treatment if the information necessary to make a QEF lection is not available.

Transfer pricing. The Internal Revenue Service has broad authority to reallocate income, deductions or expenses between commonly controlled taxpayers if they engage in transactions that do not satisfy an arm's length standard. Regulations under section 482 prescribe the method for determining whether loans of money or transfers of tangible property, intangible property, and services are within a range of arm's length prices. Normally, if an arm's length price determined under methods prescribed in the regulations falls within the inter-quartile range of arm's length prices as finally determined, no transfer pricing adjustment will be made. I will discuss some of the challenges that transfer pricing poses to our international tax rules later in my testimony.

B. Planning Opportunities Under the Current U.S. International Tax Rules

As I have testified previously, the current U.S. rules, while complex, represent the best of all worlds for well-advised U.S. multinational taxpayers. Current U.S. tax rules relating to foreign business activity are, in practice, a hybrid between actually taxing

[14] A "controlled foreign corporation" is a foreign corporation that is more than 50% owned, by vote or value, considered either directly or indirectly under constructive ownership rules, by United States shareholders. A "United States shareholder" is a U.S. person that owns 10% or more by vote, directly or indirect under constructive ownership rules, of the foreign corporation. A "passive foreign investment company" is a foreign corporation that has 75% or more passive income or 50% or more passive assets.

worldwide income and taxing foreign income at a lower or even zero rate (i.e., exempting foreign income).

The most advantageous feature of the current rules for U.S. multinationals is deferral. First, deferral is essentially elective: if foreign income is earned through a foreign corporation, instead of directly by a U.S. person, and the earnings are reinvested in a foreign business, the U.S. tax may be deferred. If U.S. multinationals earn income from active business operations carried on through foreign corporations in low-effective-tax rate structures, enhanced by transfer pricing planning (discussed below), the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. Over a long enough period, deferral can be quite valuable and even approach exemption.[15]

In addition, U.S. anti-deferral rules have been narrowed, directly or through interpretation, in recent years.[16] In 2004, Congress adopted a so-called "homeland dividend" provision, which temporarily allowed corporations to repatriate offshore deferred earnings at a low rate.[17] As a result, the perceived benefit of deferral may now have increased, if taxpayers believe such a provision will be enacted again at some point in the future.[18] All of this taken together with the adoption of elective entity classification and the inherent flexibility of transfer pricing, there is substantial scope for tax planning, often involving low-taxed countries, to reduce foreign taxes and accelerate

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[15] If a taxpayer will suffer a loss, it may establish its foreign business through a limited liability entity that elects to be taxed as a pass through for U.S. tax purposes so that the tax benefit for the loss may be used currently on its U.S. federal income tax return.

[16] *See e.g.*, I.R.C. § 954(c)(6) (2006) (expanding the ability to shift income from high to low taxed affiliates without triggering current income inclusion to a United States shareholder); I.R.S. Notice 2007-13, 2007-5 I.R.B. 410 (limiting the circumstances in which services performed by a controlled foreign corporation will be considered to benefit from assistance of a U.S. person and therefore be subject to current income inclusion to a United States shareholder); Prop. Treas. Reg. § 1.954-3(a)(4)(iv), 73 Fed. Reg. 10716, 10719–22 (Feb. 28, 2008) (providing that a controlled foreign corporation that makes a substantial contribution to manufacturing of the personal property sold will satisfy the manufacturing exception to current income inclusion as base company sales income notwithstanding that the manufacturing itself is performed under contract with a separate manufacturer if certain enumerated activities, including oversight, direction, material and vendor selection and quality control, among others, are performed by its own employees).

[17] The 85 percent dividends received deduction of section 965 effectively exempted from U.S. tax substantially all of the earnings repatriated under that relief provision. Ostensibly, 15% of the repatriated earnings were subject to U.S. tax at up to 35% for an effective rate of 5.25% on the dividend. In many cases, the U.S. tax was eliminated by foreign tax credits so the earnings were effectively exempted from U.S. tax. While billed as an economic relief measure, the homeland dividend provision would be more accurately described as a partial amnesty from U.S. tax for low-taxed offshore profits. For a perceptive critique of the "farce" that homeland dividend relief represented, see Charles I. Kingson, *The Great American Jobs Act Caper*, 58 TAX L. REV. 327, 388–91 (2006) [hereinafter Kingson, *Great American Jobs Act Caper*]. An IRS study indicates that 843 mostly very large corporations (out of 9700 corporations that had controlled foreign corporation subsidiaries) repatriated almost $362 billion. Melissa Redmiles, *The One-Time Received Dividend Deduction*, in I.R.S. STATISTICS OF INCOME BULLETIN, SPRING 2008, at 102, 103. There is no empirical analysis to date that demonstrates that the repatriation had a meaningful impact on U.S. economic activity or employment.

