

# The new non-territorial U.S international tax system

May 2018

WP18/06

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Working paper series |  
2018

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# THE NEW NON-TERRITORIAL U.S. INTERNATIONAL TAX SYSTEM

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May 24, 2018

## I. INTRODUCTION

A fading truism – and not, as we will see, a very useful one – holds that countries may apply either of two distinct types of international tax systems to multinational companies (MNCs) that they classify as domestic residents. Under a pure “worldwide” system, resident MNCs’ foreign source income (FSI) is taxed, but foreign tax credits are allowed. Under a pure “territorial” system, FSI is exempted and foreign taxes are ignored.

Prior to the enactment of the formally nameless 2017 U.S. tax act,<sup>1</sup> it was still sometimes said that the United States had a worldwide system, while all other major countries had territorial systems. Suppose we initially assume this description’s accuracy and usefulness. Then what about afterwards? The 2017 act exempted dividends paid to U.S. companies by their foreign subsidiaries,<sup>2</sup> in keeping with common practice abroad.<sup>3</sup> In other words, its core international

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<sup>1</sup> H.R. 1, 115th Cong. (2017). The proponents meant to name the bill the Tax Cuts and Jobs Act of 2017, but this was stricken from the final enacted version, apparently because the Senate parliamentarian ruled that so naming it was a non-germane amendment, in violation of applicable budget rules. The Act therefore ended up having no name.

<sup>2</sup> I.R.C. § 245A(a). This so-called “participation exemption” is limited to U.S. shareholders within the meaning of 951(b)—that is, persons who have at least a 10% ownership share in a foreign corporation. § 245A(b).

<sup>3</sup> See KYLE POMERLEAU & KARI JAHNSEN, TAX FOUNDATION, DESIGNING A TERRITORIAL TAX SYSTEM: A REVIEW OF OECD SYSTEMS, <https://taxfoundation.org/territorial-tax-system-oecd-review/>, (stating that twenty-nine out of thirty-five OECD members states offer some form of a participation exemption). Some countries, such as France, offer only a partial exemption (95% in the case of France). *Id.* This has been described as an indirect response to the lack of expense allocation in the rules for measuring domestic source income.

feature was repealing deferral, or the postponement of U.S. taxation of FSI until the U.S. parent's receipt of a dividend. Did this change mean that the United States now has a territorial system?

The answer to this question would clearly be Yes if the 2017 act had eliminated, not only (nearly all) deferred taxation of U.S. MNCs' FSI,<sup>4</sup> but also any current taxation thereof. Instead, however, the act not only generally retained preexisting current taxation of FSI (under subpart F of the Internal Revenue Code),<sup>5</sup> but significantly expanded it.<sup>6</sup> In short, the act took a preexisting "now or later" model for taxing FSI, and changed it to a "now or never" model – with greater "now" taxation than previously. So deferral was cashed in for changes in both directions (i.e., both towards "now" and towards "never"), not just to MNCs' benefit.

Given this point, sophisticated observers immediately recognized that the newly enacted system could not accurately be described as "territorial." For example, the law firm Davis Polk, in a nearly contemporaneous Client Memorandum concerning the 2017 Act that it made publicly available,<sup>7</sup> called the new U.S. system a "not quite territorial" or "modified territorial" system.<sup>8</sup> The accounting firm KPMG backed even further away from the territorial label. It concluded that, while the new law had "substantially eliminate[d] any element of deferred taxation of foreign income within a U.S.-parented multinational group," the "sum total of [other] changes represents a significant expansion of the base of cross-border income to which current U.S.

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<sup>4</sup> Even with the participation exemption, the sale of a foreign subsidiary's stock may yield taxable capital gain to the extent that it exceeds amounts that could have been paid out as dividends. *See* I.R.C. § 1248(b)(2). Thus, suppose that a given foreign subsidiary's stock has \$10X basis, no earnings and profits, and is sold for \$50X, presumably reflecting expectations of future profitability. The entire \$40X gain is taxable. One could view this as taxing FSI that has accrued economically, but not as yet under applicable tax accounting rules.

<sup>5</sup> *See* H.R. 1., 115th Cong. (2017) (generally leaving intact the subpart F rules of §§ 951–965 of the Internal Revenue Code).

<sup>6</sup> *See* I.R.C. § 951(A) (including in gross income "global intangible low-taxed income" (GILTI)); § 250(a)(1)(B) (providing a partial deduction for GILTI income).

<sup>7</sup> *See* DAVIS, POLK & WARDWELL, *GOP TAX CUTS AND JOBS ACT: PREVIEW OF THE NEW TAX REGIME* (2017), [https://www.davispolk.com/files/2017-12-20\\_gop\\_tax\\_cuts\\_jobs\\_act\\_preview\\_new\\_tax\\_regime.pdf](https://www.davispolk.com/files/2017-12-20_gop_tax_cuts_jobs_act_preview_new_tax_regime.pdf).

<sup>8</sup> *Id.* at 3.

taxation applies.”<sup>9</sup> International tax practitioner Nathan Boidman asserted, not just that the United States had merely changed between “type[s] of quasi-worldwide system,” but that the new system was “harsher” than the old one in its treatment of FSI.<sup>10</sup>

Given expansion of the “now” category for taxing U.S. MNCs’ FSI, continued use of the worldwide and territorial labels would require characterizing the United States as having a “hybrid” system. Only, it already had a hybrid system under pre-2017 law,<sup>11</sup> albeit of a significantly different kind. Moreover, peer countries’ putatively territorial systems are likewise best viewed as hybrids.<sup>12</sup>

It is easy to see that, when a term, such as “hybrid,” can be used to describe practically all existing or recent systems, it ends up providing useful information about none of them. Yet this is not the only reason why the worldwide and territorial labels, which make use of the term “hybrid” necessary, ought to be retired. In addition to there generally being no pure worldwide or territorial systems in peer countries, the labels are in many respects analytically unhelpful. As we will see, among the important margins that international tax systems may affect, the worldwide and territorial labels affirmatively ignore some, while conflating and unduly narrowing the purportedly available choices in others. Thus, apart from their offering fixed

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<sup>9</sup> KPMG, NEW TAX LAW (H.R. 1) – INITIAL OBSERVATIONS (2017), <https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/12/tnf-new-tax-law-dec22-2017.pdf>. KPMG’s final report on the new tax law states that dividend exemption “moves the United States away from a worldwide tax system and closer to a territorial system for earnings of foreign corporations, but only to the extent those earnings are neither subpart F income, nor subject to [a] minimum tax rule described below” (i.e., that for global intangible low-taxed income, discussed infra). See KPMG, TAX REFORM – KPMG REPORT ON NEW TAX LAW 108 (2018) <https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf>.

<sup>10</sup> Nathan Boidman, *The U.S.’s Illusionary Turn to Territoriality*, 89 TAX NOTES INT’L 619 (2018). To similar effect, Lee Sheppard finds “so much clawback [in the 2017 act that] ... hardly anything is left of the vaunted participation exemption” for dividends. Lee J. Sheppard, *International Clawbacks and Minimum Taxes in Tax Reform*, 89 TAX NOTES INT’L 9, 10 (2018).

<sup>11</sup> See ROSANNE ALTSHULER, STEPHEN SHAY, & ERIC TODER, LESSONS THE UNITED STATES CAN LEARN FROM OTHER COUNTRIES’ TERRITORIAL TAX SYSTEMS FOR TAXING INCOME OF MULTINATIONAL CORPORATIONS 1 (2015), <https://www.taxpolicycenter.org/publications/lessons-united-states-can-learn-other-countries-territorial-systems-taxing-income/full>.

<sup>12</sup> *Id.*

reference points to which one can compare existing systems, “worldwide” and “territorial” fail the prime test of a classification system, which is that it be informative and useful.

A better, although unfortunately messier, classification scheme requires recognizing that there are multiple important margins at which international tax systems can independently differ. The core issues include, not just what FSI is taxed domestically and at what rate, but also at least the following: (1) how to define corporate residence, (2) how to define the source of income, (3) how to respond to suspected profit-shifting<sup>13</sup> between jurisdictions, and (4) how companies’ foreign tax liabilities should affect their domestic tax liabilities. Given this slew of distinct issues, the use of broad and simplistic labels can only get one so far.

Happily, the complexities associated with international tax policymaking cause assessment of the 2017 tax act’s international changes to be considerably more interesting and ambiguous than if the act had simply made the U.S. system a “territorial” one, in an alternative universe in which this was actually a useful classification. This article’s main purpose, other than proposing a better set of categories for parsing key international policy issues, is to offer a very broad and preliminary assessment of several of the main international provisions in the 2017 tax act.

In general, I find three main grounds for examining the new provisions in a relatively lenient spirit. First, given deferral’s defects,<sup>14</sup> prior law was so bad that, even if the provisions, as they stand, have not improved U.S. international tax law – a low bar indeed – they could readily be tweaked to do so. While this will not necessarily end up happening, its nonoccurrence would implicate future policymakers, not just current ones.

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<sup>13</sup> As I will discuss below, the term “profit-shifting” refers to changing the reported source of income without commensurate (or perhaps any) change to where actual economic activity occurs.

<sup>14</sup> See *infra* section II.C.4 (discussing deferral).

Second, the international tax provisions were significantly tougher than U.S. MNCs seem to have expected. This might be either good or bad as a policy matter, depending on one's sense of the very complex and multifaceted underlying merits. But at least it helps to show that – in contrast to, say, the passthrough rules, which (for no discernible policy reason) offer a special 20 percent deduction to favored businesses<sup>15</sup> – they cannot be dismissed as merely a crass giveaway to the Republican Congressional leadership's friends and donors. Perhaps the difference was that, in Willy Loman's terminology from *Death of a Salesman*, MNCs were merely "liked" by the 2017 act's proponents, whereas passthroughs in favored sectors such as real estate were evidently "well-liked." Hence, given overall revenue constraints, the MNCs had to help pay, whether by fair means or foul, for the benefits that were being showered on closer friends.<sup>16</sup> While this is hardly grounds for turning advance cartwheels over the 2017 act's international provisions, it can help to motivate approaching them in a more tolerant spirit. After all, once Congress had decided to be revenue-conscious in the international sector, there was reason to hope, whether or not to expect, that it would tend to look in the right places.

Third, at least some of the provisions respond meaningfully, and not entirely unreasonably, to important tradeoffs in international tax policy that lack clear answers. On the other hand, it is true that the provisions have a number of basic design flaws,<sup>17</sup> failed to specify

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<sup>15</sup>See Daniel Shaviro, *Evaluating the U.S. Passthrough Rules*, 2018 BRIT. TAX REV. 49–67 (2018) (suggesting that both the passthrough rules, and the rejection of any safeguards against using the 21 percent corporate rate to shelter labor income, lack any honest and honorable rationale).

<sup>16</sup> See Tara Golshan, *The Republican Tax Reform Bill Will Live and Die by This Obscure Senate Rule*, VOX (Nov. 14, 2017), <https://www.vox.com/policy-and-politics/2017/11/14/16634200/republican-tax-reform-byrd-rule>, for a description of some of the difficulties Republicans faced in meeting the \$1.5 trillion ceiling.

<sup>17</sup> See *infra* Section III.B.3 (evaluating the BEAT); Section III.C.3 (evaluating GILTI); Section III.D.3 (evaluating FDII). For a thorough (although avowedly incomplete) discussion of design flaws and technical problems just with GILTI, see New York State Bar Association, Report No. 1394 on the GILTI Provisions of the Code (May 4, 2018) (henceforth, "NYSBA Report"). Perhaps the single greatest problem under GILTI – albeit, one of many – that the NYSBA Report identifies is generally treating each CFC of a common U.S. parent as a separate company for GILTI purposes. The NYSBA Report concludes that "existing rules [in GILTI] that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. *Id.* at 101. Given, however, that in this regard "the existing rules are clear and are supported by the legislative history of

how they actually apply in a number of crucial respects,<sup>18</sup> and include significant drafting errors<sup>19</sup> – all presumably reflecting their highly rushed enactment with only minimal vetting and public feedback. Thus, how positively one should view them depends in part on whether one is assessing them exactly as they now are, or at a level of Platonic abstraction that permits one to discern underlying purposes that might have been (and perhaps might still be) more artfully accomplished.

The remainder of this article proceeds as follows. Section II discusses how one could more crisply, comprehensively, and accurately conceptualize international tax policy than through the outdated and unhelpful language of “worldwide versus territorial.” In addition, section II explores the reasons for several key margins’ normative ambiguity – which include, without being limited to, the tension between what I call unilateral and strategic approaches to international tax policymaking. These differ in that only the latter involves considering how a given country’s international tax policy choices might subsequently affect other countries’ behavior. Thus, for example, engaging in tax competition is not inherently “strategic” in my sense of the term. Indeed, it fails to be strategic if it involves overlooking how one’s own tax law changes might affect what other countries subsequently do. Unfortunately, while all

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the Act .... We urge the Congress to reconsider these provisions [in subsequent legislation] and for Treasury to support such reconsideration.” *Id.*

<sup>18</sup> For just a few examples that were identified early on, consider the following: Does the BEAT apply to controlled foreign corporations (CFCs) owned by a common U.S. parent on a group basis, or a company-by-company basis? *See, e.g.,* Lee A. Sheppard, *Proposed Regs Coming on TJCA International Rules*, 158 TAX NOTES 991 (2018). How should one allocate research and development expenses between categories? *See id.* (quoting Paul Oosterhuis on one possible answer). Under the BEAT, if a U.S. company pays a foreign affiliate a markup for services, is the entire amount paid, or only the markup, included in the expanded tax base? *See, e.g.,* Martin Sullivan, *Marked-Up Services and the BEAT, Part II*, 158 TAX NOTES 1169 (2018). Is the section 78 gross-up in the GILTI basket for FTC purposes? *See, e.g.,* Elizabeth J. Stevens & H. David Rosenbloom, *GILTI Pleasures*, 89 TAX NOTES INT’L 615 (2018). How do expense allocation rules work – for example, in applying the foreign tax credit limit to GILTI? *See, e.g.,* Mindy Herzfeld, *Tax Cuts Chaos, Part 3: Can Treasury Fix It?*, 159 TAX NOTES 1097 (2018).

<sup>19</sup> For example, for purposes of the 3% limit for the BEAT to apply, the statutory text may require treating a U.S. company and its foreign affiliates as the same taxpayer. Thus, for purposes of this rule arguably “intragroup payments could be utterly disregarded, making it almost impossible for the BEAT threshold to be met.” Sheppard, *supra* note 18.

sophisticated actors in international tax policy should consider the strategic aspect, it tends to make the underlying policy choices even harder to parse confidently. Strategic interactions are often unpredictable, and all the more so when they involve government actors that are subject to the vagaries of domestic politics.

Section III then evaluates three of the main international features of the 2017 tax act, in light of the forgoing analysis. These are as follows:

1) the BEAT (for “base erosion and anti-abuse tax”),<sup>20</sup> a measure that appears to have been aimed mainly at “inbound base erosion” engaged in by foreign MNCs investing in the United States,<sup>21</sup> but that can also affect outbound profit-shifting by U.S. MNCs;<sup>22</sup>

2) GILTI (for “global intangible low-taxed income”),<sup>23</sup> an anti-tax haven provision that is aimed at outbound profit-shifting by U.S. MNCs;<sup>24</sup> and

3) FDII (for “foreign-derived intangible income”),<sup>25</sup> which Lee Sheppard has called “a stingy patent box laid on in the hope that some [U.S.] companies will want to keep intangibles onshore.”<sup>26</sup>

I conclude that BEAT and GILTI, although not FDII, have the potential (with suitable revisions) to serve as important parts of an improved U.S. international tax system that eschews deferral. Or at least, with suitable revisions they would be reasonably defensible, subject to the underlying conceptual challenges in specifying good international tax policy design. As for

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<sup>20</sup> I.R.C. § 59A.

<sup>21</sup> Itai Grinberg, *The Senate Introduced a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule*, (Nov. 12, 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3069770](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3069770).

<sup>22</sup> *See* Sheppard, *supra* note 10 (suggesting that the BEAT was enacted because “the Senate developed an interest in imposing U.S. corporate tax on other countries’ multinationals,” but noting that it “hits U.S.-parented groups as well as its intended target, foreign-parented groups”).

<sup>23</sup> *See* I.R.C. § 951(A) (including in gross income “global intangible low-taxed income” (GILTI)); § 250(a)(1)(B) (providing a partial deduction for GILTI income).

