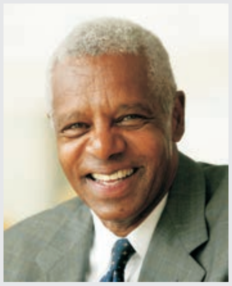
Logic Says No to Options Y, Z, And C, but Yes to Imputation

By Samuel C. Thompson Jr.



Samuel C. Thompson Jr.

Samuel C. Thompson Jr. is a professor and director at the Center for the Study of Mergers and Acquisitions in Penn State's Dickinson School of Law. He thanks the following for their comments on this report: Joshua Bam, a 2013 graduate of Penn State Law and a fellow in Penn State's Center for the Study of Mergers and Acquisitions; and Kimberly John, a third-year student at Penn State Law and Thompson's research assistant.

In this report, Thompson demonstrates why the approach to the taxation of controlled foreign corporations under the international business tax reform discussion draft of former Finance Committee Chair Max Baucus does not reflect sound tax policy and should be rejected. He argues that Congress should instead adopt an imputation system and use the revenue generated from that system to significantly reduce the corporate tax rate for all corporations.

Table of Contents

I. Introduction

A. Senate's International Draft

On November 19, 2013, the Senate Finance Committee issued the international business tax reform discussion draft.[1] The summary of the draft says that it ''proposes a modern international tax system that is simpler, fairer, promotes U.S. growth and job creation, and is revenue neutral in the long-term.'' The draft's principal focus is on reforming the tax treatment of controlled foreign corporations. In discussing CFCs, this report assumes that they are 100 percent owned by a U.S. parent corporation, which is the normal case.

The heart of the Senate draft is its proposal for a modified territorial regime (also known as a participation exemption system) for taxing foreign active income of CFCs. The draft would:

> 1. ensure that a CFC paid at least a minimum tax on its income through the adoption of what the draft refers to as option Y or option Z; and
>
> 2. allow the tax-free repatriation of the CFC's earning through dividends to the U.S. parent.

---

[1]Senate Finance Committee International Business Tax Reform Discussion Draft in Legislative Language (Nov. 19, 2013). *See also* Max Baucus, ''Summary of Staff Discussion Draft: International Business Tax Reform'' (Nov. 19, 2013); and Joint Committee on Taxation, ''Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation,'' JCX-15-13 (Nov. 19, 2013).

Thus, the Senate draft would abandon the current deferral system for the taxation of a CFC's foreign active income. Under the current system, U.S. tax on the CFC's foreign active income is deferred until that income is repatriated to the U.S. parent.

B. The House's International Draft

On February 27, 2014, the House Ways and Means Committee issued a discussion draft of the Tax Reform Act of 2014. TRA 2014 would adopt a participation exemption system for taxing active foreign income earned by CFCs, which I will refer to here as option C.[2] The summary of that option explains:

> Under the provision, the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed would be replaced with a dividend-exemption system. Under the exemption system, 95 percent of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent or more of the foreign corporation would be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend.[3]

The summary gives the following reasons for adoption of option C:

> The provision would allow U.S. companies to compete on a more level playing field against foreign multinationals when selling products and services abroad.
>
> The provision would eliminate the "lock-out" effect that results from the U.S. residual tax under current law, which discourages U.S. companies from bringing their foreign earnings back into the United States.[4]

The summary explains that after the effective date of option C, the deferred earnings and profits of CFCs would be subject to tax at a rate of 8.75 percent to the extent the E&P consists of cash or cash equivalents, and a rate of 3.5 percent for any remaining E&P.[5] Those taxes would be partially offset by foreign tax credits, and taxpayers could elect to pay the taxes over a period of up to eight years.

The House's option C takes a lighter approach to the taxation of foreign business income than the Senate draft because, *inter alia*, option C has no minimum tax. Because I am critical of the light approach taken in the Senate draft, I obviously oppose the even lighter approach taken in option C. For that reason, option C is not discussed further in this report.

C. Purposes of This Report

The first purpose of this report is to demonstrate why the Senate draft's approach to the taxation of CFCs does not reflect sound tax policy and should therefore be rejected. For that reason, this report does not explore in detail the provisions of the draft except as needed to understand the following policy issue addressed here: Should Congress adopt the Senate draft's treatment of CFCs?

A second purpose of this report is to demonstrate why instead of adopting the Senate draft's modified territorial approach, Congress should:

- adopt an imputation system (which I refer to as option I) for taxing foreign active income; and
- use the revenue generated from the adoption of option I to significantly reduce the corporate tax rate for all corporations.