[18] *See* George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 88 TAX NOTES 173, 175 (2008) [hereinafter Yin, *Reforming Taxation*].

utilization of remaining foreign taxes as credits.[19] If the United States allows unlimited deferral, it is reasonable to expect that use of low tax regimes will continue to increase.[20]

Another tax benefit for U.S. multinational taxpayers that earn high-tax foreign income is to use excess foreign tax credits against other low-taxed foreign income. The effect of this cross-crediting is to provide an incentive to a taxpayer with excess foreign tax credits to earn low-taxed foreign income and to credit the foreign tax against U.S. tax on this income. This effectively shifts the burden of a foreign country's high taxes to the United States. Excess foreign tax credits even can be used to offset U.S. tax on royalty income and income from export sales that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by the source country).[21]

Companies may also combine these effective tax reductions with other beneficial features of the U.S. international tax regime. Other benefits include tolerance for moderate to aggressive transfer pricing, defective expense allocation rules, and deductibility of overall foreign losses against domestic income. All considered, the overall effect can be more beneficial to taxpayers than an exemption system.[22] This is borne out by estimates that government tax revenues would *increase* if active foreign business earnings are exempt from U.S. tax when distributed as a dividend.

The lack of friction on U.S. planning has allowed average effective foreign tax rates on the 7,500 largest U.S. controlled foreign corporations ("CFCs") to decline from 33.98% in 1986 to 19.24% in 2002, well beyond what could be explained by declines in other countries' nominal tax rates.[23] The U.S. Treasury has found evidence that correlates this pattern with income shifting from high nominal tax rate countries to low tax rate countries.[24]

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[19] *See ABA Report*, *supra* note 8, at 705; Kingson, *Great American Jobs Act Caper*, *supra* note 17, at 370–87.

[20] *See e.g.*, Martin A. Sullivan, *The IRS Multibillion-Dollar Subsidy for Ireland*, 108 TAX NOTES 287 (2005). Charles Kingson correctly observes that repealing the application of the PFIC rules to United States shareholders in a controlled foreign corporation in 1997 eliminated the only tax-based limit on the amount of controlled foreign corporation earnings that could be deferred by a member of the U.S. control group. *See* Kingson, *Great American Jobs Act Caper*, *supra* note 17, at 382–85. U.S. shareholders with less than 10% holdings remains subject to the PFIC rules and the PFIC asset test in particular. It would have made more sense to repeal the PFIC asset test for U.S. portfolio investors and retain it as a limit on deferral for greater than 10% U.S. shareholders in a controlled foreign corporation.

[21] *See generally* J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003), 31 TAX NOTES INT'L 1145 (2003).

[22] *See e.g.*, Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income* 9–10 (Rutgers Univ. Dep't. of Econ., Working Paper No. 2006-26), *available at* http://www-snde.rutgers.edu/scripts/Rutgers/wp/rutgers-listwp.exe?200626.

[23] *See* Yin, *Reforming Taxation, supra* note 18, at 174 tbl. 1 (presenting average foreign income tax rates over time of 7,500 largest CFCs of U.S. parent corporations).

[24] *See* U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 58 (2007) [hereinafter TREASURY TRANSFER PRICING REPORT]. The Treasury emphasizes that this is a correlation and not proof that there is "inappropriate income shifting." *Id.* The Treasury is careful to hypothesize a series of non-transfer pricing reasons for this result, including that: "CFCs in low-tax jurisdictions may have more asset intensive operations, which

C. Evaluation of Current U.S. Rules for Taxing Foreign Income of U.S. Persons

Should we be concerned with the developments just described? The answer is yes. First, much of the income shifting is from the United States, so planning results in erosion of U.S. tax on income properly in the U.S. tax base. Such revenue loss can be ill afforded under present budgetary conditions. Second, reliable availability of low effective foreign tax rates will, at the margin, result in distortions of investment decision – including some shifting of productive investment from the United States to foreign locations.[25] Third, there is a real risk of erosion of confidence in the fairness of a tax system that allows a subset of taxpayers to benefit to such a great extent from tax rules that are difficult to justify as a matter of tax policy.[26]

There is no *a priori* reason for allowing a special position for foreign business income, whether the income is earned directly by individuals or indirectly through foreign activities of U.S. or foreign corporations.[27] If U.S. taxation of foreign business income is lower than on domestic business income, U.S. persons who do not earn foreign business income will be subject to heavier taxation solely because of where their business is located. To justify relief from U.S. tax on foreign business income, there should be an identifiable benefit to individual U.S. citizens and residents.

It has been argued, however, that exemption treatment is warranted here because otherwise U.S. companies would not be able to compete on a level playing field with foreign and local competitors. This argument does not appear to be supported by strong empirical evidence that distinguishes the claim from a claim that also may be made by a purely domestic business. U.S. businesses located in the United States also have to compete with foreign businesses. The location of a business does not insulate it from international competition. Additionally, the historical success of U.S. businesses in foreign markets belies the presence of any relative or disabling disadvantage.[28]

I am not aware of objective empirical evidence that the benefits of allowing U.S. companies deferral or excessive credits for foreign taxes is optimal in that it generates more benefits to U.S. citizens and residents than they cost in the losses from distortion of

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is associated with higher profit margins. . . .[and] CFCs in more research-intensive industries may operate in lower tax jurisdictions, and in fact may develop their own intangibles to exploit." *Id.* I am not aware of likely empirical support for these hypotheses.

[25] Professor Yin writes: "In summary, the U.S. tax treatment of foreign direct investment by U.S. persons has become so favorable as to exert a potentially powerful lure in favor of such investment." Yin, *Reforming Taxation*, *supra* note 18, at 175.