<sup>24</sup> GILTI is the reason for Nathan Boidman’s conclusion that the new U.S. international tax regime is “harsher” than the one it replaced. *See* Boidman, *supra* note 10.

<sup>25</sup> *See* I.R.C. § 250(a)(1)(A).

<sup>26</sup> Sheppard, *supra* note 18.

FDII, while major reworking would be necessary before one could reach such optimistic ground, the likelihood of its being held to violate World Trade Organization (WTO) rules<sup>27</sup> may give optimists grounds for hoping that it will not long persist, at least in its current form.

Finally, Section IV offers a brief conclusion and discusses possible next steps with respect to the BEAT, GILTI, and FDII.

## **II. RELEVANT MARGINS: BEYOND “WORLDWIDE” VERSUS “TERRITORIAL”**

### **A. The Artificiality of “Inbound” and “Outbound” Investment Flows, as Observed by International Income Tax Systems**

International tax policy addresses the tax consequences, in a given country, of “inbound” and “outbound” economic activity. However, these two terms merit scare quotes given that the act of crossing the border, in the eyes of a typical income tax system, can be formal rather than substantive. For example, a New Yorker’s operating a pizza parlor in Brooklyn involves inbound investment, by the lights of the U.S. tax system, if, for some reason, she chooses to incorporate the business abroad. Likewise, if French investors incorporate in Delaware in order to run a trading desk in EU stocks that is located across the street from the Euronext Paris headquarters, this looks, to the U.S. tax system, like outbound investment (presumably yielding FSI) by a U.S. company.

In both of these examples, while entity-level corporate taxation yields a formalistic view of where the relevant taxpayer resides, at least the source of the income seems reasonably clear. However, source determinations can likewise end up being determined formally, in the sense of without regard to where people are actually doing things on either the production or consumption side. In 2010, for example, U.S. companies reported earning \$94 billion in Bermuda, a nation

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<sup>27</sup> See David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN L. REV. \_\_\_ (forthcoming 2018) (m.s. at 42–49).

where gross domestic product for the year was only \$6 billion.<sup>28</sup> This helps to demonstrate massive profit-shifting, or the creation of FSI in tax haven jurisdictions where little actually happens.

The artificiality of corporate residence and source rules, and thus of the inbound and outbound categories in practice, powerfully influences a wide range of international tax policy issues. Indeed, it blurs the lines between domestic and international tax policy, by suggesting that even transactions that seemingly are not cross-border at all – involving domestic source income earned by domestic companies, or FSI earned by foreign companies – may affect one’s policy choices across the board. Thus, rather than just focusing on “inbound” investment, one must also keep international considerations in mind when addressing domestic investment by domestic companies. And there may be reason to have the rules for “outbound” investment take account of foreign-to-foreign tax planning between affiliated foreign companies, at least if there is also a domestic affiliate somewhere in the picture.

## B. Taxing Inbound and Other Domestic Source Income

### 1. Relevance of Tax Competition

If not for the artificiality, and consequent manipulability, of the residence concept, global tax competition might simply not be an issue with respect to the domestic tax rate for business income earned by resident individuals. Thus, suppose that, in lieu of there being entity-level corporate income taxation, resident individuals could be and were taxed on a current annual basis on all of their worldwide income, no matter where earned, including when they invested through a corporation. Such individuals would thus be unable to avoid the domestic business rate by investing abroad (even through a foreign entity). From the standpoint of domestic tax liability, it

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<sup>28</sup> See CITIZENS FOR TAX JUSTICE, AMERICAN CORPORATIONS TELL IRS THE MAJORITY OF THEIR OFFSHORE PROFITS ARE IN 12 TAX HAVENS (2014), <http://ctj.org/pdf/corporateoffshoreprofitsirs.pdf>.

would be almost as if they were living in a closed economy.<sup>29</sup> Thus, global tax competition would simply be irrelevant to the choice of tax rate for such individuals' business and investment income, unless their own mobility (via ceasing to be residents) was an issue.

To be sure, in this scenario global tax competition would still be highly relevant with respect to the choice of tax rate for domestic source income that was earned by non-residents on inbound investment. Indeed, insofar as foreigners would merely be earning a normal return on such investment that they could equally earn elsewhere, the optimal domestic tax rate on their income from such investment might even be zero,<sup>30</sup> as they might not be expected to bear the incidence of any such tax.<sup>31</sup>

In short, if not for the artificiality and consequent manipulability of both the residence and source concepts: (1) residents' purely domestic and outbound investment might be treated the same (leaving aside for now the treatment of foreign taxes), while (2) inbound investment might even be exempted, at least so far as normal returns are concerned. With manipulability, however, the lines start to blur. Concern that resident individuals can camouflage their domestic source income as "inbound" places upward pressure on the choice of inbound rate. And, if resident individuals can avoid current taxation of their FSI by investing abroad through foreign corporations, that places downward pressure on the choice of outbound rate. Global tax competition therefore is generally relevant, after all, to all realms of business taxation.

## 2. Corporate Income Taxation and Global Tax Competition

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<sup>29</sup> I leave aside the question, addressed below with regard to "outbound" investment, of how foreign taxes paid on FSI would affect domestic tax liability.

<sup>30</sup> Given, however, the potential domestic national welfare benefits to taxing inbound investment that earned rents, one might want to combine expensing with the imposition of a positive tax rate.

<sup>31</sup> For example, suppose a globally available after-tax rate of return equal to 6 percent. In a very simple model (lacking, for example, diversification objectives), if inbound investment was exempt, foreigners would treat 6 percent as their hurdle rate for engaging in such investment. By contrast, if they were taxed, at, say, a 25 percent rate on the returns from such investment, this would increase the hurdle rate to 8 percent – potentially shifting the burden of the tax to domestic counterparties.

a. Lower Corporate Tax Rates?

Through almost the entire history of the U.S. federal income tax, the top corporate income tax rate has been lower than the top individual rate.<sup>32</sup> This has also been common in other countries. The rate disparity has tended to grow in recent decades – most recently, in the United States, which, in 2017, lowered the top individual rate only from 39.6 percent to 37 percent, while the corporate rate declined from 35 percent to 21 percent. This more than tripled the gap between the top individual rate and the corporate rate, from 4.6 percentage points pre-2017 act to 16 percentage points afterwards.<sup>33</sup>

At one time, the most prominent rationale for setting the top corporate rate below the top individual rate was to mitigate the discouragement of corporate equity investment that might otherwise result from shareholder-level taxation of corporate income that had already been taxed at the entity level.<sup>34</sup> However, concern in the United States about this issue has recently eased. This reflects, not just the lowering of the tax rate on dividends, which now stands at 20 percent,<sup>35</sup> but also the fact that the stock of dividend-paying U.S. companies is now predominantly held by tax-exempt shareholders, for whom the second level of tax is not an issue.<sup>36</sup>

Today the more prominent rationale for setting the top corporate rate well below the top individual rate pertains to global tax competition. Reflecting the artificiality and consequent

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<sup>32</sup> Compare Tax Policy Ctr., *Corporate Top Tax Rate and Bracket: 1906 to 2016* (Feb. 14, 2017), <https://www.taxpolicycenter.org/statistics/corporate-top-tax-rate-and-bracket> with Tax Policy Ctr., *Historical Highest Marginal Income Tax Rates* (Mar. 22, 2017), <https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates>. However, in the immediate aftermath of the 1986 Tax Reform Act, the top marginal rate on corporate income rose above that on individuals.

<sup>33</sup> As has been discussed elsewhere, this was done with insufficient attention posed by issues pertaining to the use of corporate entities as a tax shelter. See, e.g., Kamin et al. *supra* note 27; Shaviro, *supra* note 15.

<sup>34</sup> See, e.g., INTEGRATION OF U.S. CORPORATE AND INDIVIDUAL TAXES (Michael Graetz & Alvin Warren eds.) (2d ed. 2014); Michael Graetz & Alvin Warren, *Integration of Corporate and Shareholder Taxes*, 69 NAT'L TAX J. 677 (2016).

<sup>35</sup> See I.R.C. 1(h)(11).

<sup>36</sup> Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923 (2016). Even before this was known to experts, it presumably lowered political pressure to address double taxation of equity-financed corporate income.

manipulability of corporate residence determinations, effective residence electivity for corporations is presumably substantially higher than that for individuals.<sup>37</sup> In addition, corporations are generally considered the main vehicle for attracting investment capital from around the world, for making mobile investments, and for engaging in profit-shifting. This makes the corporate tax rate a plausible proxy, if an imperfect one, for the tax rate on income that is especially mobile and hence subject to global tax competition.

b. Still-Lower Effective Tax Rates for MNCs?

Even with a corporate tax rate well below that applying to resident individuals, there is still further scope for differentiation in response to global tax competition. Suppose that there are two types of corporations: those that operate purely in the residence country, and those that are MNCs engaged in global operations (at least, through affiliated companies). Suppose, moreover, that one has some ability to tell the two types of companies apart, and that they are imperfect substitutes for each other. Finally, suppose that MNCs are more able than purely domestic companies to respond to global tax competition, both by shifting actual operations abroad and through artificial profit-shifting that involves no actual, or at least commensurate, shift in where significant activities occur.<sup>38</sup> Under these conditions, a source country might reasonably aim to impose lower effective tax rates on MNCs than on purely domestic companies.<sup>39</sup>

An easy mechanism for achieving such a differentiation in effective tax rates is deliberately to tolerate some degree of profit-shifting by MNCs. To be sure, the notion of profit-shifting presumes an underlying “true” source of income, which may often be hard or even

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<sup>37</sup> See Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377 (2011).

<sup>38</sup> MNCs may also more directly compete for funds in global capital markets than domestic companies, which may matter to a degree insofar as capital markets are not perfectly globally integrated.

<sup>39</sup> This is most likely to be domestically beneficial, however, if the differentiation increases net domestic investment, rather than causing it to be reallocated from purely domestic to multinational companies.

impossible to define.<sup>40</sup> This, however, implies only that source determinations with respect to MNCs that are operating domestically must at times be inaccurate, or at least arbitrary – not that measures of their domestic source income must systematically aim to be lenient, rather than harsh. Thus, deliberately allowing some profit-shifting to occur is best seen as a deliberate choice, and plausibly a rational one from the domestic national welfare standpoint.<sup>41</sup>

This does not, however, automatically establish that one should welcome any and all such profit-shifting, and thus reduction of the domestic tax rate on MNCs to zero (or below), when purely domestic companies are paying tax at a positive effective rate. Unfortunately, however, “[w]hile it is perfectly logical to favor some, but not too much ... [profit-shifting by MNCs], quantifying the analysis is considerably harder. Source countries lack clear guidelines for determining how much profit shifting is ‘too much.’”<sup>42</sup>

In short, determining how much profit-shifting by MNCs to tolerate (or even encourage) presents a “Goldilocks problem.” When is the amount of it just right, rather than being either too great or too small? As I discuss below, this problem becomes even more complicated if countries are interacting strategically – that is, if one’s own anti-profit-shifting efforts will affect what other countries do, either in this regard or others of interest to one’s own national welfare.

### c. Resident MNCs versus Non-Resident MNCs

A further design question with respect to combating profit-shifting by MNCs relates to the distinction between those that are classified as domestic residents, and as non-residents.<sup>43</sup> As an initial matter, policy-relevant systematic differences between these two types of MNCs might

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<sup>40</sup> See, e.g., Hugh J. Ault & David F. Bradford, *Taxing International Income*, in TAXATION IN THE GLOBAL ECONOMY 11 (2008); Mitchell A. Kane, *Transfer Pricing, Integration, and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard*, 6 WORLD TAX J. 282 (2014).

<sup>41</sup> See Daniel N. Shaviro, *Ten Observations Concerning International Tax Policy*, 151 TAX NOTES 1705, 1706 (2016).

<sup>42</sup> *Id.* at 1706–07.

<sup>43</sup> This distinction typically is made with reference to the residence of the affiliated group’s common corporate parent.

conceivably offer a rationale for treating them differently with respect to profit-shifting. Suppose, for example, that U.S. investment by resident MNCs was less tax-elastic than that by foreign MNCs. This might support a more rigorous U.S. effort to combat profit-shifting by resident MNCs, on the view that (under the Ramsey or inverse elasticity rule from public economics) this supported imposing a higher effective tax rate on their U.S. activity.<sup>44</sup>

Now suppose instead a lack of any pertinent differences between resident and foreign MNCs. There still remains a possible rationale for addressing profit-shifting by the former more vigorously than that by the latter. This relates to the distinction between the tools that are legally and practically available for combating profit-shifting by each.

A country can directly tax resident MNCs' FSI, such as by imposing deemed repatriation taxes, even if the FSI is earned through foreign subsidiaries that are viewed as themselves nonresidents. This facilitates distinguishing between what the residence country may deem resident MNCs' "bad" as opposed to "good" FSI – a distinction that, as I will discuss shortly, they commonly make for reasons that appear to be related to concern about profit-shifting.<sup>45</sup> By contrast, non-resident MNCs' FSI can only be taxed indirectly, such as by denying domestically incurred interest deductions – an approach that is arithmetically "equivalent to indirectly taxing [FSI generally] in an amount that equals the disallowed ... deductions."<sup>46</sup> Thus, absent other routes to the same end, countries may lack a comparable ability to distinguish between "good" and "bad" FSI that is earned by foreign MNCs.

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<sup>44</sup> See F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 *ECON. J.* 47, 58 (1927).

<sup>45</sup> See *infra* Section II.C.2.a.

<sup>46</sup> Shaviro, *supra* note 41, at 1709. While the ground for disallowing the interest deductions may be that the underlying loans are deemed to have financed foreign rather than domestic operations, the fungibility of money makes this hard to judge. See James R. Hines, *Foreign Income and Domestic Deductions*, 62 *NAT'L TAX J.* 461 (2008) (arguing that, under a territorial system, all locally incurred interest deductions should be allowed, on the ground that denying them amounts to taxing FSI indirectly, in contradiction of a supposed underlying commitment not to do so).

Insofar as distinguishing between “bad” and “good” FSI permits one to deploy more refined and better-directed tools against undesired profit-shifting by resident MNCs than against that by foreign ones, one may choose more rigorously to combat profit-shifting by the former than by the latter. However, use of the more refined tools comes at a price, insofar one does not otherwise want to treat the two groups differently. I have argued that, prior to the 2017 act, the United States, in contrast to peer countries such as Germany, appeared to be comparatively “overus[ing] residence-based, relative to non-residence-based, anti-profit-shifting approaches.”<sup>47</sup>

### C. Taxing Resident Companies’ Foreign Source Income

#### 1. Inadequacy of the “Worldwide Versus Territorial” Frame

When we turn to the international tax policy choices that pertain to the taxation (or not) of resident MNCs’ “outbound” investment, at last we are in the realm of the supposed divide between worldwide and territorial systems. Even here, however, the distinction serves little good purpose, due to its undernourished presentation of the rich set of possible choices that countries actually consider. These pertain to (1) how one taxes FSI, including different categories thereof, (2) how foreign taxes paid affect the domestic tax burdens on FSI, and (3) the role, if any, played in a given system by deferral.

Neither a pure worldwide nor a pure territorial system would employ deferral. So they are in agreement here, but not on the first two elements. Again, FSI is taxed at the full domestic rate in a pure worldwide system, and at a zero percent rate in a pure territorial system. Likewise, foreign taxes are fully creditable in a pure worldwide system (without even foreign tax credit limits), while being ignored in a pure territorial system.

This, in turn, means that foreign taxes have a marginal reimbursement rate (MRR) of 100 percent in a pure worldwide system, in which each dollar of foreign taxes paid triggers a full \$1

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<sup>47</sup> Shaviro, *supra* note 41, at 1709.

reduction in domestic tax liability.<sup>48</sup> Such a system thereby “induces resident companies to maximize *before*-foreign tax [FSI], and to have [zero] cost-consciousness with regard to foreign taxes paid.”<sup>49</sup> By contrast, in a pure territorial system, the MRR for foreign taxes is zero percent. However, since this causes the MRR to equal the zero percent marginal tax rate (MTR) for FSI, territoriality is an implicit deductibility system for foreign taxes. Just like explicit foreign tax deductibility in the face of a positive tax rate on FSI, it induces resident companies to maximize *after*-foreign tax FSI.<sup>50</sup>

Given the two distinct margins at which worldwide and territorial taxation differ, they are actually compound systems, combining rival approaches at each of two distinct margins. This raises the question of why it would not be preferable, from the standpoint of analytical clarity, to focus the analysis at one margin at a time.<sup>51</sup> It also raises the question of whether it might be fruitful to consider intermediate approaches at either or both margins, rather than just the polar alternatives that the two compound systems offer.