In several articles, I have argued for this two-pronged approach — that is, adopt option I and lower the corporate rate.[6] However, the summary of the Senate draft explains that the proposal does not provide for a reduction in corporate tax rates. It says that the package of reforms "is intended to be revenue-neutral in the long-term (*i.e.*, in a steady state)."[7] Thus, the adoption of these reforms would not produce any revenue with which to reduce the corporate tax rate. On this point, the summary states: "These reforms are . . . intended to be coupled with a significant reduction in the corporate tax rate that is financed by broadening the corporate tax base [through domestic reforms] in a manner that is revenue neutral in the long-term."[8]

---

[2]My use of the term "option C" is different from the use of that term by Ways and Means Committee Chair Dave Camp, R-Mich., in his prior international tax proposals. There Camp proposed both a territorial system and an option C that would reduce the incentive for moving intangibles to a tax haven. *See* Jaime Arora, "Reform of Intangibles Income Taxation Debated," *Tax Notes*, Feb. 18, 2013, p. 809. With the adoption of option I, discussed *infra*, there would be no need for that option C or for the similar provision that is included in TRA 2014. *See* TRA 2014, section 4211 (foreign intangible income subject to taxation at a reduced rate; intangible income treated as subpart F income).

[3]Ways and Means Committee, "Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary," at 142 (Feb. 26, 2014).

[4]*Id.*

[5]*Id.* at 143.

[6]*See, e.g.*, Samuel C. Thompson Jr., "An Imputation System for Taxing Foreign-Source Income," *Tax Notes*, Jan. 31, 2011, p. 567; and Thompson, "Obama's International Tax Proposal Is Too Timid," *Tax Notes*, May 11, 2009, p. 738.

[7]Baucus, *supra* note 1, at 3.

[8]*Id.*

Table 1. Computation of Minimum Tax Under Option Y

[1] Foreign Corporate Tax Rate	Foreign Country A With a 0 Percent Corporate Tax Rate	Foreign Country B With a 20 Percent Corporate Tax Rate	Foreign Country C With a 30 Percent Corporate Tax Rate
[2] CFC active taxable income	$100	$100	$100
[3] Foreign tax	$0	$20	$30
[4] CFC low-taxed active income (income subject to a foreign tax of less than 28 percent)	$100	$100	NA
[5] 20 percent partial deduction for CFC low-taxed active income	$20	$20	NA
[6] CFC low-taxed active income after 20 percent deduction	$80	$80	NA
[7] U.S. corporate tax rate	35%	35%	NA
[8] Pre-credit U.S. minimum tax on CFC low-taxed active income ([7] x [6])	$28	$28	NA
[9] FTC ([2])	$0	$20	NA
[10] U.S. minimum tax due under option Y ([8] - [9])	$28	$8	NA
[11] Combined foreign and U.S. effective rate ([3] + [10])	28%	28%	30%

II. Outline of the Draft's Treatment of CFCs

A. Treatment of Passive Income Under the Draft

For passive income of CFCs, the Senate draft would in essence retain the current treatment of CFCs by imputing that passive income to the U.S. parent. As a result of the imputation of passive income, later distributions of that income to the U.S. parent would be tax free to the parent. Thus, the draft would continue the anti-deferral treatment under the subpart F rules for passive income earned by CFCs.

B. Treatment of Foreign Active Income

1. Introduction: Participation exemption and minimum tax. For active foreign income of CFCs, which is the principal focus of this report, the draft proposes the adoption of a modified participation exemption system (that is, a territorial system). Under that system, the active business income of a CFC would not be subject to U.S. tax on repatriation. However, unless the CFC active income was subject to a foreign tax above a specified threshold, the draft would impose a minimum tax on that income under option Y or option Z, discussed below.

2. The option Y minimum tax. The summary describes option Y as a minimum tax that immediately taxes all active income at 80 percent of the U.S. corporate tax rate with full FTCs, "coupled with a full exemption for foreign earnings upon repatriation."[9] Under option Y, the minimum tax would apply to "low-taxed income," which is active income that is subject to a foreign tax that is less than 80 percent of the maximum U.S. corporate statutory rate (now 35 percent). Thus, the minimum tax would kick in when the foreign tax is less than 28 percent. Also, an FTC is allowed for the foreign tax imposed on that income.

Cutting through all the technical aspects of option Y, this minimum tax would apply as demonstrated in Table 1, when a CFC has $100 million of active income that is subject to one of the following foreign tax rates: 0 percent, 20 percent, or 30 percent.

As shown in rows 10 and 11 in Table 1:

1. when the foreign income is subject to a foreign tax that is less than 28 percent, which is 80 percent of the 35 percent maximum U.S. corporate rate, a minimum U.S. tax is imposed to make the combined U.S. and foreign rate equal to 28 percent; and

2. when the foreign rate equals or exceeds 28 percent, no U.S. tax is due.