[26] *See generally* Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 6; Graetz, *Taxing International Income*, *supra* note 4; Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POLICY INT'L BUS. 145 (1998) [hereinafter Kaufman, *Fairness*].

[27] *See* Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 6, at 311; *see also generally* Graetz, *Taxing International Income*, *supra* note 4; Kaufman, *Fairness*, *supra* note 26.

[28] For a sample of anecdotal sources regarding the successes of U.S. multinational corporations in foreign markets, see Russell Gold, *Exxon to Boost Spending, Broaden Exploration*, WALL ST. J., Mar. 6, 2008, at B1; Christopher Hinton, *Monsanto Net Early Triples*, WALL ST. J., Jan. 4, 2008, at C14; Kathryn Kranhold, *GE's Strength Abroad Helps It Weather Weakness in U.S.*, WALL ST. J., Jan. 19–20, at A3; Tom Lauricella, *Economic Split Seen in Corporate Earnings*, WALL ST. J., April 18, 2008, at A1.

economic decisions and higher taxes on U.S. citizens and residents and domestic businesses. If the reduced level of U.S. tax on corporate income allowed under current U.S. international tax rules shifts the tax burden to U.S. citizens and residents beyond what can be justified to avoid double taxation of income, then it likely has an overall undesirable effect.

Our current international tax rules offer substantial planning opportunities to reduce foreign taxes and to shift income to entities with low-effective tax rates. The effect is not only wasteful administration costs due to extensive planning, but distortion of economic decisions by creating incentives to structure business activity in a manner that takes advantage of low or reduced effective tax rates. As discussed below, the incentive of substantially lower effective foreign taxes fosters aggressive transfer pricing that is beyond the ability to transfer pricing rules to conduct.

The current rules permit excessive cross-crediting of foreign taxes that subsidize the cost of high foreign taxes for taxpayers and create an additional incentive to earn low foreign taxed income. In the absence of excess foreign tax credits to offset U.S. tax on the repatriation of foreign earnings, a further inefficiency of deferral is that the U.S. tax on repatriation skews the decision against repatriation.

To summarize, significant defects of the current U.S. international tax regime include:

(i) Permitting the combined U.S. and foreign effective rates of taxation of foreign income to be so low as to encourage shifting of activity and income outside the United States for tax rather then business reasons;

(ii) Subsidizing high foreign taxes through excessive cross-crediting of foreign taxes against U.S. tax on repatriations of low-taxed foreign income; and

(iii) Imposing, where cross-crediting is not available, additional tax on foreign income when repatriated, instead of when earned, so as to create a disincentive to repatriated earnings.

Before turning to possible reforms to the current U.S. rules, it is worthwhile to review the particular challenge that transfer pricing generally, and transfer pricing for intangibles in particular, poses to any international tax regime. There is a large scope for transfer pricing planning that is inevitable in a cross-border environment under any plausible approach to transfer pricing. This exacerbates the structural defects in any international tax regime and should be a major factor in considering why a tax system allows foreign business income to go untaxed by the United States.

III. The Problem of Transfer Pricing

A. The International Consensus Behind the Arm's Length Principle

The need to allocate income and deductions among related parties is a central feature of international income taxation. Following the leadership of the United States, a fairly remarkable international consensus has developed around the idea that the market-based principles of the arm's length separate transaction method should guide the international division of income to the extent possible.[29] When the U.S. Internal Revenue Service seeks to make a transfer pricing adjustment using arm's length methods, it does so knowing that most other countries accept the principles underlying the basis for the allocation. Notwithstanding the substantial benefits that arise from having a consensus guiding principle and how it should be applied, the application of the arm's length principle in practice is challenging for all governments.

B. When Income or Deductions Are Misallocated: What is At Stake

The benefits (or detriments) of a misallocation of income or a deduction recognized by both countries is measured by the return that is earned on the difference in tax that results from the improperly allocated income or deduction.

> *Example 1*. If U.S. Multinational (USM) has a marginal effective tax rate of 35% on its US income and a marginal effective tax rate of 10% on income earned in Country X by a foreign affiliate, F Sub, the tax benefit of allocating income from USM to F Sub would be a tax saving of 25% of the amount of income transferred.

A comparable analysis applies to a USM deduction that benefits F Sub and that, if charged to F Sub, would be allowed to F Sub to offset its income taxed in Country X.

> *Example 2*. Under the facts of Example 1, USM incurs a payment that benefits F Sub and that, if charged to F Sub, would be allowed as a deduction. USM does not charge F Sub for the deduction and no allocation of the deduction is made. The tax benefit of not allocating the deduction to F Sub would be a tax saving of 25% of the deduction amount.

These are classic transfer pricing issues and are the subject of section 482 of the Code as well as income tax treaty provisions designed to allow countries to reach agreement on the appropriate arm's length allocation of income and deductions.

A somewhat different analysis applies to deductions that benefit foreign income in whole or in part but would not be allowed as a deduction in the foreign country. These deductions, including an allocable share of corporate overhead, research and development and interest expenses of a parent company, have been a source of controversy in the

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[29] *See* ORG. FOR ECON. CO-OPERATION AND DEV., ARTICLES ON THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND CAPITAL *passim* (2005) *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf (using arm's length valuation); ORG. FOR ECON. CO-OPERATION AND DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS *passim* (2005).

determination of the U.S. foreign tax credit limitation. Similar issues arise in an exemption system of avoiding double taxation. The policy issue raised by each of these kinds of deductions is the extent to which the country of residence should allow a deduction that supports assets that generate income in the source country, even where the source country would not allow the deduction if the expenditure were charged to the source country.