Yet despite these problems with the “worldwide versus territorial” framework, much international tax policy scholarship used to focus intensively on comparing them at an abstract level as unitary alternatives. Often, such comparisons were mystifyingly based on the supposed choice between two rival global efficiency norms: capital export neutrality (CEN), which supports the worldwide approach, and capital import neutrality (CIN), which supports territoriality.<sup>52</sup> This focus on CEN versus CIN begged the question, among others, of why

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<sup>48</sup> In the truly pure case, foreign tax credits would even be refundable, to the extent in excess of net domestic tax liability on worldwide income.

<sup>49</sup> Shaviro, *supra* note 41, at 1707.

<sup>50</sup> *See id.*

<sup>51</sup> *See* DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* (2014).

<sup>52</sup> *See* PEGGY B. MUSGRAVE, *TAXATION OF FOREIGN INVESTMENT INCOME* (1963). Desai and Hines then added capital ownership neutrality (CON) to the mix, also in practice supporting territoriality. *See* Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003). I should note that the invention of

countries should be expected to focus on global rather than national economic welfare. Mercifully, however, in recent years the “CEN versus CIN” debate seems largely to have abated.<sup>53</sup>

From the standpoint of contemporary international tax policy debate, the reasons for the inadequacy of the “worldwide versus territorial” framework are not limited to its conflating two distinct margins, and seemingly requiring a choice between polar, rather than intermediate, approaches at each margin. In addition, the framework fails to address or illuminate the key issues at each margin that countries appear actually to care about. This is best shown by looking next more closely at each margin, as well as at the issues raised by deferral.

## 2. Domestic Tax Rate on Resident MNCs’ FSI

### a. “Good” Versus “Bad” FSI

I have suggested in earlier work that reasoning like that which underlies the Ramsey rule<sup>54</sup> might support taxing U.S. companies’ FSI at a rate that is above zero, but below the tax rate for domestic source income. The rationale for taxing FSI at a lower rate than domestic

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these concepts was a genuine intellectual contribution, first by Musgrave and then by Desai and Hines; the problem lay in overusing them.

<sup>53</sup> But see J Clifton Fleming, Robert J. Peroni, & Stephen E. Shay, *Two Cheers for the Foreign Tax Credit*, 91 TULANE L. REV. 1 (2016). Here, Fleming, Peroni, and Shay (“FPS”) argue that U.S. international tax policy should be based on CEN, which generally is satisfied when each taxpayer makes the most profitable investment as determined on a pretax basis—thereby effectively treating foreign and domestic taxes as equivalent, even though one only gets the money from one’s own taxes. FPS accept that U.S. international tax policy should be based on national rather than global welfare, but assert that “economists generally believe [it] to be the case” that “U.S. welfare is enhanced by ... [following] tax policies that are consistent with free trade.” *Id.* at 17. They note that, if the U.S. income tax system treated foreign income taxes as merely deductible, rather than creditable, the resulting double taxation would discourage outbound investment from the United States – inconsistently with free trade and global welfare. Unfortunately, FPS are simply mistaken in their analysis of what “economists generally believe to be the case” with respect to promoting free trade through the unilateral provision of foreign tax credits. To the contrary, a standard analysis suggests that we are overpaying for it, from a selfish national welfare standpoint, if we unilaterally rebate foreign income taxes dollar-for-dollar. As Joel B. Slemrod explains, “[t]he U.S. policy of providing foreign tax credits has even been characterized as ‘mercantilist’ ... because it favors foreign investment at the expense of the national interest. This claim is correct from a unilateral perspective because it is in the interest of one country to ensure that, at the margin, the return to the country of all investments be equal, and the return to the country includes taxes paid to the country and not taxes paid to ... [another] country. Thus, full taxation of foreign investment income with deductibility of foreign taxes paid is unilaterally appropriate ... [even though it is] not consistent with global free trade in the presence of ubiquitous source-based taxes.” See Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT’L TAX & PUB. FIN. 471, 479 (1990).

<sup>54</sup> See Ramsey, *supra* note 44.

source income is that the United States is likely to have “significantly more market power with respect to domestic investment than with respect to the use of a resident entity to invest abroad,”<sup>55</sup> thus helping to make resident companies’ FSI more tax-elastic than domestic source income. The rationale for not wholly exempting FSI is that this would “forgo[] the opportunity to reduce [overall] deadweight loss by using a positive rate [on it] to fund a reduction in the domestic source-based rate.”<sup>56</sup> Unfortunately, however, the choice of an optimal outbound rate is no less difficult, and inevitably context-specific, than that of an effective rate for domestic and/or foreign MNCs’ U.S. source income.

One reason for taxing FSI at a greater-than-zero rate (at least if one has some market power at the corporate residence margin) pertains to profit-shifting. Apparently by reason of concern about this issue, countries that have MNCs engaged in significant outbound investment – including putatively territorial countries – pervasively tend to distinguish between different types of FSI. Under controlled foreign corporation (CFC) rules that apply to resident MNCs,<sup>57</sup> specified types of FSI trigger deemed dividends from foreign subsidiaries to the domestic parents, thereby rendering such FSI taxable rather than exempt. As Kim Clausing has noted, “the point of CFC laws is to distinguish ‘good’ [FSI] from ‘bad’ [FSI]”<sup>58</sup> – a distinction that lies wholly outside the “worldwide versus territorial” framework.

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<sup>55</sup> See Daniel N. Shaviro, *The Crossroads Versus the Seesaw*, 69 TAX L. REV. 1, 10 (2015).

<sup>56</sup> *Id.* at 15. It also seems clear that an intermediate rate on FSI can be combined with partial creditability for foreign taxes, without violating bilateral tax treaties that require signatories either to exempt FSI or offer foreign tax credits. As Fadi Shaheen has explained, all this requires is that 100 percent of each dollar of FSI be partly exempted and partly granted a foreign tax credit. See Fadi Shaheen, *How Reform-Friendly Are U.S. Tax Treaties?*, 41 BROOK. J. INT’L L. 1243 (2016).

<sup>57</sup> As Brian Arnold has noted, CFC rules are almost universally found in countries that have MNCs with significant FSI, and that are not actively engaged in functioning as tax havens. Brian J. Arnold, *Comparative Perspective on the U.S. Controlled Foreign Corporation Rules*, 65 TAX L. REV. 473, 478 (2012).

<sup>58</sup> Kimberly A. Clausing, *Beyond Territorial and Worldwide Systems of International Taxation*, 15 J. INT’L FIN. & ECON. 43 (2015). See also Arnold, *supra* note 57, at 479–80.

When one surveys CFC rules from around the world, as three recent studies have,<sup>59</sup> three perhaps surprising things become clear. The first is how much consensus CFC rules exhibit regarding the general characteristics of “bad,” as distinct from “good” FSI. The second is how much they overlap with regard to how “bad” FSI may in principle be identified. The third is how little consensus there is – even within a single country across time – regarding how rigorously or leniently one should search for “bad” FSI.

1) Defining “Bad” FSI in Principle – As Brian Arnold has noted: “At a fundamental level, the policy and operation of CFC rules is the same in all countries ... [that have them. Their] policy ... is to prevent the diversion of certain income ... but, at the same time, not to interfere with the ability of resident multinationals to carry on legitimate foreign business activities.”<sup>60</sup> He adds that “CFC rules ... are widely known and referred to as anti-tax haven measures.”<sup>61</sup> Thus, the “goodness” or “badness” of FSI tends to be defined in terms of an underlying anti-tax haven policy. Tax havens are conceptualized, for this purpose, as countries that do not just offer extremely low (or even zero) income tax rates, but that operate as convenient locales for locating profits that can be divorced from actual activity of any non-formalistic kind in the jurisdiction.<sup>62</sup>

2) Identifying “Bad” FSI in Practice – To operationalize this aim, countries have tended, through their FSI rules, to choose from a relatively limited menu of implementation strategies. In

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<sup>59</sup> See ALTSHULER, SHAY & TODER, *supra* note 11 (discussing the CFC rules of Australia, Germany, Japan, and the United Kingdom); Arnold, *supra* note 57 (discussing the CFC rules of Brazil, Canada, China, Germany, Italy, Japan, Korea, and the United Kingdom); and JOINT COMM. ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME, JCX-33-11 (May 20, 2011) (discussing the CFC rules of Australia, Canada, France, Germany, Japan, the Netherlands, Spain, Switzerland, and the United Kingdom).

<sup>60</sup> Arnold, *supra* note 57 at 475.

<sup>61</sup> *Id.* at 478–79.

<sup>62</sup> As Mitchell Kane has noted, CFC rules may address “parking” as well as “milking” – keeping one’s past reported profits indefinitely in a low-tax jurisdiction, as well as reporting them there initially. See Mitchell A. Kane, *Milking Versus Parking*, 66 TAX L. REV. 487 (2013).

general, according to the three studies, there are three main types of circumstances under which resident companies are denied exemption with respect to FSI of their CFCs. First, “[p]assive investment-type income is the principal target for all countries’ CFC rules.<sup>63</sup> Arnold attributes this to the fact that “such income is more easily shifted among group countries in various countries than other types of income,<sup>64</sup> and thus can readily be placed in a tax haven.

Second, subpart F of the U.S. Internal Revenue Code addresses the use of intermediary arrangements to shift FSI away from the countries where it is actually produced or consumed.<sup>65</sup> Similar rules can be found in other countries, although they are less common than rules addressing passive income.<sup>66</sup> Once again, the issue raised is that the use of a mere intermediary, along with aggressive transfer pricing, facilitates locating profits in a tax haven.

Third, some countries base the application of CFC rules on where FSI was actually reported. In effect, rather than inferring tax haven placement from its being passive or earned by an intermediary, rules of this sort aim to observe the use of a tax haven directly, by measuring the effective foreign tax rate on particular FSI.<sup>67</sup> Some countries instead use blacklists, under

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<sup>63</sup> *Id.* at 489. For example, passive income is expressly targeted, at least in specified circumstances, by the CFC rules of Australia, Canada, France, Germany, Spain, and the United Kingdom. JOINT COMM. ON TAXATION, *supra* note 59, at 16, 20, 23–24, 28, and 36–37. The Netherlands, while it lacks a formal CFC regime, taxes FSI from certain “low-taxed portfolio participations” of a passive character. *Id.* at 32

<sup>64</sup> Arnold, *supra* note 57, at 489. Such shifting can involve, not only causing one’s passive income from third parties to arise in tax havens, rather than in countries with higher tax rates (and greater productive capacities and consumer bases), but also using intra-group financial flows to shift net income to tax havens.

<sup>65</sup> Thus, consider I.R.C. § 954(d)(1), under which certain “foreign base company sales income” (FBCSI) gives rise to a deemed dividend to the U.S. parent. FBCSI may arise from a CFC’s purchase plus sale of personal property if (a) at least one of its two counter-parties is a related party, and (b) the items are neither manufactured nor used in the CFC’s country of incorporation. To illustrate, suppose that the American Widget Corporation (AWC) produces widgets in the United States, and then sells them to its Luxembourg CFC, which then on-sells them into France and Germany. It is easy to see how, with the aid of aggressive transfer pricing, this structure might be used to locate widget export profits in Luxembourg, even if nothing significant actually happens there.

<sup>66</sup> Australia and Canada have rules that are broadly similar to those in subpart F addressing FBCSI. See JOINT COMM. ON TAXATION, *supra* note 59, at 16, 19. Approaching the intermediary issue from the opposite direction, Japan exempts FSI that its CFC rules would otherwise reach, if the CFC is actually itself doing enough things in the country where the income is reported. *Id.* at 29-30.

<sup>67</sup> For example, Japan generally taxes FSI that is subject to an effective tax rate below 20 percent. *Id.* at 29-30. Germany only taxes passive income if the tax rate applying to it is below 25 percent. *Id.* at 26. The United Kingdom, until recently, examined whether FSI had borne less than three-quarters of the tax that the U.K. rules

which FSI from designated tax havens is denied exemption,<sup>68</sup> or whitelists, under which FSI from designated (and generally non-haven) countries is allowed it.<sup>69</sup>

3) Lack of Consensus Regarding How Rigorously to Address “Bad” FSI – CFC rules only matter insofar as they are potentially binding, or at least costly to avoid. Thus, even two countries with formally similar sets of CFC rules might in fact be imposing very different tax burdens and incentives if they differed in this dimension. Indeed, a single country’s rules may be very different in this sense at Time 1 as opposed to Time 2, even if they do not facially change at all, if tax planning technologies evolve in the interim in such a way as to alter the practical tradeoffs that resident MNCs face.

Here, in contrast to the first two attributes, there is little consensus. Indeed, even just within the United States, both the apparently intended and the actual rigor of subpart F have greatly fluctuated over time.<sup>70</sup> This reflects (whether or not influenced by) pervasive

would have levied with respect to the same income. *Id.* at 44. The U.K. now instead looks for indicia of tax avoidance behavior, in addition to using a “whitelist” approach. See ALTSCHULER, SHAY, & TODER, *supra* note 11, at 23.

<sup>68</sup> Arnold notes that Argentina, Venezuela, and Italy use blacklists to identify tax haven income, and that Japan, Korea, and Mexico did so for a while, but then concludes that “this simplistic approach ... is [too] easy to avoid.”, Arnold, *supra* note 57, at 484.

<sup>69</sup> For example, the United Kingdom now does this. See ALTSCHULER, SHAY, AND TODER, *supra* note 11, at 23.

<sup>70</sup> For example, the U.S. Treasury Department greatly weakened the rigor of subpart F in 1998, when it adopted what are known as the “check-the-box” rules, allowing taxpayers expressly to elect whether or not particular types of legal entities would be treated as corporations for U.S. federal income tax purposes. Treas. Reg. §§301-7701-2 and 3. These rules appear to have been directed primarily at purely domestic entity classification issues, as to which prior regulations, applying a “corporate resemblance” test, had been widely disparaged as complicated, manipulable, and pointless. See, e.g., Heather M. Field, *Checking in on Check-the-Box*, 42 LOYOLA L. REV. 451, 457-63 (2009) (reviewing the history and evolution of the corporate resemblance test). In the international realm, however, the check-the-box rules substantially weakened subpart F’s capacity to impede foreign-to-foreign tax planning that would facilitate U.S. multinationals’ locating their FSI in tax havens. This resulted from the rules’ making it far easier than it had previously been to achieve cross-border “hybridity” with regard to whether two formally separate foreign legal entities that were ultimately owned by a U.S. MNC would be regarded as one entity or two for income tax purposes, if one of them owned the other.

Commentators disagree—at times, seemingly reflecting their own policy preferences—regarding the extent to which this weakening of subpart F’s impact on foreign-to-foreign tax planning was deliberate and advertent. The IRS was aware of the issue, and solicited comments about it. See IRS Notice 95-14, 1995-1 C.B. 215 (expressing concern about the possibility of inconsistent, or hybrid, entity classification). Yet it ultimately settled for noting, in the check-the-box regulations’ preamble, that it would monitor the area carefully and take “appropriate action” where it espied inappropriate results. See T.D. 8697, 1997-1 C.B. 215 (1996). It then promptly issued a Notice announcing its plan to address the subpart F consequences of hybridity. IRS Notice 98-11, 1998-1 C.B. 433.

disagreement among American tax policy experts regarding where the national interest lies in using this tool to address profit-shifting.<sup>71</sup> It also reflects a related ambiguity affecting revenue estimates for proposals that would make subpart F more rigorous.