This system would not eliminate the tax incentive for investing in low-tax foreign jurisdictions. For example, assume that other things are equal for a U.S. corporation considering an investment in the United States; its CFC operating in Foreign Country A, with its 0 percent rate; Foreign Country B, with its 20 percent rate; or Foreign Country C, with its 30 percent rate. It is clear that the corporation would likely invest in a foreign jurisdiction because (1) with investment in Foreign Country A or Foreign Country B, the combined effective rate is 28 percent, which is 80 percent of the U.S. rate; and (2) with investment in Foreign Country C, the combined foreign tax and zero U.S. tax is 30 percent, which is 86 percent of the U.S. rate. As between the current

[9] *Id.*

Table 2. Computation of Minimum Tax Under Option Z			
[1] Foreign Corporate Tax Rate	Foreign Country A With a 0 Percent Corporate Tax Rate	Foreign Country B With a 20 Percent Corporate Tax Rate	Foreign Country C With a 30 Percent Corporate Tax Rate
[2] CFC active foreign market income	$100	$100	$100
[3] Foreign tax	$0	$20	$30
[4] 60 percent of CFC active income	$60	$60	$60
[5] U.S. corporate tax rate	35%	35%	35%
[6] Pre-credit U.S. minimum tax on CFC active foreign market income ([5] x [4])	$21	$21	$21
[7] FTC (60 percent of [3])	$0	$12	$18
[8] U.S. minimum tax due under option Z ([6] - [7])	$21	$9	$3
[9] Combined foreign and U.S. effective rate ([3] + [8])	21%	29%	33%

deferral system and option Y, in some cases, the greatest incentive for foreign investment may be option Y.

3. The option Z minimum tax. The summary describes option Z as a minimum tax that immediately taxes all active foreign market income at 60 percent of the U.S. corporate rate, "coupled with a full exemption for foreign earnings upon repatriation."[10] Active foreign market income, which is narrower than what would otherwise constitute CFC active income, is defined in proposed section 953 as:

> the aggregate of all items of income which are —
>
> 1. attributable to economically significant activities with respect to a qualified trade or business, and
>
> 2. derived in connection with —
>
> A. property which is sold, exchanged, or otherwise disposed of for use, consumption, or disposition outside of the United States, or
>
> B. services which are provided outside of the United States with respect to persons or property located outside of the United States.

In computing a CFC's imputable subpart F income under option Z, the CFC is required to impute 60 percent of its active foreign market income to the U.S. parent. The CFC's nonactive foreign market income, such as passive income, is subject to full imputation. The U.S. parent is allowed an FTC of 60 percent of the foreign tax imposed on the active foreign market income.

Greatly simplified, the option Z minimum tax would apply as demonstrated in Table 2 when a CFC has $100 million of active foreign market income that is subject to one of the following foreign tax rates: 0 percent, 20 percent, or 30 percent.

As with option Y, option Z would not eliminate the tax incentive for investing in low-tax foreign jurisdictions. Under the assumed facts, as Table 2 demonstrates, option Z would have the bizarre effect of imposing the lowest combined rate on the CFC located in the jurisdiction with the lowest rate. Thus, under option Z, the lower the foreign rate, the lower the combined rate. With option Y, however, the combined rate is the same for all jurisdictions with rates lower than 80 percent of the U.S. corporate rate.

It might be said that for CFCs doing business in countries with rates lower than 80 percent of the U.S. rate, option Z does not treat similarly situated taxpayers the same and consequently does not promote horizontal equity, whereas option Y treats similarly situated taxpayers the same, thereby promoting horizontal equity.

C. Treatment of Intangibles

The Senate draft contains a provision titled "Limitations on income shifting through intangible property transfers," which would apply under both options. This provision is designed to limit the strong incentive under a territorial system for a U.S. parent to transfer intangibles to a foreign subsidiary.

D. Other Proposals for a Minimum Tax

As pointed out by Martin A. Sullivan, minimum taxes on foreign profits have also been proposed by both the Obama administration, in its February 2012 corporate and international tax reform proposals, and the Ways and Means Committee, in its

[10] *Id.*

October 2011 discussion draft on international tax.[11] Those proposals are not discussed here.

III. Brief Introduction to an Imputation System

Under an imputation system, option I, all earnings of a foreign subsidiary, whether active or passive, and all loss, would be imputed to the parent corporation for the year in which the earnings or losses are realized. The parent would be given an FTC for any foreign taxes paid on that income. Thus, the income and loss of a foreign subsidiary passes through to the parent corporation much like the income and loss of a partnership passes through to the partners.