Allowance of a deduction against domestic income to earn exempt income results in a revenue loss equal to the tax saved from the amount expensed.[30] If the tax rate is 35%, deducting an expense of $100 results in saved tax of $35. The benefit of expensing is the return on the $35 until the deferred income is included in taxable income.[31] If the source country does not allow the deduction (i.e., it would not accept that the deducted amount should be charged to the source country business), should the residence country nonetheless allow the deduction?

> *Example 3*. Assume the same facts as in Example 1. USM incurs $100 of R&D expense in relation to a product line sold by F Sub. Country X, however, will not allow F Sub to deduct a cost reimbursement or royalty paid to USM in relation to the R&D expenditure. As a result, F Sub pays a 10% tax on income that otherwise would have been deducted.

If the United States does not tax F Sub's income, allowing the deduction provides a 35% benefit in addition to the exemption of the income that is taxed at a 10% rate by Country X. In other words, allowing the deduction creates a negative tax on (i.e., subsidizes) the exempt foreign income.[32] Also, in this circumstance, the tax rate of the foreign nation does not factor into the amount of domestic revenue lost by allowing the deduction. The foreign rate will only work to determine how attractive at the margin the foreign investment is to a U.S. resident.

These examples illustrate the consequences of misallocating income and deductions. It is critical to understand that when a deduction properly allocable to foreign income is allowed against domestic income, the foreign investment is advantaged resulting in an inefficient pre-tax distortion of taxpayer behavior. Nor are these simply hypothetical scenarios. Under-allocation of expenses to foreign income is prevalent in the U.S. international tax rules.

The following discussion will illustrate why enforcing proper transfer pricing for income and expenses can be so challenging.

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[30] Under a well-known tax equivalence, generally attributed to Cary Brown, a deduction against current income of an amount invested is equivalent (under several assumptions) to exempting the yield from that investment. *See* E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN E. HANSEN (Lloyd A. Metzler, et al., eds., 1948). For a modern usage, see Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921, 921– 24 (Feb. 25, 2008).

[31] A recent proposal by Chairman Rangel would defer a deduction until income is repatriated to deal with this issue. *See infra* text accompanying notes 51–54.

[32] *See ABA Report*, *supra* note 8, at 760 (stating how U.S. resident taxpayers generally prefer to allocate deductions domestically).

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

Notwithstanding the potentially high stakes, transfer pricing is difficult for any government to administer and enforce. At the heart of the problem facing the government is that the taxpayer possesses all the relevant facts to evaluate the transfer pricing decision. Moreover, applying the arm's length standard is difficult for both the taxpayer and the government in many circumstances because the character of the goods and services is highly fact specific. There is an unavoidable uncertainty in the application of substantive law. This problem is particularly acute for income from intangible property and high value services. In this context, the effects of practical hurdles to government enforcement are magnified and operate to taxpayer advantage.

It is important to understand the difficulties facing any government in administering and enforcing transfer pricing rules. Most often, a government trying to evaluate a taxpayer's transfer pricing decision faces a steep information asymmetry.[33] Taxpayers need not routinely disclose relevant facts on either tax returns or consolidated financial statements.[34]

If the government does start an audit, it must ask the right questions in order to elicit information that is relevant to a pricing analysis. They must learn enough about the business and its economics to determine when income and margin are out of line. Well-advised and disciplined taxpayers prepare their cases as soon as the audit starts (in addition to prior planning for these issues) and know where the sensitive points are. While a taxpayer must answer truthfully and fully an information document request ("IDR"), they have no obligation to direct the government to the right question or data absent an IDR request. Even for large taxpayers subject to continuous audit, there is a material risk of non-detection of a broad range of inappropriate transfer pricing. Too often, when the IRS does propose an adjustment it is so over the top that they lose credibility with the trier of fact (whether an appellate conferee or a judge) that they do not recover during the case.

Even if the IRS's proposed adjustment has sufficient merit to support an adjustment, it often is the case that the taxpayer can persuade a reviewer (an appellate conferee or trial counsel) that the government has sufficient "hazards of litigation" that the taxpayer's allocation would be sustained (even with the burden falling to the taxpayer

[33] *See* Ilan Benshalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 647 (2007) [hereinafter, Benshalom, *Sourcing the Unsourceable*]. The problem of information asymmetry is especially acute in the case of the allocation of expenses. It is extremely difficult for the government to readily identify how expenses should be allocated to a category of income or activity.