To illustrate the underlying problem, suppose that a provision strengthening subpart F would thereby prevent U.S. MNCs from engaging in foreign-to-foreign profit-shifting that allowed the placement of substantial FSI in tax havens. The correct revenue estimate for such a proposal might be high if U.S. MNCs responded primarily either by incurring subpart F liability on continuing intragroup transactions, or by shifting less taxable income out of the U.S. to begin with. It might be low, however, if they responded primarily by just accepting that they would now have to pay more foreign tax.

b. The Underlying Unilateral National Welfare Dilemma or Tradeoff

The reasons for the ambiguity both of such revenue estimates, and of underlying judgments regarding the unilateral national welfare effects of rigorously enforcing anti-tax haven CFC rules, should be clear. Placing FSI in tax havens permits MNCs to avoid foreign taxes, which (so far as it goes) is all to the good from a unilateral national welfare standpoint, since resident individuals (some of whom may be shareholders) do not get to use the revenues paid to foreign governments. Yet foreign-to-foreign tax planning that MNCs use to reduce their foreign tax liabilities may be complementary with reducing home country taxes (whether through mere profit-shifting or more substantive locational changes). Moreover, even if one wishes to allow

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However, it swiftly withdrew the Notice in the face of a storm of criticism that included threats of Congressional action. IRS Notice 98-35, 1998-2 C.B. 34.

Congress in 2007 enacted temporary legislation, which it has since kept extending (although still due to expire at the end of 2019), that in effect provides the subpart F benefit of using hybrid entities without requiring that one actually use them. Under Internal Revenue Code section 954(c)(6), portfolio income items, such as interest that a CFC receives from a related CFC, generally does not give rise to a subpart F inclusion if it was not so includable in the hands of the payer. Although both the House and Senate bills that gave rise to the 2017 act would have made section 954(c)(6) permanent, any such extension was omitted from the final legislation.

<sup>71</sup> See Shaviro, *supra* n. 41, at 1709.

profit-shifting up to a point, on the view that MNCs are more mobile than purely domestic taxpayers, at some point it may exceed the desired level. The use of anti-tax haven CFC rules may therefore usefully expand one's arsenal of tools against undesired tax avoidance.

Just as we have seen at other margins, however, there is a fundamental ambiguity about just how much use of CFC rules is unilaterally nationally optimal. It may come at the price, not only of inducing resident MNCs to accept higher foreign tax liabilities that are just a cost from the domestic standpoint, but also of disfavoring foreign investment by such MNCs relative to that by nonresident companies (which are not subject to domestic CFC rules). Accordingly, the optimal usage level for this tool is ambiguous and hard to judge.

These tradeoffs are present even in the (relatively) consensus case of taxing passive FSI. If resident MNCs are not taxable domestically on the passive income that they report abroad through tax haven MNCs, they have reason to try to shift *all* of their passive income to tax havens. But one cannot stop foreign MNCs from doing this (if not constrained by their own home country rules). Thus, CFC rules that tax passive FSI discourage domestic residence by MNCs, relative to not having such rules. Moreover, if one allows foreign tax credits with respect to passive FSI, one may wholly eliminate resident MNCs' incentive to seek to reduce foreign taxes on such FSI to anything below the applicable domestic rate.<sup>72</sup> The same basic tradeoffs apply with respect to rules addressing intermediary arrangements and directly observed tax haven income. Thus, the optimal level of countries' use of anti-tax haven CFC rules cannot be determined in the abstract, and may vary both between countries and across time.

### 3. Marginal Reimbursement Rate for Foreign Taxes

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<sup>72</sup> Even if one provided an MRR of below 100 percent with respect to foreign taxes on passive FSI, resident MNCs would be induced to under-value (from a domestic national welfare standpoint) foreign tax liabilities as compared to other equivalent outlays or forgone inflows.

With respect to the MRR for foreign taxes, the analysis would be considerably simpler if not for the anti-tax haven aspect of the profit-shifting analysis. Actual or implicit deductibility, the result under pure territoriality, follows logically from the fact that foreigners, rather than resident individuals, get the revenues from foreign tax payments. As Joel Slemrod notes, “the return to [any] country includes taxes paid to the country and not taxes paid to ... [another] country. Thus ... deductibility [for] foreign taxes paid is unilaterally appropriate ... [even though it is] not consistent with global free trade in the presence of ubiquitous source-based taxes”<sup>73</sup> and a positive domestic tax rate on FSI.

On the other hand, even absent concern about profit-shifting, strategic considerations (which I discuss more fully below) might complicate the analysis. For example, suppose that countries A and B are currently crediting each other’s taxes. If A is considering making B’s taxes merely deductible when incurred by its own MNCs, it may need to consider the possibility that B would respond by making A’s taxes merely deductible when incurred by B’s MNCs. This might adversely affect A, by causing B’s MNCs to be more averse to investing in A and/or to incurring A’s taxes. The possibility of such a response thereby inevitably complicates the question of whether A should make the change, and potentially reverses the answer.

Now, however, let us suppose that such strategic considerations are immaterial – for example, because peer countries already predominantly do not credit one’s own taxes. If a putatively “territorial” country has anti-tax haven CFC rules, this can cause the foreign taxes that resident MNCs incur in lieu of facing domestic tax liability under such rules to be better than

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<sup>73</sup> Slemrod, *supra* note 53, at 479. While the FPS point about non-zero domestic marginal utility from friends’ and allies’ tax collections might require slight modification of this point, it seems unlikely to do so significantly. Generous foreign aid, such as direct transfers to the treasuries of affluent peer countries, does not appear to be a prominent U.S. budgetary practice outside of the provision of foreign tax credits.

deductible at the margin – and indeed even, in some realistic hypotheticals, better than creditable.

For example, suppose that paying \$20 (rather than zero) in foreign taxes with respect to \$100 of FSI would permit a resident MNC to eliminate \$21 of domestic tax liability under a particular CFC rule. Then, in effect, those foreign taxes face a 105 percent MRR. Although they were not literally creditable, incurring them in the amount of \$20 reduced the MNC's U.S. tax liability by \$21. So the marginal effect of paying the extra \$20 in foreign taxes is arithmetically the same as that of offering 105 percent foreign tax credits. Either way, under the assumed facts, incurring those particular foreign taxes permits the MNC to reduce its domestic tax liability by more than their full amount.

This particular scenario, at least when considered in isolation, seems unlikely to have positive unilateral national welfare effects. With a 105 percent MRR, the MNC simply pays more foreign taxes than it would have if the relevant CFC rule did not exist, and the rule raises zero revenue (in this instance) for the United States. Charging the MNC a domestic tax "price" of no more than \$19 – and perhaps as little as zero, given the multiple considerations discussed above – would have been preferable, under these particular facts. Suppose, however, that, absent the CFC rule at issue, the MNC would have shifted substantial domestic profits, and not just the above-noted \$100 of FSI, to a tax haven. Then the CFC rule might conceivably have positive national welfare effects on balance.

All this should help to show that there is no simple right answer to the optimal MRR question, once the rationale for anti-tax haven CFC rules has been added to the analysis. Still, reasonable prudential guidelines may be available from a design standpoint. For example, one may generally wish to minimize the creation of MRRs in excess of 100 percent.

When evaluating MRRs in practice, an important point to keep in mind is that they can depend on more than just how a given system expressly treats foreign taxes (such as by making them either creditable, deductible, or neither). The above hypothetical, in which anti-tax haven CFC rules caused foreign tax liability to co-vary with the scope of domestically taxable FSI, is only one illustration of this. For another example, say a country imposed a “minimum tax” on resident MNCs’ worldwide income, requiring that it equal at least, say, 15 percent, with domestic taxation of FSI replacing any shortfall.

Suppose that, under such a provision, a resident MNC with \$100 billion of worldwide income would pay \$15 billion of domestic tax if it otherwise paid zero worldwide, declining to zero domestic tax liability if the MNC paid \$15 billion or more of tax abroad. Even if the legislation made no express mention of “foreign tax credits” as such, its effect would be to create a 100 percent MRR as foreign tax liability rose from zero to \$15 billion, followed by a zero percent MRR past that point. A minimum tax that was designed in this way would be expected to eliminate all foreign tax cost-consciousness by resident MNCs within the range of such effective full creditability.

#### 4. Deferral

While the 2017 act did not cause the United States to have a territorial system, it did indeed repeal deferral, by generally exempting dividends paid by CFCs. Thus, with respect to particular current year FSI, U.S. MNCs will henceforth, in the main, be taxable in the United States either now or never, but not later. Deferral’s repeal raises three main questions for analysis: why it existed in the first place, what main incentive effects it had while in place, and what main issues its repeal raises.

1) Why would one have deferral? – As a matter of history, deferral arose purely formalistically, as an application of the realization requirement. Just as an individual who owns, say, a share of General Electric (GE) stock does not have taxable income therefrom until she receives dividends or sell the stock, so GE does not, as a general matter, have taxable income merely by reason of its owning, say, 100 percent of the stock of a foreign subsidiary. However, while the two cases are equivalent from a formal legal standpoint, few if any of the practical or administrative arguments in favor of awaiting realization<sup>74</sup> are likely to apply to an MNC's foreign subsidiary that it completely controls, and that is effectively verging on identical to an unincorporated foreign branch.

In 1962, when the Kennedy Administration sought to repeal deferral and make foreign subsidiaries' income immediately taxable to the U.S. parents, it emphasized the lack of any significant practical distinction between foreign subsidiaries and foreign branches. In the course of fighting back politically, U.S. MNCs made no significant effort to rebut this line of argument. Instead, they invoked policy considerations – “arguing that their ability to compete with foreign companies that did not have to pay U.S. tax would be adversely affected.”<sup>75</sup> The policy dispute ended in compromise between the basically worldwide system that the Kennedy Administration favored, and the shift to a purely territorial system that the companies' arguments supported. Deferral was retained, subject to the enactment of subpart F, but this was essentially a “ceasefire in place” between the proponents of higher and lower U.S. tax burdens for U.S. MNCs.<sup>76</sup> While deferral remained a key component of the compromise outcome, simply because it was already

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<sup>74</sup> On some of the practical reasons for generally not taxing unrealized appreciation, *see, e.g.*, JOSEPH BANKMAN, DANIEL N. SHAVIRO, KIRK J. STARK, AND EDWARD D. KLEINBARD, FEDERAL INCOME TAXATION: SEVENTEENTH EDITION 229 (2017). These include, for example, measurement and liquidity issues, neither of which should generally apply to a U.S. parent that must compute its CFCs' earnings and profits and that has the power to compel repatriation (such as through the payment of dividends).

<sup>75</sup> Daniel N. Shaviro, DECODING THE U.S. CORPORATE TAX 104 (2009).

<sup>76</sup> SHAVIRO, *supra* note 51, at 56.

there, it had “a particular structure that surely no one would have deliberately chosen from a design standpoint.”<sup>77</sup> It persisted as long as it did due merely to political inertia, plus the difficulty of resolving the fraught question of what, exactly, should replace it.

2) What were deferral’s main incentive effects? – To illustrate deferral’s main incentive effects while it remained in force (and while the U.S. corporate tax rate was 35 percent), suppose Acme-US, an American MNC, owned stock of a CFC that, in its first year of operations, earned pre-foreign tax profits of \$100X, on which it paid foreign taxes of \$10X. An immediate repatriation to Acme-U.S. of the \$90X that remained after paying those taxes would cause it to have \$100X of U.S. taxable income, generating a U.S. tax liability of \$25X after claiming \$10 X of foreign tax credits.

The deferral of Acme-US’s \$25X tax liability until such time as repatriation occurred would have two particularly salient features. *First*, all of the above amounts would ordinarily be expected to grow over time, by reason of the CFC’s earning income from the retained earnings (generating additional foreign tax credits and residual U.S. liability) while it held them. Under specified circumstances that included the constancy of the U.S. repatriation tax rate over time, the annually rising residual tax could potentially make Acme-US indifferent between repatriating the funds sooner as opposed to later.<sup>78</sup> *Second*, deferring the taxable repatriation would have option value if the U.S. tax rate that would apply to it might be lower in a future year than in the current year. Such option value would be especially be high if there was reason to expect such a rate decline in a future year – for example, by reason of a repeat of the 2004 repatriation tax

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<sup>77</sup> *Id.* at 55.

<sup>78</sup> This would require not just that the U.S. repatriation tax rate be constant over time, but also that Acme’s after-tax return be uniform as between funds invested at home and abroad. See SHAVIRO, *supra* n. 51, at 82-85.

holiday,<sup>79</sup> or the repeal of deferral (as actually happened in 2017), or simply a reduction in the corporate rate (as also happened in 2017). The resulting expectation of a lower repatriation tax rate in the future than the present helped to make U.S. MNCs, in many cases, extremely reluctant to repatriate foreign earnings currently.<sup>80</sup>

This was commonly called a “trapped earnings” problem, although the phrase was more of a metaphor than literally accurate. The financial value arising from past profits, even if embodied in cash, is intangible, rather than being “held” in a particular place (although, for that matter, U.S. MNCs’ unrepatriated profits could take the form of dollar-denominated deposits in U.S. banks). What nonetheless made deferral relevant to daily operations was that the need to avoid a taxable repatriation could “disrupt MNC internal capital markets, creating liquidity constraints that require[d] cash-rich MNCs like Apple to borrow to fund domestic operations, investments, and even shareholder payouts.”<sup>81</sup> The real costs of all this could be significant, especially as the profits that one had booked offshore grew relative to one’s total financial capital.<sup>82</sup>

One key incentive effect, then, was discouraging taxable repatriations. In effect, U.S. MNCs were being induced to play Twister with their internal finances until such time as the repatriation tax rate was at least temporarily lowered. Deferral also, however, affected the expected tax burden on FSI and the expected MRR for foreign taxes paid. As to the former, both the possibility that *some* positive repatriation tax rate might be paid in the future, and the deadweight loss associated with disrupting MNCs’ internal capital markets in the interim, meant

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<sup>79</sup> On the 2004 repatriation tax holiday and its effects, *see, e.g.*, Thomas J. Brennan, Where the Money Really Went: A New Understanding of the AJCA Tax Holiday, Northwestern Law & Econ. Research Paper No. 13-35, [http://images.politico.com/global/2013/08/22/brennan\\_where\\_themoney\\_really\\_went\\_20130819.pdf](http://images.politico.com/global/2013/08/22/brennan_where_themoney_really_went_20130819.pdf).

<sup>80</sup> Accounting considerations also could discourage repatriation. *See* Shaviro, *supra* n. 51, at 57.

<sup>81</sup> Lisa De Simone, Joseph D. Piotroski, and Rimmy E. Tomy, Repatriation Taxes and Foreign Cash Holdings: The Impact of Anticipated Tax Reform (8 Dec. 2017), <https://ssrn.com/abstracts=2927120>.

<sup>82</sup> *See* Harry Grubert, MNC Dividends, Tax Holidays and the Burden of the Repatriation Tax: Recent Evidence, Working Papers 0927, Oxford University Centre for Business Taxation (2009).

that a U.S. MNC with foreign profits (whether the fruit of substantive economic activity abroad or profit-shifting) generally would face an expected U.S. tax burden on FSI that was higher than that under a pure territorial system, but lower than that under a pure worldwide system. As to the latter, foreign tax credits would have some value, unlike under a pure territorial system where they would never be claimed, but less than under a pure worldwide system where they were certain to be claimed. Hence, U.S. MNCs engaged in overseas tax planning that showed they were foreign tax-averse, rather than viewing their MRRs for foreign taxes as actually being 100 percent.<sup>83</sup>

Post-repeal, the end of deferral's disrupting influence on U.S. MNCs' internal capital markets should not, as such, be mourned by anyone – except, perhaps, the tax, accounting, and financial planners whom its complexities helped to keep busy. Even if one favored its effect on expected tax rates for U.S. companies' FSI relative to that of a pure territorial system, and/or on foreign tax MRRs relative to a pure worldwide system, it exacted, in return, a high and seemingly gratuitous efficiency price. While anomalous side effects are surely inevitable in these uncertain and acutely second-best realms, deferral's lack of any underlying rationale (beyond its formalistic origins) inspires hope that, through deliberate design, one might be able to do better.

In any event, however, given deferral's effects on the tax burden on FSI and on foreign tax MRRs, its repeal logically called for reevaluating both margins. With respect to the former, U.S. policymakers concluded that the increase in profit-shifting from eliminating deferral's overhang called for otherwise expanding outbound taxation. As to MRRs, replacing deferral with increased immediate taxation of specified FSI meant that this issue would inevitably require fresh attention. U.S. MNCs' foreign tax cost-consciousness might be affected either by offering

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<sup>83</sup> See SHAVIRO, *supra* note 51 at 12-13.

them foreign tax credits with respect to immediately taxable FSI, or as an indirect consequence of having anti-tax haven rules that in effect penalized avoiding foreign taxes.<sup>84</sup>

#### D. Unilateral Versus Strategic Analyses

Before I discuss the main new international tax provisions in the 2017 act, one last input to an evaluation merits brief discussion. A given country's international tax policy (and other) choices may influence what other countries do. Thus, there is reason to think strategically, rather than just unilaterally – that is, to incorporate into one's own decisional processes the question of how what one does might affect what other countries subsequently do, rather than simply assuming that there is no such effect. The strategic perspective is relevant whether or not policymakers in other countries are themselves deliberately acting strategically. All that matters is that their future decisions might be affected in some way.