As discussed later, the adoption of option I would generate substantial revenues, which could be used to significantly reduce the U.S. corporate tax rate on a revenue-neutral basis.

Option I is similar to both (1) President Kennedy's 1962 proposal for the adoption of a full imputation system, which was rejected in favor of the current CFC provisions, which provide for imputation of some tax-haven-type income; and (2) the Bipartisan Tax Fairness and Simplification Act, S. 3018, which was introduced on February 23, 2010, by Finance Committee Chair Ron Wyden, D-Ore., and former Sen. Judd Gregg.

Also, similar imputation systems have recently been proposed by professor Edward D. Kleinbard, a former head of the Joint Committee on Taxation staff,[12] and Stephen E. Shay, a former Treasury international tax counsel in the administration of President George H.W. Bush and Treasury deputy assistant secretary for international tax affairs in the Obama administration.[13]

IV. Problems With the Current System

The summary identifies several problems with the current deferral system:

> Current law creates incentives for many multinational corporations to invest and create jobs overseas. This is partially due to the U.S. statutory corporate tax rate, which is the highest in the developed world. It is also due to our deferral-based international tax system, which generally allows U.S. companies operating through foreign subsidiaries to choose if and when foreign profits are subject to U.S. tax. This can result in lower effective tax rates on U.S. companies investing abroad rather than in the United States.
>
> Current law allows multinational corporations (both domestic and foreign) to shift earnings to tax havens and to take advantage of differences between U.S. and foreign laws to reduce their U.S. tax bill.
>
> Current law makes it difficult for U.S.-based multinational businesses to compete with foreign-based multinationals. U.S. businesses are held back by tax rules that are complex, inefficient, and unfair. In addition, many foreign multinationals are based in countries with significantly lower corporate tax rates and with dividend exemption systems instead of the deferral and credit-based system that the United States uses. These impediments to competitiveness hurt job creation and economic growth.
>
> Current law creates incentives for U.S.-based multinationals to keep the earnings of foreign subsidiaries offshore and not repatriate such earnings to the United States (the lock-out effect).

I refer to these as (1) the incentive for foreign investment problem, (2) the shifting earnings to foreign subsidiaries problem, (3) the lockout problem, and (4) the unlevel playing field for horizontal competitiveness problem. The focus of this report addresses the effect of options Y, Z, and I on these four problems.

V. Addressing Problems: Options Y, Z, and I

A. The Incentive for Foreign Investment Problem

1. Options Y and Z. Both options Y and Z have, at their core, a move in the direction of a territorial system for taxing foreign income. A territorial system has a built-in incentive for foreign as opposed to domestic investment whenever the foreign tax rate is less than the domestic tax rate. Thus, while the expectation of the Senate draft is that options Y and Z would reduce the incentive for foreign investment, they might increase it.

Also, as indicated previously, the draft's provision titled "Limitations on income shifting through

---

[11] Sullivan, "The Baucus Draft and Other Options for Taxing Foreign Profits," *Tax Notes*, Dec. 9, 2013, p. 1007.

[12] *See, e.g.*, Kleinbard, "Stateless Income's Challenge to Tax Policy, Part 2" *Tax Notes*, Sept. 17, 2012, p. 1431 (arguing in Section VIII for the adoption of a "worldwide tax consolidation" system, which is an imputation system for income and loss of CFCs).

[13] *See, e.g.*, J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Perspectives on the Worldwide vs. Territorial Taxation Debate," *Tax Notes*, Dec. 7, 2009, p. 1079; and Fleming and Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System," *Tax Notes*, Dec. 19, 2005, p. 1557 (analyzing the territorial proposal of the tax reform panel report and a similar proposal by the JCT; concluding that the United States should move to an imputation system). *See also* Jasper L. Cummings, Jr., "Shay, Peroni, and Fleming?" *Tax Notes*, Mar. 17, 2014, p. 1263.

intangible property transfers'' demonstrates that there would continue to be a strong incentive to move intangible property offshore.

2. Option I. With option I, the tax incentive for a U.S. parent corporation to transfer property overseas or to conduct business operations overseas would be eliminated. There would be a level playing field from a tax perspective for domestic and foreign investment. There would be no need to limit the transfer of intangibles to foreign subsidiaries, because there is no tax benefit gained from that transfer. Therefore, option I should be an effective device for addressing the incentive for foreign investment problem.