[34] There is reporting of related party amounts under section 6038, but these reports do not highlight when the pricing may be inconsistent with the arm's length standard. Although many taxpayers with large intercompany payments prepare section 6662 transfer pricing documentation, it is designed to demonstrate the reasonableness of the taxpayer's method. It generally is prepared to support the taxpayer's position without highlighting major exposures. It remains unclear whether and how the relatively new financial standards known as "FIN 48" will affect this calculus.

to demonstrate that the government's proposed allocation is unreasonable and the taxpayer's allocation is reasonable) to achieve a compromise at less (and often substantially less) than a 100 percent taxpayer concession. Moreover, unless the taxpayer's conduct is egregious, if the IRS does persuade a trier of fact that the IRS adjustment should be sustained, it is difficult for the IRS to effectively impose a transfer pricing penalty (and is particularly difficult in the context of settling a controversy). In the face of such difficulties and the large expense to the Government of trying a case, settlements are common and necessary to allow the tax enforcement system to function. While there are (relatively rare) transfer pricing controversies where penalties are applied, the penalty structure generally is not sufficient to create a significant taxpayer disincentive to taking full advantage of the preceding difficulties in enforcement (and it is unlikely that such a penalty system could be adopted).[35]

These features of transfer pricing make it rational for a taxpayer to take positions that are, at a minimum, moderately aggressive. To fail to do so is to leave a tax decision maker open to criticism that the tax planning has "left money on the table." Whether a taxpayer goes further is largely a function of its appetite for tax risk and whether the taxpayer (in particular a public company) can persuade its auditors that either it is not necessary to establish a reserve or that a modest reserve is sufficient. None of the preceding discussion is intended to refer to tax positions that are not fully justified from a legal and ethical perspective. Indeed, that is the point.

D. The Challenge of Intangible Property

The advent of market and taxpayer recognition of the value of intangible property rights such as patents, know-how and trademarks has added pressure on the ability of governments to employ the separate transaction arm's length method. Almost by definition, these property rights exclude the rights of third parties to use the protected invention or brand mark or logo. Whether the person possessing the intangible property right licenses the right in an arm's length transaction to a third party involves a business calculation of the likely share of the return that must be allowed to the licensee. The conventional view, although evolving, is that a highly valuable intangible right will not be shared with third parties. In the absence of reliable third party benchmarks, taxpayers have substantial latitude to determine the return to the intangible.

Intangible property, while not passive when used in the business, nonetheless is particularly mobile property. International legal protections for forms of intellectual property have substantially improved in recent decades so that it is feasible as a commercial and legal matter to transfer legal ownership to companies organized in a wide range of countries. The tax law has well-developed tax ownership concepts for intangible property that allow the tax ownership of intangible property to be divorced from legal ownership. These economic and legal features of intangible property make it possible to locate intangible property in low-taxed environments within the taxpayer

[35] *See generally* Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX. REV. 241 (2007) (discussing optimal penalty structures).

group to earn low-taxed income without materially sacrificing the legal protections and value of the intangible property in question.

The fundamental difficulty with administering transfer pricing rules where comparable third party transactions are unavailable or inexact lies in: (i) the operational flexibility available to a multinational in planning and executing a transfer pricing strategy,[36] (ii) the necessary flexibility of the transfer pricing rules to allow taxpayers to structure their affairs (as well as an arguably excessive electivity of methods),[37] and (iii) the information asymmetry and procedural advantages described above in documenting and defending transfer pricing controversies. Cost sharing for intangible property is one example of where these advantages are particularly favorable.

Treasury regulations have allowed cost sharing of intangible costs from the 1960s. A primary argument made for cost sharing is that it reduces uncertainty in transfer pricing. Cost sharing is used by taxpayers to increase the future profit that can be allocated to the cost sharer by reason of its deemed joint ownership of the intangible. In many cases, the cost sharer is an affiliate in a lower tax jurisdiction than the developer of the intangible. In such a case, cost sharing represents a "bet" that the lower value of deductions for cost sharing payments will be less, on a present value basis, than the savings from earning future intangible income in the lower tax jurisdiction.

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

- Cost sharing is elective to the taxpayer; this implicitly permits a substantial degree of "cherry-picking" of intangibles to be cost shared.[38]

- As with all related party transactions, information asymmetry favors the taxpayer and allows it to price the cost sharing favorably and frame the documentation and supporting "data" in the way that reduces the apparent exposure.[39]

- Parties to cost sharing agreements may include affiliates whose interest is financial rather than as a developer or user of the intangible in business it conducts itself.

Intercompany services with embedded intangibles also present opportunities to make identification of the intangible pricing issue and valuation of the intangible difficult.[40]

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[36] *See* Benshalom, *Sourcing the Unsourceable*, *supra* note 33, at 646–47 ("[The] characteristics [of arm's length transfer pricing] render futile the attempt of the transfer pricing rules to determine the reasonable price at which affiliated transactions would have been valued if made with unrelated parties.").

[37] The section 482 regulations treat results within a defined range as "arm's length" and not subject to adjustment. This is only one element of the regulations' flexibility.

[38] It would be interesting to know what percentage of related party cost sharing agreements involve one or more unsuccessful products compared with arm's length agreements (that are not actually *de facto* partnerships).

[39] *See* TREASURY TRANSFER PRICING REPORT, *supra* note 24, at 48–50.

E. Policy Implications of the Transfer Pricing Problem

The conclusion to be derived from the preceding analysis of the inherent substantive and procedural limitations on a government's ability to enforce transfer pricing rules, particularly when applied to intangible property, is that the taxpayer has a fundamental and systemic advantage over the government in applying the regime. While it is indeed important to improve our substantive transfer pricing rules, it is unrealistic to believe that this alone will bring about robust transfer pricing compliance.