To be clear about the underlying issue, I define a country as acting unilaterally if (or insofar as) its policymakers assume that other countries' choices, in international tax policy or otherwise, will not be affected by its own. This could either reflect ignoring the question of how other countries might respond – say, due to limited decisional bandwidth or policymakers' indifference to such considerations – or expressly believing that other countries will not respond. A country's decisions can be unilateral in this sense even if its policymakers are highly mindful,

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<sup>84</sup> The repeal of deferral also raised an important transition issue. By eliminating expected repatriation taxes (along with expected deadweight loss from disrupting U.S. MNCs' internal capital markets), repeal potentially handed the MNCs' shareholders a "windfall gain," while also further accentuating the "trapped earnings" problem during the run-up to enactment. See Shaviro, *supra* note 37, at 380, 418–421. The 2017 act addressed this by enacting new Code section 965, which imposed a one-time transition tax via the mechanism of a deemed repatriation. The tax rate imposed was 15.5 percent for deferred foreign income up to the taxpayer's aggregate foreign cash position, and 8 percent above that. Unfortunately, the transition tax, whether otherwise too high or too low (and I would tend to argue the latter), has a number of serious glitches and flaws, which the U.S. Treasury may or may not attempt to address. See, e.g., Stephen E. Shay, Treasury Can Close a Potential Loophole in the Treatment of Deferred Foreign Income in the Tax Cuts and Jobs Act (TJCA) – Will It Act? (Jan. 2, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3093379](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3093379); Libin Zhang & Joshua A. Rabinovits, *The End of Eternity: Anomalies in Section 965 and the Transition to a Territorial System*, 159 TAX NOTES 621 (2018). I do not address section 965 in this article, because its one-time character causes the analysis to be somewhat distinct from that raised by the new regime's forward-looking elements.

say, of other countries' tax rules, countries' mutual incentive to compete for investment and tax revenues, and how its own choices might affect other countries' welfare. The question is one of interdependent decisions – not of positively or negatively interdependent welfare.

By contrast, a country is acting strategically if (or insofar as) its policymakers assume that its choices might affect other countries' choices. This can reflect multiple causal pathways. For example, suppose that the United States is influential, in the sense that other countries tend to imitate its policies, for whatever reason. In addition or instead, other countries might be prone to rewarding what they regard as friendly acts, and to punishing through retaliation what they deem as unfriendly acts, even if the impetus is emotional rather than consciously strategic. Or the effects might simply reflect new constraints or opportunities for other countries that result from one's own actions. No matter what the underlying cause, if our behavior might influence theirs (and whether or not they are acting strategically), then we ourselves have reason to be strategic.

An example from the 2017 tax act concerns the decision to lower the U.S. corporate tax rate to 21 percent, at least partly in response to pressures of global tax competition. Official “dynamic” revenue estimates by the Joint Committee on Taxation were made under the assumption that other countries' corporate tax rates would remain the same as under their existing laws.<sup>85</sup> This involved ignoring, not only the unilateral possibility that such rates might have changed in any event, but also the strategic concern that other countries will respond to the very substantial U.S. rate cut by lowering their own corporate rates.<sup>86</sup> Yet, ““even before the ink was dry on the bill,’ other countries were making plans to reduce their tax rates” in response to what the United States had done.<sup>87</sup>

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<sup>85</sup> See Kamin et al., *supra* note 27, at 55.

<sup>86</sup> *Id.*

<sup>87</sup> Jonathan Curry, *Hassett Defends Deficits and Predicts Transfer Pricing Drop*, 158 TAX NOTES 1261 (2018) (quoting Drew Lyon of Price Waterhouse Coopers).

As this section has shown, even a purely unilateral perspective reveals that many of the main issues in international tax policy are complicated and indeterminate, such as by reason of their involving “Goldilocks problems” that lack clear answers. A strategic perspective can make the analysis murkier still. Even predicting the very next steps that other countries might take in response to one’s own – much less, the full iterative process that might unfold over time – can be highly challenging.<sup>88</sup>

### III. KEY INTERNATIONAL FEATURES OF THE 2017 TAX ACT

#### A. Motivating a Structural Assessment

As we have seen, the 2017 act is best seen neither as making the United States a territorial system, nor as simply repealing deferral. Rather, its core feature was replacing deferral with other provisions that aim to address profit-shifting, whether via the tax rules for “inbound” or “outbound” investment. A question of prime interest, therefore, is how the new provisions compare to deferral as instruments for addressing profit-shifting, and thereby incidentally affecting a number of relevant margins (e.g., the tax burden on true inbound and outbound investment, along with effects on U.S. companies’ foreign tax cost-consciousness).

Bad though prior U.S. international tax law is widely recognized to have been,<sup>89</sup> it would be easy, in this assessment, to load the dice against the new rules, by emphasizing not just underlying design flaws and tradeoffs,<sup>90</sup> but how underspecified and sloppy they were as

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<sup>88</sup> It is plausible, however, that the strategic case for offering foreign tax credits tends to be weakened when other countries start using exemption more, and foreign tax credits less. Insofar as foreign tax credits already are not reciprocal, one has less reason to be concerned that one’s reducing the creditability of other countries’ taxes will induce those countries to respond by reducing the creditability of one’s own taxes.

<sup>89</sup> See, e.g., SHAVIRO, *supra* n. 51, at 3.

<sup>90</sup> See *infra* Section III.B.3 (evaluating the BEAT); Section III.C.3 (evaluating GILTI); Section III.D.3 (evaluating FDII). An example of an all too justified critique along these lines is the comment in Stevens and Rosenbloom, *supra* note 18, at 615, that the new rules’ “promotion of foreign tangible investments coupled with an encouraged reduction in U.S. tangible investments” – reflecting deliberate design, not just drafting errors – “was not among the advertised goals of the legislation (to put the point mildly)”.

enacted.<sup>91</sup> In my view, however, on balance they merit a kinder and more charitable assessment than, say, the 2017 act's passthrough rules, which I have elsewhere argued are so lacking in any plausible or good faith rationale (other than rewarding Republican campaign donors and their broader sociological group) that they send out a "dark message ... about contempt at high levels of government for basic principles of competence, transparency, and fair governance."<sup>92</sup> The international rules, unlike the passthrough rules, most definitely did *not* aim at simply rewarding the majority party's particular friends. Indeed, even the question of whether they raised or lost revenue, relative to prior law, depends on how one counts.<sup>93</sup>

At least two of the three rules that I evaluate – the BEAT and GILTI – respond innovatively to longstanding problems that lack either clear right answers or simple solutions. Even FDII aims to address genuine concerns raised by international tax competition, and that have helped to spawn not wholly unrelated "patent box" rules in various peer countries.<sup>94</sup> The 2017 act's international rules would therefore merit a reasonably tolerant evaluation of how their key features might plausibly be adjusted, taking as given their basic forms, even if there were good prospects for simply returning to prior law, rather than moving forward.

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<sup>91</sup> See text accompanying notes 17-19, *supra*.

<sup>92</sup> Shaviro, *supra* note 15.

<sup>93</sup> According to official ten-year revenue estimates, dividend exemption cost \$224 billion, the transition tax on deferred FSI raised \$339 billion, GILTI raised \$112 billion, BEAT raised \$150 billion, and FDII cost \$64 billion. The sum total of all these changes is positive, in the amount of \$313 billion over ten years. Arguably, however, counting it this way is too generous, given that the transition tax is a one-time revenue raiser that will not recur outside the ten-year budget window. If one excludes it from the count, the act's "permanent" international features lost \$26 billion over ten years. However, if one compares just GILTI and BEAT to dividend exemption – for example, on the ground that FDII is a conceptually separate giveaway, and/or may not persist given the likelihood that it will be found to violate the WTO – then the net ten-year revenue effect is a gain of \$38 billion. Again, I note all this just to suggest that there was some genuine intent to address seriously the broader issues raised by repealing deferral. As I discuss below, GILTI and BEAT could readily be altered in a number of dimensions, thus either raising or lowering the net revenue that they raise.

<sup>94</sup> See Martin A. Sullivan, *Where Will The Factories Go?* 158 TAX NOTES 570, (2018) (calling FDII "patent box-like"). Nine out of thirty-five OECD member countries have patent boxes, and two more (Ireland and Israel) are considering proposals for one. See Kyle Pomerleau, *Ways and Means Committee Introduces "Innovation Box" Discussion Draft*, TAX FOUNDATION (July 31, 2015), <https://taxfoundation.org/ways-and-means-committee-introduces-innovation-box-discussion-draft>

The evaluation that I will offer will be broad-brush and structural. That is, I identify key features and ask how they might generally be improved, abstracting from the question of whether the burdens imposed on affected MNCs should be higher or lower. For example, suppose that, at a given margin, Alternative A is more favorable to MNCs than Alternative B, all else equal, but that A also has greater anomalous side effects. I might then propose adopting B, rather than A, but adjusting the underlying rule in other respects, as needed to set the overall burdens that it imposes at whatever one deems to be the proper level.

## B. The BEAT

### 1. The Underlying Problem

The BEAT addresses profit-shifting out of the United States by MNCs that rely on the use of deductible payments by U.S. affiliates to their foreign affiliates. Its enactment evidently reflects the view that, even if *some* such profit-shifting has domestic national welfare benefits by reason of its lowering the effective tax rates that highly mobile taxpayers face on U.S. investment, there is a danger of excessive profit-shifting that needs to be addressed.

A further underlying concern relates to the U.S. rules' treatment of foreign, as compared to resident, MNCs. The latter not only now face GILTI, but remain subject to subpart F, which can impede some profit-shifting via the making of deductible payments to foreign affiliates. For example, suppose that a U.S. parent borrows money from its CFC, generating deductible interest payments. The CFC's interest income from the loan will generally be taxable to the U.S. parent as subpart F income, thereby eliminating the net tax benefit. This constraint does not apply to

foreign MNCs, however, since only a foreign subsidiary (as opposed to a corporate parent or sibling) can cause a U.S. company to have subpart F income.<sup>95</sup>

The relative ease with which foreign MNCs, as compared to residents, can shift profits out of the United States may have two adverse consequences, from a U.S. national welfare standpoint. First, excessive profit-shifting out of the United States may be an even bigger problem with respect to foreign MNCs than those that are U.S. residents, if the former face even weaker constraints than the latter. Second, over-reliance on residence-based rules to address such profit-shifting may create undesirable tax bias in favor of foreign MNCs, relative to those that are U.S. residents.<sup>96</sup>

These concerns may provide reason to favor the enactment of a rule that has two key features. First, it constrains all MNCs with U.S. operations, rather than just those with a U.S. parent. Second, it “deal[s] with all forms of base erosion payments in a comprehensive manner ... [so as to avoid] simply creat[ing] incentives for [MNCs] to engage in restructuring exercises to access the unaddressed avenues of base erosion.”<sup>97</sup> The BEAT made use of a novel approach to address both dimensions.

## 2. The BEAT’s Main Mechanics

In form, the BEAT is a classic minimum tax,<sup>98</sup> in the sense that it (i) creates an expanded tax base, (ii) imposes tax on this base at a rate below that for the regular tax, and (iii) makes the resulting liability payable only to the extent that it exceeds regular tax liability.<sup>99</sup> Under alternative minimum taxes (AMTs) that the U.S. tax law has featured, in one form another, since

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<sup>95</sup> While the 2017 act eliminated a further source of relative disadvantage to U.S. companies with respect to profit-shifting out of the United States – deferral, under which the shifted profits might be hard to access straightforwardly – its enactment of GILTI creates a new potential source of relative disadvantage.

<sup>96</sup> Shaviro, *supra* n. 41, at 1709; Grinberg, *supra* note 21, at 5.

<sup>97</sup> Bret Wells, *Get With the BEAT*, 158 TAX NOTES 1023, 1029 (2018).

<sup>98</sup> See Sheppard, *supra* note 10; Wells, *supra* note 97.

<sup>99</sup> See Daniel Shaviro, *Perception, Reality and Strategy: The New Alternative Minimum Tax*, 66 TAXES 91 (1988) (discussing reasons for minimum taxes’ political and optical appeal).

1969, the regular tax base is expanded by modifying or eliminating items that are deemed to constitute tax preferences. Under the BEAT, “applicable taxpayers” compute an alternative tax base that generally is expanded by adding “base erosion tax benefits” to regular tax benefits.<sup>100</sup> The expanded tax base then faces a 10 percent rate, as distinct from the 21 percent general corporate rate.<sup>101</sup> In general, base erosion tax benefits are deductible payments made by U.S. companies to foreign affiliates within the same worldwide corporate group. However, they generally do not include either the cost of goods sold, such as payments for inventory,<sup>102</sup> or an amount paid to a foreign affiliate for services if “such amount constitutes the total services cost with no markup component.”<sup>103</sup>

To illustrate the BEAT’s basic functioning with a very simple example, suppose that Acme-US has \$10X of taxable income (all U.S. source), causing it to owe \$2.1X of regular U.S. tax. This measure reflects, however, that Acme-US made \$30X in deductible payments (constituting base erosion tax benefits) to foreign affiliates. Accordingly, for BEAT purposes, its “modified taxable income” is \$40X. Its BEAT liability, at a 10 percent rate, is \$4X minus the regular tax liability, or \$1.9X.

Suppose we now modify this example so that Acme-US, in addition to having \$10X of U.S. source taxable income, also has \$2X of includable FSI, on which it pays no additional U.S. tax by reason of claiming foreign tax credits. Thus, its regular taxable income is \$12X, its regular tax liability is still \$2.1X – the BEAT measures regular tax liability net of foreign tax credits claimed – and its modified taxable income is \$42X. Now its BEAT liability is \$4.2X

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<sup>100</sup> I.R.C. § 59A(a); (c). Of course, this is a highly compressed summary and omits many details in this complex provision.

<sup>101</sup> § 59A(b)(1)(A). This tax rate is only 5 percent in 2018 and rises to 12.5 percent starting in 2026. *Id.*; § 59A(b)(2)(A).

<sup>102</sup> Payments for inventory are outside the scope of the BEAT because they are not deductible, but rather are treated as a reduction in gross receipts. See Grinberg, *supra* note 21, at 5. n. 7; Treas. Regs. §1.61-3.

<sup>103</sup> § 59A(d)(5).

minus \$2.1X, or \$2.1X. What has happened here, relative to the prior example where Acme-US had no FSI or foreign tax credits, is BEAT taxation of FSI at a 10 percent rate without any effective allowance of foreign tax credits.<sup>104</sup>

There are two important limits to the class of “applicable taxpayers” (generally, just C corporations)<sup>105</sup> that are subject to the BEAT. First, it does not apply if one’s average annual gross receipts, over the prior three taxable years, were less than \$500 million.<sup>106</sup> Second, it generally does not apply if, for the taxable year, less than 3 percent of one’s total deductions constituted base erosion tax benefits.<sup>107</sup> As we will see, both of these exclusions may be important.

### 3. Assessment

Evaluating the Means and the Ends – Suppose we think of the BEAT as using a particular means to advance a particular end. The means is addressing MNCs’ use of deductible payments to foreign affiliates to reduce their U.S. tax liabilities. The end is preventing undesired base erosion with respect to MNCs’ U.S. economic activity. Both the choice of means and the end are reasonably defensible.

Payments to foreign affiliates can advance profit-shifting at the expense of the U.S. domestic tax base in either of two ways. First, MNCs can exploit transfer pricing ambiguities, such that U.S. affiliates purport to overpay foreign ones, with the result that U.S. source income is reduced. Second, even with defensible transfer prices, MNCs may over-assign costs to U.S. affiliates, such as by attributing disproportionate borrowing to them.

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<sup>104</sup> See, e.g., LOWELL D. YODER, DAVID G. NOREN & JONATHAN LOCKHART, MCDERMOTT, WILL & EMERY, THE NEW BASE EROSION MINIMUM TAX 4 (2018), <https://www.mwe.com/en/thought-leadership/publications/2018/01/the-new-base-erosion-minimum-tax>.