B. The Shifting Earnings Problem

1. Options Y and Z. Under options Y and Z, there would still be a shifting earnings to foreign subsidiaries problem. For that reason, under both options there would have to be:

- limits on interest deductions for domestic companies to the extent that the earnings of their foreign subsidiaries are exempt from U.S. tax and to the extent that the domestic companies are overleveraged when compared with their foreign subsidiaries; and
- limits on deductions for related-party payments arising in a base erosion arrangement.[14]

2. Option I. Option I would take away most, if not all, of the incentive to engage in transfer pricing and expense manipulation in transactions between a U.S. parent and its foreign subsidiary. Thus, adoption of option I would significantly reduce transfer pricing and deflection of expense abuse in outbound transactions.

Option I, like options Y and Z, would not address the shifting of earnings between a foreign parent and its U.S. subsidiary. Thus, there would have to be active enforcement of the transfer pricing rules for those transactions.

3. OECD BEPS project. In 2013 the OECD issued two papers on the base erosion and profit-shifting problem with the territorial tax systems in many OECD countries.[15] Those systems are similar to options Y and Z. Although option I would directly and effectively address BEPS in outbound transactions, options Y and Z would not significantly reduce — and might increase — the incentive for U.S. corporations to engage in BEPS transactions.

C. The Lockout Problem

1. Options Y and Z. Options Y and Z would reduce but not eliminate the lockout problem. Although a company would be able to repatriate income without triggering U.S. tax, the participation exemption for active income would create a tax incentive for U.S. corporations to invest and reinvest in foreign businesses in low-tax jurisdictions.

2. Option I. Option I would eliminate the lockout problem by creating a level playing field for domestic and foreign investment by U.S. parents. As a consequence, investment by U.S. companies would be made in either the United States or in a foreign jurisdiction on the basis of the economic attributes of the investment and not the tax attributes.

D. The Horizontal Competitiveness Problem

1. Options Y and Z.

a. In general. Many proponents of a territorial system argue that such a system would promote foreign competitiveness of U.S. corporations by putting a CFC operating in a host foreign country on a level tax playing field with both:

1. a corporation operating in the host foreign country, when the corporation is owned by host-country shareholders; and

2. a foreign subsidiary operating in the host foreign country, when the foreign subsidiary is owned by a foreign parent located in a country with a territorial system.

I refer to the corporations specified in paragraphs 1 and 2 as host-country-taxed corporations (HCTCs). I refer to this argument as the horizontal competitiveness argument because the focus is on direct competition between a CFC and its competitors that are HCTCs.

The argument is that if an HCTC has a lower tax rate than a CFC operating in the host country, the HCTC will have a competitive advantage over the CFC.

The Senate draft addresses this horizontal competitiveness argument to an extent, but the minimum taxes in options Y and Z would not completely resolve the problem, because a CFC doing business in a host country where the option Y or option Z minimum tax applies would not be on a level playing field with its HCTC competitors. Thus, in proposing options Y and Z, the draft is not completely accepting the horizontal competitiveness argument and thereby implicitly acknowledges that the argument is not compelling.

I believe the horizontal competitiveness problem is exaggerated and that, to the extent it exists at all, the problem affects only a small portion of foreign investment.

---

[14]Baucus, *supra* note 1, at 4.

[15]OECD, ''Action Plan on Base Erosion and Profit Shifting'' (July 19, 2013); and OECD, ''Addressing Base Erosion and Profit Shifting'' (Dec. 2, 2013). *See generally* Nathan Boidman and Michael N. Kandev, ''BEPS: The OECD Discovers America?'' *Tax Notes Int'l*, Dec. 16, 2013, p. 1017.

b. Obvious overstatement of the horizontal competitiveness problem. In discussing options Y and Z, professor Reuven S. Avi-Yonah has made the following point regarding the relative tax burdens of U.S. and foreign multinational enterprises: ''EU-based MNEs and Japanese MNEs already face effective overall tax rates that are higher than their U.S. counterparts, despite having territoriality.''[16]

That fact alone is a major hole in the horizontal competitiveness argument. For instance, as this comment suggests, the major competitors of CFCs are EU- and Japanese-based MNEs that are HCTCs with higher effective tax rates than CFCs. Thus, by the logic of the competitiveness argument, CFCs already have a competitive advantage over HCTCs.

c. Effect of the NPV investment model on the horizontal competitiveness debate. It is not clear that a higher corporate tax rate will reduce a CFC's ability to compete with an HCTC. Most investment decisions are based on the net present value (NPV) model of finance.[17] Under that model, a corporation should invest in a project when the present value of the free cash flows from the project, discounted at the cost of capital, is greater than the cost of the project. If an investment is profitable under this model (that is, the project has a positive NPV), it makes economic sense for the company to invest.