An alternative to the current arm's length separate transaction method is a formulary apportionment regime – a method that, based on several inputs such as allocation of property, wages and sales, will determine how income is split by formula. Substituting formulary apportionment for the current system will not, however, be a panacea for the above-described pressures on transfer pricing. If, as is the case under U.S. state formula apportionment methods, income allocated under a formula apportionment method to another taxing jurisdiction is exempted by the jurisdiction applying the formula apportionment method, the existing tax rate differentials will continue to exist.[41] If the present effective tax rate differentials are permitted to remain unchanged, the same taxpayer advantages described above will allow taxpayers to manipulate the factors underlying formula apportionment to the same or a greater extent as under the arm's length separate transaction method.

There is no precedent for employing formula apportionment in a system with worldwide taxation and a foreign tax credit. In order for a formula apportionment regime to work in the context of a foreign tax credit, the two taxing jurisdictions would have to have sufficiently similar income allocation formulas so that the income apportioned by the residence state to the other state bears some resemblance to the income actually taxed by the other state. Otherwise there will be substantial risk of double taxation and double non-taxation in everyday business transactions that today are handled adequately under the arm's length separate transaction method that is the subject of the international consensus described above.

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

The policy implication of the preceding analysis is that, in the face of the inherent limits on the ability of a government to monitor and enforce any transfer pricing regime,

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[40] *Id.* at 50–51. While the Treasury Department has identified these and other issues as allowing scope for income shifting, and has documented that income shifting is occurring, the Treasury's remedy appears to be limited to proposing regulatory changes to the rules.

[41] It is possible that under formulary apportionment methods, income (particularly from intangibles) would be allocated away from low tax countries where little economic activity involving property, payroll or sales takes place. That will depend, of course, on the specifics of the rules adopted. Experience at the level of U.S. states suggests that these rules remain subject to manipulation. Moreover, if income is allocated under U.S. rules to higher tax foreign countries, it could encourage such countries to adopt rules that would allow them to tax such income.

it is important that there be structural limits on the ability of taxpayers to take advantage of effective tax rate differences in implementing transfer pricing within a controlled group. The only reform that address this issue as well as the inefficiency of a deferred tax on repatriation is increased current taxation of foreign income.

IV. Possible Reforms to Current U.S. Rules for Taxing Foreign Business Income

This part discusses possible reforms to the current U.S. international tax rules. For the reasons explained below, I would favor increased current taxation of foreign income (with a foreign tax credit) as part of a package of reforms that broadens the corporate tax base and reduces the U.S. corporate tax rate.

A. The Exemption System Alternative

The major approaches by which a country taxes income earned by its residents in a foreign country are worldwide taxation, subject to a credit for foreign taxes, and an exemption system (also referred to as a territorial system).[42] Due to some exemption features of our current system, the U.S. worldwide system is more accurately described as a hybrid between worldwide and exemption systems. Countries that employ exemption systems have, likewise, worldwide taxation features in their systems.[43]

The President's Advisory Panel on Federal Tax Reform is the most recent exemption proposal.[44] The Advisory Panel proposal would:

- Exempt foreign source active business income when earned and when repatriated as a dividend. Active business income earned through a foreign branch also would be exempt. There would be no requirement that the income be subject to any foreign income tax.

- Currently tax investment income and mobile active income under Subpart F type rules.

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[42] There have been a number of proposals to exempt foreign business income, including in the President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Proposal. The President's Advisory Panel's exemption proposal would exempt a domestic corporation from tax on (i) dividends from a foreign corporation attributable to certain active business income, and (ii) active business income earned through a foreign branch. *See* PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 10, at 124–25. The Joint Committee on Taxation Staff also has an exemption proposal that is more detailed than the President's proposal. *See* STAFF OF JOINT COMM'N. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 191 (Comm. Print 2005).

[43] *See* Hugh J. Ault, *U.S. Exemption/Territorial System vs. Credit-Based System*, 32 TAX NOTES INT'L 725, 726 (2003). The only countries with "pure" territorial systems are countries that do not have an income tax on business income. Substituting a consumption tax for an income tax would have extremely broad ramifications and, while ideologically appealing to some, is widely understood to be impractical. *See generally* AM. BAR ASS'N, A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS (1997); Bruce Bartlett, *Fair Tax, Flawed Tax,* WALL ST. J., Aug. 25, 2007, *available at* http://online.wsj.com/public/article_print/SB118800635034508655.html. For an analysis of international aspects of shifting entirely to a consumption tax, see Stephen E. Shay & Victoria Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997).

[44] *See* PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 10, at 102–05, 132–35, 239–43.

- Currently tax non-dividend payments to controlling shareholders, including royalties, rents, interest, service fees and income from intercompany transactions.

- Allow a credit for foreign taxes on foreign source income not eligible for exemption; eliminate the separate limitation categories of section 904.

- Disallow deductions for interest and overhead-type expenses allocated to exempt foreign income. Significantly, research and development expense would be allocated entirely to taxable income and not to exempt foreign income.

- Exempt pre-effective-date earnings currently subject to deferral.[45]

The principal attractions of a foreign exemption proposal are that it would eliminate the tax on repatriation of earnings under a deferral regime and would foreclose relief for high foreign taxes through cross-crediting. It nevertheless leaves other problems of current law unsolved, and, in fact, adds to them.