<sup>105</sup> See § 59A(e)(1)(A).

<sup>106</sup> § 59A(e)(1)(B).

<sup>107</sup> See § 59A(e)(1)(C) and 59A(c)(4). However, the applicable percentage is 2 percent, rather than 3 percent, for banks and registered security dealers. See §§ 59A(e)(1)(C), 59A(b)(3)(B).

The BEAT has several virtues, taking as given its end and the choice of means. First, it is unusually far-reaching. For example, since it does not just focus on, say, interest deductions, it resists being avoided through the mere relabeling of particular cash flows – with the important exception of its excluding the cost of goods sold.<sup>108</sup> Second, it is apparently administrable.<sup>109</sup> For example, it does not require idiosyncratic – or indeed, any – transfer pricing determinations, although this turns out to be a weakness as well as a strength. Third, it weighs towards “level[ing] the playing field between U.S.-headquartered and foreign-headquartered [MNCs],”<sup>110</sup> which may be important given that the former remain distinctively subject to subpart F and GILTI. Fourth, in keeping with the Goldilocks principle, it allows MNCs to use intra-group payments to reduce their U.S. effective tax rates up to a point, but not beyond that. Bret Wells notes that “slightly more than half of the combined profits of a U.S. corporation may [still] be stripped out of the U.S. tax base through base erosion payments.”<sup>111</sup>

Despite these virtues, the BEAT has “become a ‘four-letter word’ for many in the tax world,” even among proponents of assertively addressing U.S. base erosion.<sup>112</sup> Edward Kleinbard, for example, calls it “the most consequential and poorly thought out of all the major business tax provisions” in the 2017 act.<sup>113</sup> The widespread criticism that has emerged in this vein has multiple causes. One is the BEAT’s rushed and flawed drafting, which left unsettled many important interpretive questions. A second is its having multiple features, not logically necessary under the basic design, that cause it to combine being too harsh in some cases and too

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<sup>108</sup> Wells, *supra* note 97.

<sup>109</sup> Grinberg, *supra* note 21.

<sup>110</sup> *Id.*

<sup>111</sup> Wells, *supra* note 97.

<sup>112</sup> Toby Eckert, *We’ve Got the BEAT*, Politico, (Mar. 23, 2018), <https://www.politico.com/newsletters/morning-tax/2018/03/23/weve-got-the-beat-148636>.

<sup>113</sup> *Id.*

easy to avoid in others. However, the criticism that it has attracted also reflects core design features that could not so easily be changed.

In this last regard, consider that the BEAT – at least, if one treats it as a standalone rather than as a minimum tax – effectively presumes that the correct transfer price, for purposes of computing modified taxable income, is always zero. This is implausible in any instance where the foreign affiliate incurs any positive cost and/or conveys any positive value. The presumption causes modified taxable income to have elements of gross basis, rather than net income, taxation. The best way of defending it is as a deliberate overreaction to transfer pricing (and domestic cost over-assignment) concerns that is made tolerable by its applying only at a reduced tax rate. Still, however, the over-reaction causes the BEAT to have mixed, rather than purely positive, efficiency implications for MNCs' choices between integrated and outsourced production.

To illustrate both directions of distortion, suppose that the U.S. affiliate of an MNC would pay \$100X if it bought a highly customized machine, to be used in U.S. production, from an unrelated party. However, the IRS cannot gauge this “true” transfer price accurately unless the third party transaction actually occurs. Suppose further that, in Case 1, the true in-house cost for production by a foreign affiliate is \$105X, while in Case 2 it is \$95X, but that these true costs are likewise unobservable by the IRS.

In Case 1, absent the BEAT, the MNC will inefficiently choose in-house production if it is able to set the transfer price high enough to make up for the \$5X pretax loss. For example, at a 21 percent U.S. tax rate, a \$125X transfer price may save the MNC \$5.25X of U.S. taxes (relative to paying a third party \$100X), thereby inducing inefficiently internalized production for tax reasons. In effect, in-house tax synergies outweigh the economic advantages of outsourcing. The BEAT, however, by adding the entire \$125X payment to modified taxable

income, induces the efficient choice of purchase from a third party, unless its character as merely a minimum tax prevents standalone BEAT liability from mattering sufficiently.

In Case 2, the MNC would efficiently choose in-house production even if the transfer price could not be inflated for tax reporting purposes. The BEAT, however, disfavors the in-house choice, by causing it to increase the MNC's U.S. tax liability by as much as \$10X (given the consequences for modified taxable income of not paying \$100X to a third party). It may thereby induce economically inefficient outsourcing. So here we get *reduced* production efficiency under the BEAT, as a consequence of its overreaction to transfer pricing concerns. This, of course, is the downside of its achieving greater administrability through the lack of any effort to discern "true" transfer prices.

Use of a minimum tax structure – One can reasonably view the BEAT either as a kind of minimum tax, since one pays it only to the extent in excess of regular tax liability, or as a kind of variable-rate excise tax on otherwise deductible payments to foreign affiliates. Each perspective offers particular insights analytically. I start here with the minimum tax perspective.

Minimum taxes have a decidedly mixed reputation in public discourse concerning tax policy. The individual and corporate AMTs – the former of which was curtailed, and the latter repealed, by the 2017 act – have attracted widespread, albeit not universal, condemnation. Yet in U.S. international tax policy debate, there has been much talk in recent years of enacting an outbound minimum tax for resident MNCs' FSI – as GILTI to some extent is.<sup>114</sup> Now the BEAT has been enacted, to my knowledge without especial criticism of its minimum tax character as such.

The controversiality of the individual AMT reflected a number of its distinctive elements, including what many viewed as its failure to focus on actual income tax preferences (as distinct

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<sup>114</sup> See *infra* section III.C.

from provisions, such as personal exemptions or state and local income tax deductions, that at least some viewed as normatively appropriate). Yet consider the following question about its basic underlying motivation, which I offered (writing more than thirty years ago) at a time when the top individual rate was 28 percent and the AMT rate was 21 percent:

[I]t is difficult to see what is uniquely bad about [using tax preferences to lower one's effective tax rate "too much"] .... For example, if an individual legitimately can use preferences to reduce taxes from 28 percent to 21 percent, why is there anything wrong with further reductions, to 14 percent, 7 percent, and finally zero? After all, in simple arithmetical terms, each equal percentage step in the reduction of one's tax liability has the same effect on revenues, no matter what the starting or stopping point."<sup>115</sup>

In the case of the BEAT, suppose that modified taxable income was a plausible measure of true economic income, despite its effectively assuming zero transfer prices of zero. Then there actually would be a distinctive defense of its minimum tax character, not comparably available with respect to AMTs that in effect ration the use of tax preferences. As discussed earlier, MNCs' presumed high mobility might plausibly motivate lowering their effective tax rates on U.S. investment up to a point, but not by too much. Hence, allowing them to use deductible payments to foreign affiliates to lower their U.S. tax liabilities from 21 percent to the effective rate that was "just right" might distinctively make sense here, if the underlying Goldilocks question could be answered confidently. Given, however, that modified taxable income generally is not a plausible proxy for true U.S. source economic income, this line of defense for the BEAT's minimum tax structure appears to be unavailing.

Excise tax perspective – Now suppose instead that we adopt an excise tax perspective, and ask how the BEAT affects the U.S. tax consequences of making otherwise deductible

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<sup>115</sup> Shaviro, *supra* note 99, at 95–96.

payments to foreign affiliates. Consider again the Acme-US example, in which the taxpayer had \$10X of regular taxable income plus \$30X of base erosion tax benefits, yielding modified taxable income (for BEAT purposes) of \$40X, leading to BEAT liability of \$1.9X. At a prior planning stage, Acme's tax planners then might ask themselves: How much overall U.S. tax liability does Acme save per dollar of such payments? In other words, taking account of both the regular tax and the BEAT, what is Acme's marginal reimbursement rate (MRR) for base erosion tax benefits? (While I elsewhere use the MRR concept in relation to U.S. MNCs' foreign tax payments, the concept – U.S. tax reduction per dollar of some outlay – can readily be deployed more generally.<sup>116</sup>)

Under the above facts, each dollar of base erosion tax benefits would reduce Acme's U.S. tax liability by 21 percent – its marginal tax rate under the regular tax – until Acme crossed over to facing BEAT liability. Thereafter, its MRR for such payments would become zero, as any reduction in regular tax liability was offset by the BEAT, which would ignore the payments and thus remain fixed at \$4X minus the regular tax liability.

Now consider instead a, non-minimum tax structure, in which base erosion tax benefits faced a uniform MRR. An example would be a flat rate excise tax on deductible payments to foreign affiliates, enacted in lieu of the BEAT. Now the MRR would be constant, at the regular tax rate minus the excise tax rate.<sup>117</sup> This, in turn, would generally be equivalent to making base erosion tax benefits only partly deductible. For example, combining a 21 percent corporate tax

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<sup>116</sup> For an earlier use of the MRR concept, see David F. Bradford & Daniel N. Shaviro, *The Economics of Vouchers*, in *VOUCHERS AND THE PROVISION OF PUBLIC SERVICES* 40 (C. Eugene Steuerle et al. eds. 2000) (applying the MRR concept to “grant[s] per dollar of earmarked expenditure as the amount of such expenditure by the consumer increases”).

<sup>117</sup> Section 4303 of the House bill had a 20 percent excise tax, in lieu of the BEAT (which newly emerged in the Senate bill). However, this proposal diverged from the BEAT in numerous respects unrelated to the MRR issue that I discuss here. For example, it relied on certain financial statement data, made novel use of the permanent establishment concept in delineating the excise tax's applicability, and included cost of goods sold in the tax base in some instances, although not others. See Grinberg, *supra* note 21, at 7.

rate with a 7 percent excise tax on deductible payments to foreign affiliates would be akin to making such payments two-thirds deductible.

The use of an excise tax or partial deductibility would lead to a more uniform MRR for base erosion tax benefits than that which results from the BEAT, given its minimum tax character. One virtue of a uniform MRR for base erosion tax benefits, compared to a variable one that raises the same revenue, is that it need not be as high in cases where the BEAT is engaged in overreach at the expense of incentives to engage in efficient in-house production. As I discuss next, this concern is made even stronger by seemingly gratuitous exclusions from the BEAT's reach.

Effective disallowance of foreign tax credits – As noted in relation to the Acme-US example above,<sup>118</sup> the BEAT includes FSI that is part of regular taxable income, while not allowing foreign tax credits and treating regular taxable income as reduced by such credits. The 10 percent marginal tax rate is less than that under the regular tax (i.e., 21 percent), and this only happens once the taxpayer has shifted, at the margin, from facing regular tax to BEAT liability, but it clearly is a controversial result that, at a minimum, is in tension with bilateral tax treaties that eschew “double taxation.”

Exclusions from “applicable taxpayers” – As noted above, the statutory definition of “applicable taxpayers” that are subject to the BEAT excludes any company that had less than \$500 million in average annual gross receipts over the prior three years. It also excludes any company for which, during the current taxable year, base erosion tax benefits constituted less than 3 percent of total deductions.<sup>119</sup> Both of these provisions appear to be ill-advised –

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<sup>118</sup> See text accompanying note 104.

<sup>119</sup> I.R.C. § 59A(e). The threshold is 2 percent for banks and registered securities dealers. §§ 59A(e)(1)(C); 59A(b)(3)(B).

suggesting that the BEAT should be extended more broadly, even if this was done in a revenue-neutral fashion (such as by reducing its rate to offset its greater breadth)

One problem with both exclusions is that they create “notches,” by making application of the BEAT discontinuous. Thus, suppose a company that is right next to one of the thresholds changes either its gross receipts or its total deductions by just a few dollars – but, in either case, with the effect of changing whether or not the BEAT applies. This small change could easily make a multimillion dollar difference in U.S. tax liability.

In the case of the size threshold, perhaps the imposition of a notch is not easily avoidable. Suppose one agrees that “small” companies do not pose as great a profit-shifting problem as larger companies, and/or are less well-equipped to handle BEAT-related tax planning and compliance issues.<sup>120</sup> Then one may want to exclude companies below a requisite threshold. Moreover, while liability above the threshold could in principle be phased in, this presents a trade-off, as it would add computational complexity. Even so, however, it is hard to see why Congress set the threshold so high. As Bret Wells notes, the concerns about profit-shifting that motivated the BEAT’s enactment are seemingly not limited to companies with so high a level of average annual revenue. Thus, drawing the line where Congress did “creates artificial winners and losers without a policy reason for doing so.”<sup>121</sup>

The 3 percent threshold creates a similar notch problem, but without having a plausible underlying motivation. To illustrate the problem, recall the hypothetical involving Acme-US, with its \$10X of taxable income and \$30X of base erosion tax preferences, causing it (with a 21

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<sup>120</sup> Simply computing and paying the BEAT does not appear to be enormously complicated, however. It is surely simpler than, say, regulating corporate AMT liability under prior law – which could require, for example, keeping track of multiple tax attributes (such as asset basis, net operating losses, and foreign tax credit carryforwards) under both the regular tax and the AMT.

<sup>121</sup> Wells, *supra* note 97, at 1031. Wells proposes setting the threshold so that the BEAT will apply to companies that have either at least \$50 million in average annual gross receipts or at least \$100 million in assets.

percent corporate rate) to owe \$1.9X under the BEAT. Suppose, however, that its \$10X of regular taxable income reflected its having \$1,010X of gross income, and \$1,000X of total deductions. In that instance, just a \$1 increase in its total deductions, or a \$1 decline in its base erosion tax benefits, would allow it to eliminate the entire \$1.9X in BEAT liability.

There are many avenues for tax planning at this margin. Buying low-margin U.S. businesses, such as supermarket chains, is one possibility. Another is reducing base erosion tax benefits by “checking the box open” with respect to selected foreign affiliates, thereby converting them into disregarded entities for U.S. federal income tax purposes. Now payments to them are ignored by the U.S. tax system, rather than being deductible. While this would generally increase regular tax liability, such increase could be far less than the BEAT liability that was avoided. A third possibility is arranging offsetting hedged transactions in which offsetting income inclusions and deductions net to zero (or at least are not highly negative), but the deductions raise the denominator sufficiently to make the BEAT nonapplicable.

There appears to be no good reason for creating tax planning complexity at this margin. Given that MNCs’ tax planning incentives are generally a function of net taxable income, rather than of gross income or deductions, it is hard to discern an underlying rationale for the 3 percent threshold. For example, in the case of Acme-US, should one’s concern about its using payments to foreign affiliates to shift profits out of the United States be higher when its \$10X of taxable income reflects (a) \$810X of gross income and \$800X of deductions, rather than (b) \$1,210X of gross income and \$1,200X of deductions? There is no obvious reason why these two cases should be considered even marginally different. And again, if eliminating the 3 percent threshold meant that the BEAT would impose too large an aggregate burden, this could be

addressed by slightly lowering its rate, thereby both spreading the burden more broadly and eliminating tax planning incentives around the threshold.

Items not in the base – The fact that U.S. companies can buy inventory from foreign affiliates without incurring BEAT liability creates an obvious pathway for avoidance. It encourages MNCs to rearrange their supply chains with an eye to maximizing opportunities to profit-shift via generously priced “inventory” payments from U.S. companies to foreign affiliates. For example, it is better to buy, from a foreign affiliate, inventory that derives its value from underlying intellectual property, than it is to pay the affiliate a royalty for the intellectual property.<sup>122</sup> Given this set of problems, even Itai Grinberg, who in other respects is an enthusiastic BEAT advocate, agrees that all the provision achieves here is to “in effect table this issue for study (and perhaps action if/when a solution is found).”<sup>123</sup>

To be sure, ignoring the cost of goods sold on purchases from foreign affiliates would be a further instance of overreach. Paying an arm’s length price for goods produced outside the United States does not constitute “profit-shifting,” and subjecting it to the BEAT (if not sufficiently avoidable through tax planning) would penalize the use of integrated production in lieu of arm’s-length suppliers. This, however, is the same conceptual problem that the BEAT faces generally. So perhaps it is best addressed either by not having the BEAT, or by further extending its reach in order to fund lowering its rate. .

The exclusion for amounts paid to a foreign affiliate for services raises similar issues, albeit subject to the requirement that the excluded amount “constitute[] the total services cost with no markup component.”<sup>124</sup> How careful MNCs need to be about generously computing the “total services cost” depends on whether the inclusion of a markup would result in treatment of

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<sup>122</sup> See Kamin et al., *supra* note 27, at 37 n.106.