In the NPV model, income taxes are taken into account in computing the free cash flows. Therefore, all else being equal between a CFC and an HCTC regarding a particular project, if a CFC faces a higher tax rate than the HCTC, the present value of the project for the CFC would be less than the present value to the HCTC. This means that the HCTC would be more likely to invest in the project. However, as long as the project produced a positive NPV for the CFC, it would likely make the investment; and if there were a negative NPV on the project, the CFC would likely invest in another project (possibly a U.S. project) that had a positive NPV.

The only situation in which the CFC would clearly walk away from the project while the HCTC pursued it is when the project would produce a positive NPV for the HCTC and a negative NPV for the CFC.

Financial theory shows that the NPV of a project is likely to be higher when the company has market power — power over price — in the particular market. Market power will generally be present when the market exhibits features of a monopoly or an oligopoly as opposed to a competitively organized market in which prices are low because there are many companies competing to sell a homogeneous product.

Although I have no empirical information on this point, I believe that in many of the foreign markets in which a CFC will be competing with an HCTC for a project, both the CFC and the HCTC will have market power and the prices will not be at the competitive level. Whichever corporation prevails, the CFC and the HCTC will be able to charge a supercompetitive price, and the project will therefore show a significant positive NPV.

In that case, the horizontal competitiveness argument reduces to the following: The United States should not impose a corporate tax on the CFC's supercompetitive profits, because the HCTC's supercompetitive profits would be taxed at a lower rate. This argument is flawed because the U.S. corporate tax is in no way a barrier to a CFC competing for a foreign project in which it will have market power.

Although the above analysis is based on the assumption that other things are equal between the CFC and the HCTC, other things are never really equal. The ability to compete involves many aspects, including the cost of labor, the state of a company's technical know-how, and the quality of products. These elements are certain to be more important to the ability to compete than the income tax rate.

d. The competition between S and C corporations analogy. The following is a domestic taxation analogy to the horizontal competitiveness argument: Because S corporations are subject to one level of taxation, in making investments and operating, they should have a competitive advantage over C corporations, which are subject to two levels of taxation. I am aware of no evidence showing that S corporations have a competitive operating advantage over C corporations.

e. The unaddressed unlevel playing field for vertical competitiveness problem. A territorial system, including the Senate draft proposal and its options Y and Z, creates a vertical competitiveness problem in that it tilts the tax playing field in favor of foreign as opposed to domestic investment. This, I believe, is a real competitiveness problem for the United States because it creates an artificial incentive for foreign investment.

For example, assume that a U.S. corporation is faced with the following two investment decisions:

1. invest in a project in State College, Penn., where the corporate-level tax is 35 percent; or

[16]Avi-Yonah, ''Why Y? Reflections on the Baucus Proposal,'' *Tax Notes Int'l*, Dec. 16, 2013, p. 1005.

[17]*See generally* Thompson, *Mergers, Acquisitions and Tender Offers*, ch. 11, ''Valuation Considerations in M&A and Dealing With Investment Bankers'' (2013).

2. invest through a CFC in a foreign project with similar attributes except that (a) the corporate tax rate is 0 percent, 20 percent, or 30 percent as shown in row 1 of tables 1 and 2, and (b) the United States has adopted a modified territorial system with a minimum tax like option Y or option Z.

In that case, the investment will likely be made in the foreign project because, despite the minimum tax, there will be greater cash flow from the foreign project than the U.S. project. Consequently, the NPV of the foreign project will be more than the NPV of the U.S. project.

This vertical competitiveness problem is much more powerful than the horizontal competitiveness problem. That is because in the vertical competitiveness situation, the U.S. corporation itself will benefit from the lower tax rate from the foreign investment, whereas in the horizontal competitiveness situation, the foreign competitor gets the benefit of the lower tax rate.

2. Option I. Option I would clearly eliminate the vertical competitiveness problem, but arguably it would create a horizontal competitiveness problem. However, in my view, the detriments associated with this horizontal problem pale in comparison to the benefits that would flow from option I's elimination of the vertical competitiveness problem.

3. Proper measurement of the detriments and benefits associated with the horizontal and vertical competitiveness problems. Before moving forward with option Y or Z or any other form of territorial system, Congress should ask the JCT to undertake a careful study of the actual competitiveness advantages and disadvantages that would likely result from:

1. the horizontal competitiveness problem that options Y and Z would address, and the vertical competitiveness problem they would create; and

2. the vertical competitiveness problem option I would address, and the horizontal competitiveness problem it would create.

It seems only reasonable that before reforming the international tax rules on the grounds of promoting the international competitiveness of U.S. corporations, Congress should receive an independent report quantifying precisely what competitive gains and losses are likely to occur.