Significantly, the incentive for income shifting activity to low-tax locations would increase.[46] Moreover, the exemption and tax-free repatriation of foreign earnings would expand the range of businesses that could tax advantage of exemption to businesses who need to repatriate their funds to the United States. In light of the preceding analysis of the ability to constrain transfer pricing aggressiveness, it would seem foolhardy to risk even greater erosion of the U.S. tax base.

Moreover, under an exemption system, expenses must be allocated between exempt and non-exempt income.[47] As noted above, the misallocation of expense against domestic income instead of foreign exempt income, in effect, exempts domestic income from tax due to the taxpayer's foreign operations.[48] This risk of misallocated expenses is a heightened concern in an exemption system.[49]

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[45] Professor Yin suggests consideration of three changes to the Advisory Panel proposal: (i) require that exempt income be subject to tax somewhere; (ii) consider a small tax on repatriation, similar to the 5.25 % under section 965, and (iii) make exemption prospective for post-enactment earnings. *See* Yin, *Reforming Taxation*, *supra* note 18, at 180–81.

[46] As noted by Edward Kleinbard, "[t]*erritorial tax systems, by contrast, reward successful transfer pricing gamers as 'instant winners'* by enabling the successful U.S. firm to recycle immediately its offshore profits as tax-exempt dividends paid to the U.S. parent." *See* Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 114 TAX NOTES 547, 554 (2007) (emphasis in original).

[47] *See generally* Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J., 811 (2001) [hereinafter, Grubert, *Enacting Dividend Exemption*] (estimating the effect on revenue from exempting dividends when considering changing taxpayer behavior).

[48] *See supra* Part III. B.

[49] In a worldwide system with deferral, if a U.S. multinational does not have excess tax credits or does not seek to repatriate income, the allocation of expenses will not have any effect on its tax liability. *See* Grubert, *Enacting Dividend Exemption*, *supra* note 47, at 813.

To conclude, the benefits from an exemption system are not likely to be superior on efficiency or fairness grounds to reforms based on current taxation of foreign business income with an appropriately limited foreign tax credit.[50]

B. Chairman Rangel's Deduction Deferral and Foreign Tax Credit Pooling Proposals

Chairman Rangel has proposed to address the problem, discussed above, of allowing expenses supporting foreign income to be deducted without an income inclusion.[51] Under Chairman Rangel's proposal in H.R. 3970, expenses allocable to deferred foreign-source earnings generally will not be allowed until the earnings are repatriated. Foreign tax credits and earnings and profits would be determined on a consolidated basis for all CFCs. Foreign taxes would be associated with repatriated earnings pro rata based on the ratio of repatriated earnings to all deferred earnings.[52] These reforms would be part of a broadening package of reforms that would allow a reduction in the nominal corporate tax rate of 35% to 30.5%.[53]

There is much to be applauded in Chairman Rangel's proposal. It would (i) reduce the value of deferral by the amount of deferred expenses (and therefore would be critically affected by how expenses are allocated), and (ii) reduce the scope for using cross-crediting planning to reduce tax on non-deferred earnings and other foreign income. The bill would deny taxpayers their current ability to selectively repatriate high foreign tax earnings, which is an important step, but it would not address the inefficiency of a deferred tax on repatriation of earnings.[54]

Chairman Rangel's bill would appear to leave the current U.S. expense allocation rules largely intact. Because these rules tend to overallocate expenses to domestic income, the proposal likely would continue an incentive to earn foreign rather than U.S. income but it is difficult to gauge its effect since it rests on how expenses ultimately are allocated. Indeed, one concern about Chairman Rangel's proposal is the extent to which weight would be placed on the proper allocation of deductions. This is an even more difficult transfer pricing area for the IRS to enforce than allocation of income, because the classification of expense is much less visible and harder to monitor than allocations of income.

C. Reforming Worldwide Taxation

I respectfully submit that reducing the scope of deferral and more closely aligning foreign tax credit rules to the purpose of avoiding double taxation would be preferred to

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[50] Based on analyses that rest more on efficiency and administrability considerations, other commentators also express skepticism regarding territorial taxation proposals. *See generally id.*; BRUMBAUGH & GRAVELLE, REFORM OF INTERNATIONAL TAXATION, *supra* note 9.

[51] H.R. 3970, 110th Cong. 1st Sess. § 3201 (2007).

[52] *See id.*

[53] H.R. 3970, § 3001.

[54] *See* Yin, *Reforming Taxation*, *supra* note 18, at 178.

exemption of foreign income and should be supported on grounds of fairness and efficiency.

The theoretically optimal approach to adopting worldwide taxation would be to adopt pass-through treatment for earnings of a foreign corporation.[55] This conduit approach would have the benefit of maintaining the character and source of the income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. This would constitute a fundamental reform of the international rules that is preferable to the current rules, an exemption system or Chairman Rangel's proposal.

In the event that basic reform is not possible, there are less fundamental reforms to the current rules that would address many of the problems of current law described above. Current taxation of U.S. shareholders under an expansion of Subpart F, while second best to a conduit approach, would be a substantial improvement over current law and probably would enjoy broader support than pass through taxation.[56] One approach would be to tax 10% or greater U.S. shareholders (by vote) in a controlled foreign corporation[57] currently on their share of the controlled foreign corporation's income as part of a package of reforms that permit reduction of the U.S. corporate tax rate. There are a number of other changes that should be considered to the specifics of these rules.[58] These rules have a history of use since 1962, and changes could be implemented without substantial re-design.