<sup>123</sup> Grinberg, *supra* note 21.

<sup>124</sup> I.R.C. § 59A(d)(5).

the entire payment, or just its markup component, as a base erosion tax benefit. This is a matter of current debate.<sup>125</sup>

Other avoidance issues – Just as one can avoid the BEAT by genuinely paying deductible amounts to third parties, rather than to foreign affiliates, so one can at least purport to avoid it by using third parties as intermediaries. Thus, suppose a true arm's length price for depreciable property constructed abroad would be \$100X. An MNC is already ahead of the game if it can tax-effectively have a foreign affiliate sell the property for \$100X to an unrelated third party that then on-sells it to the U.S. affiliate for the same price plus a modest fee. However, it can do better still if the third party agrees to overpay (say, \$120X) for the property in exchange for its then being similarly overpaid by the U.S. affiliate. In principle, existing legal doctrines concerning economic substance and tax ownership can be used to address such problems, but they are of course imperfect (as well as potentially under-enforced).

Strategic issues – The question of how other countries will respond to enactment of the BEAT has both legal and practical elements. One might start, however, by asking how the BEAT affects other major players, such as the EU countries. Here the answer, reflecting the frequent ambiguity of international tax policy issues, is mixed. For example, EU individuals who own stock in non-U.S. MNCs may be adversely affected, at least upon initial enactment, insofar as such MNCs end up paying more U.S. tax than previously. Yet, insofar as MNCs' foreign-to-foreign tax planning aids them in "excessively" reducing home country taxes, the effects on such companies' tax planning might be not entirely unwelcome.<sup>126</sup>

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<sup>125</sup> See Sullivan, *supra* note 18; Manal Corwin et al., *A Response to an Off-BEAT Analysis*, 158 TAX NOTES 933, 933 (2018).

<sup>126</sup> In addition, EU countries might benefit from the standpoint of tax competition insofar as the BEAT makes inbound U.S. investment marginally less attractive than it would otherwise be.

One can see this ambivalence at work in a public letter that five EU finance ministers sent to U.S. Treasury Secretary Steve Mnuchin in December 2017, shortly after the passage of the Senate bill.<sup>127</sup> While the letter expresses “significant concerns“ about the BEAT (among other provisions), it also “explicitly welcome[s] U.S. action in the fight against base erosion and profit-shifting.”<sup>128</sup> Moreover, it appears to deliberately pull its punches a bit regarding the BEAT. In particular, while noting the BEAT’s possible adverse effects on financial institutions in particular, and “see[ing] the possibility ... [of] unfair trade practice,”<sup>129</sup> it leaves out any mention of possibly challenging the BEAT under the WTO. (By contrast, the letter *does* mention possible WTO challenges to other provisions in the House and Senate bills.<sup>130</sup>) Given that such a challenge might have a high likelihood of success,<sup>131</sup> this omission may be deliberate, reflecting a conclusion that the BEAT’s anticipated adverse trade impact “is not sufficient to raise the ire of our trading partners.”<sup>132</sup>

The BEAT might also be challenged as violating bilateral tax treaties. As applied to incorporated U.S. subsidiaries of foreign MNCs, it has been called formally treaty-compliant, by reason of its raising the taxes only of the U.S. affiliate.<sup>133</sup> Formal treaty compliance may be harder to defend, however, when the BEAT reaches U.S. branches of foreign MNCs that are subject to it by reason of their being permanent establishments. Plus, it may be challenged as

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<sup>127</sup> See *EU Finance Ministers Warn Against Proposed U.S. Tax Measures*, TAXNOTES.COM (Dec. 11, 2017) [hereinafter, *EU Finance Ministers*], [https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/eu-finance-ministers-warn-against-proposed-us-tax-measures/2017/12/12/1xdr8?\\_\\_hstc=128951187.c10ec3de404b3473d3c218ce2eee0b77.1526667055088.1526667055088.1526667055088.1&\\_\\_hssc=128951187.2.1526667055088&\\_\\_hsfp=1784135447](https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/eu-finance-ministers-warn-against-proposed-us-tax-measures/2017/12/12/1xdr8?__hstc=128951187.c10ec3de404b3473d3c218ce2eee0b77.1526667055088.1526667055088.1526667055088.1&__hssc=128951187.2.1526667055088&__hsfp=1784135447).

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> See *id.* (mentioning possible WTO challenges to GILTI and to the House excise tax provision that the Senate bill replaced with the BEAT).

<sup>131</sup> See Kamin et al., *supra* note 27, at 43–46; Reuven Avi-Yonah, *Guilty as Charged: Reflections on TRA 17*, 157 TAX NOTES 1131 (2017).

<sup>132</sup> See David Kamin et al., *The Games They Will Play: An Update on the Conference Committee Tax Bill*, available online at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3089423](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423).

<sup>133</sup> Avi-Yonah, *supra* note 131.

violating treaties' nondiscrimination provisions, by reason of its singling out payments to foreign affiliates. And even where the BEAT is formally treaty-compliant, some countries may view it as violating their tax treaties with the U.S. in spirit, by reason of its indirectly taxing intercompany transactions. Itai Grinberg argues, however, that even foreign countries that feel aggrieved will have difficulty in retaliating, for legal and institutional reasons.<sup>134</sup>

Insofar as other countries responded by adopting their own versions of the BEAT that raised domestic taxes on U.S. MNCs, the effect on U.S. national welfare would be mixed, in the usual manner. While U.S. shareholders in these companies might lose from this, it is also possible that "excessive" profit-shifting out of the United States would decline, by reason of the increased difficulty of avoiding foreign taxes in non-haven countries.

### C. GILTI Rules

#### 1. The Underlying Problem

As noted earlier, while repealing deferral was a core policy goal of the 2017 act's international changes, policymakers viewed such repeal as undesirably increasing U.S. MNCs' incentives to engage in excessive profit-shifting. GILTI is the replacement provision, significantly broadening immediate taxation of U.S. MNCs' "bad" FSI. And it is a quite significant one – in the view of KPMG, causing the U.S. CFC rules to be "comparatively unfavorable ... [as] the CFC regimes of most of the major trading partners of the United States ... typically tax CFC earnings in much more limited circumstances."<sup>135</sup>

The GILTI rules' relatively high level of rigor, although no doubt reflecting broader revenue pressures, appears to be no accident. Martin Sullivan notes that, "[t]he more

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<sup>134</sup> See Grinberg, *supra* note 21, at 8 ("[R]ules enshrined in the EU treaties make it extremely difficult for EU member states to retaliate symmetrically against the BEAT, either at the national or EU-wide level") and 10 ("in the majority of legal systems around the world ... tax treaty overrides are difficult ... to achieve without abrogating the entire tax treaty.").

<sup>135</sup> KPMG, *supra* note 9 at 117.

practitioners study ... [the GILTI rules], the less they like them.... [O]nce they got past the broad brushstrokes, it seemed to many as if the drafters took pains at every turn to make the provision as unfriendly to taxpayers as possible.”<sup>136</sup>

Both GILTI’s enactment and various aspects of its design suggest that U.S. policymakers did indeed, whether rightly or wrongly, believe in the importance of several of the tradeoffs I discuss in section II, and that are orthogonal to the standard “worldwide versus territorial” debate. In particular, they appear to have believed the following:

--A key factor in defining “bad” FSI is that it faces low taxes abroad. Thus, GILTI is an anti-tax haven rule, enacted even though the United States does not directly benefit when its MNCs pay higher, rather than lower, foreign taxes.

--The grounds for taxing “bad” FSI are strong enough to motivate enacting a residence-based rule that, unlike the BEAT, applies distinctively to U.S. MNCs, and thus has the undesirable side effect of discouraging the use of U.S.-headquartered, rather than foreign-headquartered, MNCs to invest both in the United States and abroad.

--Despite Congress’s evident belief in the desirability of targeting low-taxed FSI, several of GILTI’s features suggest an aim of preserving resident MNCs’ foreign tax cost-consciousness, which foreign tax credits can wholly eliminate. Unfortunately, however, this concern was addressed in a somewhat scattershot fashion, rather than by addressing foreign tax MRR issues directly.

## 2. GILTI’s Main Mechanics

While GILTI stands for “global intangible low-taxed income,” the focus is on high foreign rates of return, whether from intangibles or not. Although it relies on measuring foreign profits relative to tangible assets, such profits either “could be related to the presence of

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<sup>136</sup> Martin A. Sullivan, *More GILTI Than You Thought*, 158 TAX NOTES 845 (2018).

intangibles, as economists often assume, or may have nothing to do with intangibles at all.”<sup>137</sup>

For this reason, practitioners who are overly fixated on the provision’s name have even called it Orwellian.<sup>138</sup>

The first step in applying the GILTI rules is to determine the taxpayer’s “net CFC tested income,” which generally is its overall share of CFC profits minus CFC losses, reduced by certain items such as (otherwise taxable) subpart F income.<sup>139</sup> This amount is then reduced by “net deemed tangible income,” which in turn generally equals a 10 percent deemed return on the CFCs’ “qualified business asset investment” (QBAI), which generally equals the sum of the adjusted tax bases of all of the tangible assets that the CFCs use in trades or businesses.<sup>140</sup>

To illustrate the provision as described thus far, suppose that Acme-U.S. has \$100X of net CFC tested income, and \$200X of QBAI. (This high profit rate, relative to the amount of QBAI, might reflect Acme’s having booked substantial intangible profits offshore, but, again, the rules do not directly test for this.) Since a 10 percent return on Acme’s QBAI would equal \$20X, the company has \$80X of GILTI.

The tax consequences of having GILTI are as follows. Its amount is included in the U.S. parent’s taxable income (with a gross-up for the foreign tax liability that it bore), but subject to an offsetting deduction that generally equals 50 percent of its amount.<sup>141</sup> Deducting half of GILTI, while including the rest of it in taxable income that faces a 21 percent corporate rate, effectively lowers the GILTI. tax rate to 10.5 percent. Thus, in the above hypothetical, Acme-US

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<sup>137</sup> *Id.*

<sup>138</sup> See Lynlee Browning, “*Orwellian*” Offshore Tax Will Hit Some Firms Harder Than Others, BLOOMBERG (Dec. 28, 2017), <https://www.bloomberg.com/news/articles/2017-12-28/-orwellian-offshore-tax-will-hit-some-firms-harder-than-others> (quoting James Duncan of Cleary Gottlieb).

<sup>139</sup> I.R.C. § 951A(c)(1).

<sup>140</sup> Adjusted basis is determined using the alternative depreciation system under section 168(g), which generally is the tax system’s preferred measure for ostensibly economic depreciation.

<sup>141</sup> The 50 percent deduction declines to 37.5 percent beginning in 2026.

would get to deduct \$40X of its GILTI, causing Acme to owe \$8.44X of U.S. tax (at a 21 percent rate) on the remaining \$40X. This, however, is prior to considering foreign tax credits.

The GILTI deduction is limited by the taxpayer's overall taxable income. If the taxpayer has a loss other than from GILTI (and FDII, which I ignore for now), the taxpayer only gets enough of a GILTI deduction to reduce overall taxable income to zero.<sup>142</sup> Thus, suppose Acme-US has taxable income of negative \$70X, disregarding GILTI. If it merely added half of its \$90X of GILTI to this amount, it would end up with a net operating loss (NOL) of \$25X. Instead, however, it first adds back all of the GILTI, raising taxable income to \$20X, and then can only deduct \$20X under the GILTI rules, leaving it with taxable income of zero. In effect, \$25X of GILTI deductions are permanently lost, by reason of their not being allowed to create or increase a current year NOL.

In general, foreign tax credits are allowable with respect to 80 percent of the foreign taxes paid with respect to GILTI. Thus, in the above hypothetical (but without any loss issue), if Acme had paid \$10X of foreign taxes on its GILTI, the allowable foreign tax credits would amount to \$8X, reducing Acme's associated U.S. tax liability from \$8.4X to \$.4X.<sup>143</sup> Since GILTI is placed in a separate foreign tax credit "basket" from all other FSI, no other foreign tax credits could be used to eliminate this residual U.S. liability. Excess foreign tax credits against GILTI not only cannot be used against other FSI, but also cannot be carried over to other taxable years.

However, since all GILTI is placed in the same foreign tax credit basket, U.S. taxpayers can, in effect, use credits pertaining to high-tax GILTI to offset the residual U.S. tax on low-tax

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<sup>142</sup> See Section III.C for FDII. The deduction amounts that are disallowed are apportioned between GILTI and FDII.

<sup>143</sup> This illustration involves assuming that Acme's \$100X of net CFC tested income included a gross-up for the foreign taxes paid (i.e., its amount was \$90X after foreign tax), and that this gross-up is included in the GILTI foreign tax credit basket. Stevens and Rosenbloom, *supra* note 18, regard the latter assumption as open to question.

GILTI. In this respect, the GILTI rules are therefore more favorable to U.S. taxpayers than if they had applied a per-country limitation on the use of foreign tax credits.

Given the 80 percent rule, the 2017 act’s conference report explains that “the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent.”<sup>144</sup> KPMG, however, argues that “[t]his conclusion is misleading” given the multiple limitations that the GILTI rules place on foreign tax credit claims, as a result of which “U.S. shareholders whose CFCs generally are subject to significant foreign taxes may nonetheless owe residual U.S. tax in a particular year.”<sup>145</sup> To similar effect, although deliberately overstating the case for rhetorical effect, Lee Sheppard even says: “Congress repealed the foreign tax credit without telling you.”<sup>146</sup>

### 3. Assessment

GILTI’s merits depend in large part on how one views its underlying policy aim of imposing some (but not too much) domestic tax on resident MNCs’ low-taxed FSI that seems likely to reflect profit-shifting, and that may have been at the expense of the domestic tax base, perhaps via the use of intangibles. To favor the provision, one must believe that somewhat discouraging corporate residence is worth the price of expanding anti-tax haven policy beyond the reach of existing subpart F. There is also an underlying view that, while foreign-to-foreign profit-shifting should to some extent be discouraged, it is desirable to retain some cost-consciousness for U.S. companies with respect to their foreign tax liabilities – an aim that the allowance of full foreign tax credits, with their 100 percent MRR (barring effective limits on their use), can undermine or defeat.

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<sup>144</sup> See H.R. REP. NO. 115-466, at 498 (2017) (Conf. Rep.)

<sup>145</sup> KPMG REPORT, *supra* note 9, at 119. KPMG further concludes that the provision “may put some taxpayers in a position where they are better off deducting rather than crediting the relevant foreign taxes.” *Id.*

<sup>146</sup> Sheppard, *supra* note 10.

Taking these policy aims as given, the question that I will address here is how the GILTI rules' main structural features might be revised. For features that, compared to plausible alternatives, makes the resulting tax burden on U.S. MNCs higher or lower, I will aim to decouple (i) what I see as structural virtues or vices from (ii) the question of how high or low the overall burden should be, as this could be recalibrated by adjusting other margins (such as the choice of GILTI tax rate).<sup>147</sup>

Use of a 10 percent deemed return on QBAI – There is a logic to focusing on high foreign rates of return, on the views both that they might be rents that can efficiently be taxed (subject, of course, to tax elasticity at the residence margin), and that they might be indirect evidence of undesired profit-shifting at the expense of the domestic tax base. Moreover, while there may also be a logic to focusing instead on intangible returns as such, on the view that they are highly mobile and may often be associated with rents, this would raise definitional and identification problems. So it is at least plausible (whether or not ultimately best) to focus purely on high reported rates of return, while making no effort to identify income from intangibles as such – just as Congress did in designing the GILTI rules.