VI. Option I Revenue Savings

Another benefit of option I would be the additional tax revenue it would generate. The JCT's report on tax expenditures[18] shows that the current deferral system is by far the largest of more than 100 corporate tax expenditures (that is, reduction in tax liability). As a practical matter, this means that any meaningful reduction in the corporate tax rate would require a hard look at eliminating the tax deferral expenditure.

It is unclear if the JCT's revenue estimate associated with deferral takes into account all the detriments associated with transfer pricing and expense deflection abuse under the current deferral system. If those abuses are not included in the revenue estimate, the tax revenue gain from moving to an imputation system under option I would be even greater.

VII. Option I and Reduction in Corporate Rate

There is no doubt that the repeal of the deferral system could, on a revenue-neutral basis, provide the revenue needed to significantly reduce the maximum corporate tax rate from the current 35 percent. Professor Roy Clemons has reported that the revenue gained from repeal of the deferral provision could be used on a revenue-neutral basis to decrease the top corporate tax rate for all U.S. corporations from 35 percent to 28 percent.[19]

Thus, the trade-off with this type of revenue-neutral policy would be (1) to increase the tax rate on some companies investing abroad; and (2) to reduce the maximum tax rate on all companies, both those investing abroad and those investing domestically, from 35 percent to 28 percent. That is essentially the policy choice made in the bipartisan tax act proposed by Wyden and Gregg.[20]

Under that approach, investment in the United States would be more attractive for both U.S. companies and foreign companies because the 28 percent rate would also apply to foreign companies operating in the United States. Also, although there would be immediate imputation of foreign income, the imputed income would be taxed at a lower rate than the current 35 percent rate applicable to companies that earn foreign income and immediately repatriate it to the United States. Thus, U.S. companies that now repatriate low-taxed foreign income on a current basis would receive a tax reduction.

VIII. Complexity: Advantage of Option I

Any international tax system is going to be complex. It is not clear that options Y and Z would

[18]JCT, ''Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017,'' JCS-1-13 (Feb. 1, 2013).

[19]Clemons, ''U.S. International Tax Policy: Is Significant Reform on the Way?'' *Tax Notes*, Aug. 3, 2009, p. 445.

[20]Bipartisan Tax Fairness and Simplification Act of 2010.

reduce the complexity of the code's international provisions. However, it seems clear that option I would reduce the complexity in the current deferral system. For example, under option I, there would not be a need for the following:

1. separate FTC baskets, because all foreign income of a foreign subsidiary would be included in the U.S. parent's return;

2. elaborate subpart F rules distinguishing between active and passive income, which are imbedded in the current deferral system and would continue under options Y and Z;

3. complex transfer pricing, interest allocation, and other base erosion rules for outbound transactions; and

4. rules limiting the ability of tax arbitrage with the check-the-box system, because it would not matter whether a controlled foreign entity was a corporation or a tax-nothing.

IX. Taxing Previously Deferred Income

A problem with the adoption of option Y, Z, or I would be the administrative costs associated with switching from the current U.S. deferral system. For example, a decision would have to be made on the treatment of income that has been previously deferred. Would that income become subject to immediate U.S. taxation?

It would be reasonable to require that the deferred income held in a foreign subsidiary be included in the income of the U.S. parent (thereby becoming subject to U.S. tax) on a ratable basis over, for example, a three- or four-year period. That would be similar to the rules that applied in the late 1980s when tax-exempt Keogh plans were forced onto a calendar-year basis, thus eliminating the benefit of deferral for the owners of those plans.

In my view, the Senate draft's approach to this switching problem is much too generous. As explained by the summary, under the draft, ''earnings of foreign subsidiaries from periods before the effective date of the proposal that have not been subject to U.S. tax are subject to a one-time tax at a reduced rate of, for example, 20 percent, payable over eight years.''[21] A significant portion of these deferred earnings results from aggressive tax planning involving the use of tax haven subsidiaries, dubious transfer prices, and other techniques designed to erode the U.S. tax base. To reward that type of activity with a 20 percent tax rate is highly inappropriate. Also, the eight-year period for inclusion is too long.

[21]Baucus, *supra* note 1, at 3.

X. Increased Incentive for Inversions

In 2004 Congress enacted section 7874 to reduce the benefits of inversion transactions. Those transactions were designed to avoid the CFC rules and put a U.S. corporation in the position to better engage in base erosion transactions. In a common form of inversion, a U.S. corporation would, through a cross-border merger, become a subsidiary of a foreign holding company.[22]

Section 7874 treats the foreign holding company as a U.S. corporation if the U.S. shareholders own more than 80 percent of its stock. As a consequence, that foreign holding company is subject to the CFC provisions. Section 7874 also sets out enhanced anti-base-erosion provisions that apply when U.S. shareholders own 60 to 80 percent of a foreign holding company. Further, regulations under section 367 require the recognition of gain in many inversion transactions.