If a proposal for fuller current inclusion still goes too far for some, it would also be possible to rehabilitate the Subpart F rules. The Subpart F rules could be made to achieve their intended purpose of restricting deferral to business income earned where it is taxed (and taxed where it is earned). In other words, by updating Subpart F anti-deferral rules to take account of use of branches, including hybrid entity branches, it would be possible to restrict deferral for active foreign income that is not shifted for tax-

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[55] I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. *See* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837 (2000).

[56] I acknowledge the substantial benefits of Edward Kleinbard's proposal for a more fundamental reform of business income generally. *See* Edward Kleinbard, T*he Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97 (2005). That proposal also is beyond the scope of this discussion.

[57] A controlled foreign corporation is one more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by 10% U.S. shareholders, by vote. *See supra* note 14.

[58] Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a controlling U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated for portfolio investors and the passive income threshold should be reduced to 50% from 75%. The PFIC taxing rules, a deferred tax with an interest charge, qualified electing fund pass-through taxation, or mark-to-market taxation, would apply to a U.S. shareholder in a PFIC.

motivated reasons to lower tax countries. Such a proposal was outlined in the American Bar Association Report of the Task Force on International Tax Reform.[59]

In connection with any of these proposals for increased current taxation of foreign income, the current foreign tax credit mechanism should be improved, for example by repealing the sales source rule and rationalizing source rules for income from intangibles. As further a example, income from the licensing of intangibles should be sourced consistently with the sale of inventory (after repeal of the sales source rule) subject to an adjustment to allow a credit for foreign withholding tax, if any, on the royalty.[60] Current expense allocation rules permit the over-allocation of expenses to U.S. income, thereby expanding the foreign tax credit limitation. These rules should be reviewed and revised to limit their scope to what is appropriate to avoid double taxation. Other changes to limit cross-crediting of foreign taxes also should be considered.

A taxpayer's ability to control inter-company pricing is a fundamental attribute of international taxation. As I have argued above, while changes to the transfer pricing rules to decrease the government's substantive and procedural difficulties in enforcement are desirable, their benefits will be limited by the practical limitations on enforcement described above. Thus, the focus must be on reducing the effective tax rate differentials that drive transfer pricing planning in the first place. Reducing the scope for deferral under any of the approaches just described is key to constraining aggressive transfer pricing and protecting the U.S. tax base.

The changes described above would address the defects of current law by: (i) moving toward equalizing the taxation of foreign and domestic income, (ii) reducing the cross-crediting subsidy for high foreign taxes, and (iii) reducing the inefficiency of a deferred tax on repatriation. Moreover, taken together, these changes would reduce incentives to engage in aggressive transfer pricing. A base-broadening approach, such as described, that contributes to a meaningful reduction in corporate tax rates, would assist all U.S. businesses – whether they operate abroad, export from the United States, or compete against foreign imports. The result would be a fairer tax system.

I would be pleased to answer any questions the Committee might have.

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[59] *See ABA Report*, *supra* note 8, at 787–803.
[60] Approaches to these proposals may be found in the ABA Report, *supra* note 8, at 772–74.

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Before joining Ropes & Gray in 1987, Stephen was the International Tax Counsel for the United States Department of the Treasury. Prior to joining the Treasury Department as an Attorney Advisor in 1982, Stephen was associated with Reavis & McGrath and Coudert Brothers in New York City. Stephen received J.D. and M.B.A. degrees from Columbia University in 1976 and his B.A. from Wesleyan University in 1972.

Stephen has authored or co-authored numerous articles and has testified before Congress on international tax policy issues. Stephen's principal publications and testimony are set out below.

Publications and Testimony

Testimony , Committee on Ways and Means, U.S. House of Representatives, Hearing on Fair and Equitable Tax Policy for America's Working Families (September 6, 2007)

American Bar Association Tax Section, Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform," 59 Lawyer 649 (2006) (principal draftsman)

Testimony , Subcommittee on Select Revenue Measures of the Ways and Means Committee, U.S. House of Representatives, Hearing on U.S. International Competitiveness (June 23, 2006)

Testimony, President's Advisory Panel on Federal Tax Reform, Panel on International Income Taxation (May 13, 2005)

"The David R. Tillinghast Lecture: 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation," 56 Tax Law Rev. 81 (2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

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"Reform and Simplification of the U.S. Foreign Tax Credit Rules," 31 Tax Notes Int'l 1145 (September 29, 2003) and 101 Tax Notes 103 (October 6, 2003) (co-authored with Robert J. Peroni and J. Clifton Fleming Jr.)

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"An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral," 20 Tax Notes Int'l 547 (January 31, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

"Deferral: Consider Ending It, Instead of Expanding It," 86 Tax Notes 837 (Feb. 7, 2000) (co-authored with J. Clifton Fleming, Jr. and Robert J. Peroni)

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"Qualified Intermediary Status, Act III: Rev. Proc. 2000-12's Final Qualified Intermediary Agreement and Amendments to Final Withholding Rules," 29 Tax Mgmt. Int'l J. 403 (July 14, 2000) (co-authored with Susan C. Morse and Christopher J. Peters)

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