While section 7874 has slowed down (but not eliminated) inversion transactions,[23] the adoption of option I might be expected to increase the incentives for U.S. companies to engage in inversions. In any event, whether or not option I is adopted, Congress should consider erecting stronger barriers to inversion transactions than those presented in section 7874. My arguments for strong barriers to inversions are not new; I first advocated for them in 2002.[24]

One final point on inversions: Some will argue that option I should be rejected because the incentive to engage in inversions would likely increase with its adoption. Under that logic, we would not have an income tax because the adoption of an income tax clearly increases the incentive to engage in transactions to avoid it. Just as antiavoidance provisions are needed in any income tax system, enhanced anti-inversion provisions are needed now and would continue to be needed with the adoption of option I.

XI. The Flaw in the 'Me Tooism' Argument

Many of the proponents of a territorial system make some version of the following argument: ''Every other significant country has a territorial system and we should, too.'' For example, in testimony before the Joint Economic Committee, Dr.

[22]*See generally* Thompson, *Mergers, Acquisitions and Tender Offers*, ch. 22, ''Federal Income Tax Considerations in Tax-Free Cross-Border M&A,'' at section 22.5 (2013).

[23]Lee A. Sheppard, ''Inversions Continue, but Are More Difficult,'' *Tax Notes*, Oct. 28, 2013, p. 355.

[24]Thompson, ''Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions,'' *Tax Notes*, Mar. 18, 2002, p. 1505.

Laura D'Andrea Tyson, a former chair of President Clinton's Council of Economic Advisers, made the following statement in supporting a move to a territorial system:

> Every other G-8 country and 28 of the other 33 OECD member countries have adopted modern international tax systems that generally allow their internationally-engaged companies to compete globally and reinvest active foreign earnings at home without paying a second tax. . . .
>
> The current worldwide approach to corporate taxation in the U.S. puts globally-engaged U.S. companies at a competitive disadvantage. They cannot bring profits from their foreign affiliates home without paying the high U.S. corporate tax rate, while foreign-based competitors pay only the local tax rate on such profits. The combination of a high corporate tax rate and a worldwide approach to taxing the foreign active earnings of companies reduces the attractiveness of the U.S. as a place to locate the headquarters of global companies.[25]

That type of argument should be rejected. As noted above, the Senate draft would not eliminate the lockout effect because there would still be an incentive for foreign investment versus domestic investment. However, option I would eliminate that incentive and the lockout effect.

Fortunately, in adopting the present CFC regime in 1962, the United States rejected arguments similar to the one made by Tyson. At that time, no country had a CFC regime, and the argument could have been made (and I believe was made) that the adoption of such a regime would put the United States at a competitive disadvantage. However, virtually every major country now has a CFC regime for passive income, even those countries with territorial systems for active income. Indeed, one of the items in the OECD BEPS project calls for the toughening of CFC regimes.

In my view, the economic case for option I, which is a tough CFC regime, is so strong that if we adopted it, other major countries would follow, thereby eliminating any residual concerns about the horizontal competitiveness problem.

XII. Conclusion

While there are no easy solutions in international taxation, option I offers many benefits over the current deferral system and over options Y and Z. One of the major benefits of option I is that it would eliminate the incentive for foreign investment problem, whereas options Y and Z would only reduce the problem.

Another benefit of option I is that it would preserve the U.S. tax base by eliminating the shifting earnings to foreign subsidiaries problem, whereas options Y and Z could exaggerate this problem.

With option I, the lockout problem would be eliminated because there would be no tax detriment to repatriation of foreign income. Options Y and Z would reduce, but not eliminate, the tax incentive for investing and reinvesting abroad.

It appears that (1) options Y and Z may reduce the horizontal competitiveness problem, to the extent there is such a problem, and would clearly create a vertical competitiveness problem; and (2) option I would solve the vertical competitiveness problem and arguably create a horizontal competitiveness problem. But before adopting any of these options, Congress should conduct an independent study of the economic effects these options, and any other options, would have on the horizontal and vertical competitiveness problems.

Under the current deferral system, the United States loses billions of dollars in tax revenue; however, option I would eliminate that revenue loss and permit a significant reduction in the corporate tax rate on a revenue-neutral basis. A reduction in the corporate tax rate would lead to an increase in both domestic-controlled and foreign-controlled investment inside the United States.

[25]Tyson, "How Tax Reform Can Boost Economic Growth," testimony before Joint Economic Committee hearing on "Lessons From Reagan: How Tax Reform Can Boost Economic Growth" (July 31, 2013).