Once one is seeking to identify high rates of return, this implies the need for a computation relative to some sort of denominator, such as QBAI. Moreover, if one wants to focus on profit-shifting via intangibles, while sparing oneself the challenge of identifying intangible returns directly, the use of a measure, such as QBAI that counts only tangible assets, and that excludes the cost inputs to earning intangible returns, also seems plausible from a design

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<sup>147</sup> One issue that I will not address, however, by reason of its being so well-handled elsewhere, is the compelling case for revising GILTI, ideally by statute, so as to treat all affiliated CFCs as a single corporation for purposes of various GILTI calculations. See NYSBA Report, *supra* n. 17. The problems with not doing this “stem[] largely from the fact that CFCs with losses are treated differently (less favorably) than CFCs with positive income,” causing particularities of business structure to have arbitrary effects on one’s GILTI liability. Martin Sullivan, *More Than Technical Corrections Needed to Fix GILTI*, 149 Tax Notes 939 (2018). I fully agree with this analysis.

standpoint. Likewise, the exclusion from QBAI of tangible assets that are *not* used by CFCs in their trades or businesses is a friction that raises the cost to U.S. MNCs of transferring tangible assets abroad just in order to lower GILTI. Imposing this friction creates a tradeoff between (i) the benefit of reducing avoidance activity, and (ii) the cost of increasing distortion in cases where assets are transferred anyway, but now must be actively used in the wrong business.<sup>148</sup>

So far, at least arguably so good, with respect to the QBAI rule. But the approach has a serious downside if the imputed rate of return to the asset, for GILTI purposes, exceeds the actual expected rate of return. As many commentators have noted,<sup>149</sup> this creates an incentive to shift tangible assets out of the United States, which “was not among the advertised goals of the legislation (to put the point mildly).”<sup>150</sup>

Merely taxing U.S. returns to tangible assets that are used domestically at a higher rate than they would bear if used abroad already creates an incentive to shift tangible assets out of the United States. This is inherent to having source-based taxes in the face of global tax competition. But when the imputed return for GILTI purposes exceeds the actual expected return, this problem is worsened. In illustration, suppose Acme-U.S. has a tangible asset, with an adjusted tax basis of \$100X, that would earn a pre-tax return of \$4X if the asset was kept in the United States. Absent the GILTI rules, shifting it to a country with a zero tax rate would not pay off after-tax unless it could earn more than \$3.16X (the after-U.S. tax return) when used there. With the rules, however, moving it to the haven would save an additional .63X of GILTI,<sup>151</sup> lowering the hurdle rate of return for shifting it to the tax haven to \$2.53X.

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<sup>148</sup> See, e.g., Daniel Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 TAX NOTES 1359 (2002).

<sup>149</sup> See, e.g., Kamin et al, *supra* note 27; Clausing, *supra* note 58.

<sup>150</sup> Stevens and Rosenbloom, *supra* note 18.

<sup>151</sup> Moving the asset to the tax haven would increase FSI by \$4X, but the presumed return on QBAI by \$10X. Thus, the amount of GILTI would decline by \$6X, reducing Acme’s GILTI liability (at the 10.5 percent effective rate) by \$.63X.

There is of course a question of just how readily one can shift tangible assets to low-tax countries without unduly undermining their practical usability. For example, zero-rate tax havens may tend to be ill-suited for engaging in actual productive activity with tangible assets. However, there are certainly relatively low-tax countries – for example, Ireland and Singapore – in which engaging in some degree of genuine business activity clearly is feasible.

Moreover, shifting U.S. assets abroad is not the only way in which the use of QBAI can induce inefficient tax planning responses. Suppose, for example, that particular types of foreign business assets tend to earn relatively low (but perhaps relatively certain) profit margins. Then holding them jointly with assets that offer high returns, as measured relative to QBAI, can offer GILTI-reducing benefits.

Using the QBAI measure does not increase the incentive to move taxable assets outside the United States, or to buy particular foreign assets, if the statutorily presumed rate of return merely equals the actually expected one. Rather, the undesired incentive effect is the consequence of Congress's having (apparently deliberately) set so high a presumed rate of return. Even without determining here exactly how that rate should be determined – based, perhaps, on a particular contemporaneously observed market interest rate? – it seems clear that this is an instance of poor design. Moreover, lowering the presumed rate of return need not imply increasing overall tax burdens from the GILTI rules, since one could make other compensating adjustments, such as by raising the GILTI deduction percentage. This would, of course, have winners and losers, given that some U.S. MNCs are likely better-positioned than others to take advantage of the QBAI rule.

Loss of GILTI deductions that would create or increase a net operating loss – Limiting GILTI deductions so that they cannot create or increase an NOL, and permanently disallowing

the excess amount, might be an example of Martin Sullivan’s observation about “unfriendly” details in the GILT rules. Perhaps this outcome was partly optically driven, by the notion that, since the GILTI deduction is not a “real” one (i.e., for actual outlays), it somehow should not be allowed to increase NOLs, even though it is allowed to reduce taxable income to zero. This optical issue would not arise if GILTI were simply half-includable, rather than being first included and then half-deducted. In addition, however, it is unclear why NOLs, or tax benefits for GILTI that affect NOLs, should be particularly disfavored. NOLs tend to equalize the taxation of businesses with volatile, as opposed to smooth, annual earnings, and to reduce the need for timing-related tax planning that is directed at self-smoothing.<sup>152</sup> Thus, there is a reasonable case for changing this rule in taxpayers’ favor, leaving to one side the issue of how high or low tax burdens on GILTI should be.

Allowing foreign tax credits for 80 percent of foreign taxes paid – The rule limiting foreign tax credits for GILTI to 80 percent of foreign taxes paid creates an 80 percent MRR for such taxes, declining to zero percent once all residual U.S. tax liability on GILTI has been eliminated. Ignoring for now the latter aspect – as I discuss the foreign tax credit limit for GILTI below – this causes the GILTI rules, considered as a whole, to fall within the general bounds of how I have argued that FSI should generally be taxed. Again, there are plausible rationales both for taxing FSI at a rate between zero and the full domestic rate,<sup>153</sup> and for foreign tax MRRs that exceed the marginal tax rate on the income but are less than 100 percent.<sup>154</sup>

Should the MRR be lower than 80 percent? Again, this need not imply raising the U.S. tax burden on GILTI, given that other margins, such as the size of the GILTI deduction, could

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<sup>152</sup> NOLs can, of course, encourage timing-related tax planning if their expiration is a concern, and can also inefficiently affect tax planning around the continuation or acquisition of loss companies.

<sup>153</sup> See *supra* Section II.C.2.

<sup>154</sup> *Id.*

simultaneously be adjusted. While this question does not have an immediately clear answer, there is a strong case that, from a treaty standpoint, the foreign tax MRR for GILTI could be as low as the percentage of GILTI that is includable, net of the deduction. As Fadi Shaheen has explained, treaty provisions that bar “double taxation” of FSI appear to require only that 100 percent of each dollar of FSI benefit either from exemption or foreign tax creditability.<sup>155</sup> Thus, with GILTI being 50 percent exempt, a foreign tax MRR as low as 50 percent would be treaty-compliant. While this, as a standalone change, would raise the effective U.S. tax burden on GILTI, a burden-neutral change might involve somewhat lowering the foreign tax MRR, and somewhat increasing the GILTI deduction percentage, subject to not violating the above constraint.<sup>156</sup> However, it is hard to detail what approach would be closest to optimal.

Limiting foreign tax credits on a global rather than per-country basis – The foreign tax credit limit, just like nonrefundability for current year tax losses, is basically arbitrary.<sup>157</sup> It allows foreign tax credit planning to reduce the residual U.S. tax on a given quantum of taxable FSI from any positive amount to zero, but not a penny below that.<sup>158</sup> While the anti-avoidance rationale is clear, the sudden change in marginal incentives right at the zero point “seems unrelated to any accompanying change in the marginal impact on unilateral national self-interest.”<sup>159</sup> While this does not mean that foreign tax credit limits should be eliminated (especially absent offsetting changes, both generally and on the anti-avoidance front), it does impede reaching confident conclusions about just how rigorously or laxly they should apply.

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<sup>155</sup> See Shaheen, *supra* note 56. I will not herein discuss other treaty issues that GILTI may raise.

<sup>156</sup> Specifically, under Shaheen’s analysis, treaty compliance would require that the sum of (1) the percentage of relevant foreign taxes that give rise to a credit, and (2) 100 percent minus the deduction percentage for GILTI, not exceed 100 percent.

<sup>157</sup> See Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANAL. 65, 81 (2011).

<sup>158</sup> As I have noted elsewhere, “[a] common line or argument holds that ‘the foreign tax credit limitation preserves U.S. sovereignty to tax U.S. source income’ ... [but t]his is merely a semantic point ... given that, in the absence of incentive and revenue problems [that afflict the foreign tax credit more generally],” they could even be made directly refundable. *Id.* at 81 n. 18 (citation omitted).

<sup>159</sup> *Id.* at 81.

With respect to GILTI foreign tax credit limits, one of the key choices made was to allow cross-crediting, via the use of credits pertaining to high-tax GILTI to offset the residual U.S. tax on low-tax GILTI. U.S. MNCs' representatives strongly favored such an "overall tax that allowed averaging across foreign affiliates rather than the dreaded, vastly more complex per-country approach favored by the Obama Administration."<sup>160</sup> This choice between an aggregate and a per-country approach is an old and familiar one in the U.S. international tax policy realm.

People's views about the choice are often seemingly driven as much by their underlying preferences regarding higher versus lower U.S. tax burdens for U.S. MNCs as by the particular structural issues that the choice raises. There is, however, a strong argument that encouraging companies to engage in cross-crediting between higher-tax and lower-tax countries serves no particular national welfare objective. However, the complexities with separate per-country baskets weigh in the other direction, as perhaps do arguments against penalizing MNCs that "naturally" (not just due to tax planning) split integrated production between particular higher-tax and lower-tax countries.

Placing GILTI in a separate foreign tax credit basket, and denying carryovers for excess credits – While U.S. MNCs won on the cross-crediting issue as between high-tax and low-tax GILTI, they lost as to cross-crediting between GILTI and other FSI. They also were denied carryovers between taxable years within the GILTI basket. As to the first of the two issues on which they lost, the separate GILTI basket does indeed reduce cross-crediting opportunities that might serve no good purpose apart from tax minimization, without greatly adding record-keeping complexity. It may, however, encourage tax planning in other dimensions. An example would be seeking to create subpart F income, in lieu of GILTI, where this would reduce one's expected U.S. taxes despite GILTI's facing a lower marginal tax rate.

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<sup>160</sup> Sullivan, *supra* note 136.

The lack of foreign tax credit carryovers within the GILTI basket, while raising many of the same sorts of tradeoffs as other choices around the use of limits, is perhaps especially hard to rationalize. Like the loss of GILTI deductions that would otherwise have created or increased NOLs, the lack of carryovers may disfavor U.S. MNCs with relatively volatile FSI flows from year to year. It also may disfavor those investing in countries, or engaging in transactions, as to which there are especially marked timing differences as between U.S. and relevant foreign income tax law. Even if one wants generally to reduce MRRs with respect to GILTI-related foreign tax liabilities, this is not an obviously well-chosen mechanism for doing so.

Strategic issues – The prime claim that could be made in support of the GILTI rules, albeit a controversial one, is that they advance unilateral U.S. national welfare, such as by addressing undesired profit-shifting by U.S. MNCs. From a strategic perspective, there are several possible reasons – inconsistent with each other – why other countries might conceivably welcome GILTI’s enactment.<sup>161</sup> In particular:

(1) Suppose a country’s policymakers would prefer to have tougher CFC rules than they currently do, but regard themselves as constrained by tax competition, such as at the corporate residence margin. The U.S.’s enactment of a fairly tough CFC rule may make it easier for them to follow suit.

(2) Suppose that such policymakers want to engage in tax competition at the corporate residence margin, such as by offering weaker CFC rules than is the norm. Then they may view the U.S. enactment of GILTI as improving their relative position, whether or not they then choose to respond strategically.

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<sup>161</sup> The EU Finance Ministers’ letter, *supra* note 127, seems to criticize the Senate bill’s version of GILTI – which did not relevantly change before final enactment – but actually aims its fire in this regard entirely at FDII. This confusion may reflect the Senate bill’s integrated presentation of GILTI and FDII.

(3) Finally, suppose that such policymakers want cooperation from the United States with respect to discouraging profit-shifting at their expense by U.S. MNCs. Then they may welcome GILTI's enactment for reducing the payoff to such firms from such profit-shifting.

These alternative possibilities differ in how welcome they might be to U.S. policymakers. The first could help advance strategic cooperation between countries in reducing MNCs' profit-shifting generally. The second could adversely affect the United States, and reduce the GILTI rules' desirability. The third has mixed effects, as it might combine advancing strategic cooperation with unilaterally increasing U.S. MNCs' foreign tax liabilities. We may learn over time to what extent other countries are responding through emulation, such as the enactment of GILTI-like (or other tough) CFC rules, or instead by moving in the opposite direction.

#### D. FDII

##### 1. The Underlying Problem

FDII differs from the BEAT and GILTI in that it is a pro-taxpayer rule benefiting MNCs, rather than one imposing new tax burdens on them. Yet, despite this distinction, FDII can reasonably be viewed as deliberately complementing the other two rules, as part of a coherent (whether or not normatively persuasive) overall scheme.

FDII's interrelatedness with GILTI has been widely noted, and would be hard to miss given how the two provisions were intertwined as a drafting matter in the 2017 act. For example, both use the same QBAI / 10 percent deemed return concept (with FDII applying it to domestic assets), and the use of their special deductions to create or increase NOLs is jointly limited. The two rules' overlapping aim is to punish "foreign," and reward "domestic," high reported profits, whether this is a matter of substantive locational choices or merely of profit-

shifting. To this end, GILTI is a “stick” discouraging FSI, while FDII is a “carrot” that relatively encourages reporting domestic source income.<sup>162</sup>

There is also, however, a kind of complementarity with the BEAT’s intended effect of raising the effective tax rate on U.S. activity where related party transactions might otherwise allow it to drop too low (as judged from the Goldilocks framework). Against this background, FDII might be viewed as deliberately lowering the effective U.S. tax rate on domestic activity in selected instances where a Ramsey-style approach might support doing so (such as on the ground of suspected high elasticity).

Insofar as one views FDII as aimed at income from intangibles in particular – although, like GILTI, it does not essay the direct identification thereof – it naturally brings to mind patent boxes.<sup>163</sup> These are tax rules under which “income that is deemed to be associated with specified types of intangible property, such as that from patents, copyrights, and trademarks, may qualify for a special reduced tax rate.”<sup>164</sup> At one end of the spectrum, the underlying intent may be pure tax competition, aimed at luring reported profits (without regard to the location of any activity) by undercutting the tax rate that would apply to the same profits elsewhere. At the other end of the spectrum, patent boxes may reflect broader economic competition over the location of IP-related activity that is thought to generate positive local spillovers.<sup>165</sup> Unlike existing patent box regimes, however, FDII “provides a deduction for income arising from intangible assets other

<sup>162</sup> See, e.g., Linda Pfatteicher et al., *GILTI and FDII: Encouraging U.S. Ownership of Intangibles and Protecting the U.S. Tax Base*, BLOOMBERG LAW (Feb. 27, 2018), <https://www.bna.com/gilti-fdii-encouraging-n57982089387/>.

<sup>163</sup> See, e.g., Sullivan *supra* note 94; Sheppard, *supra* note 18.

<sup>164</sup> See Shaviro, *supra* note 55.

<sup>165</sup> As I have elsewhere noted, “the amount of actual domestic economic activity that must be associated with the low-rate income [qualifying for the special patent box rate] varies with the particular rule, and has recently been a topic of controversy in the European Union (EU), by reason of concerns about what some may view as ‘unfair’ tax competition.” *Id.* (citing Germany-UK Joint Statement, Proposals for New Rules for Preferential IP Regimes, November 2014, available online at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/373135/GERMANY\\_UK\\_STATEMENT.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/373135/GERMANY_UK_STATEMENT.pdf)). In any event, however, the empirical evidence regarding patent boxes’ effectiveness is mixed. Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013),

than patents and copyright software,”<sup>166</sup> in addition to its making no direct effort to identify income from intangibles as such.

## 2. FDII’s Main Mechanics

FDII generally allows U.S. corporations (although not RICs or REITs) a deduction for three-eighths (37.5 percent) of their “foreign-derived intangible income,” thereby effectively reducing the tax rate that applies to such income from 21 percent to 13.125 percent.<sup>167</sup> The special deduction does indeed appear to be mainly aimed at profits earned on exporting intangibles, whether via the sale of property or the receipt of royalties. Under our still largely origin-based system of income taxation, the income from such exports commonly qualifies as U.S. source – a result that, by reason of other changes in the 2017 act, may turn out in some circumstances to be harder than previously to avoid. However, FDII does not attempt direct observation or measurement of the income that U.S. companies derive from exporting intangibles. Instead, it infers this indirectly (or, at any rate, determines what income should benefit from the deduction) through a multi-stage computational process.

To illustrate FDII’s operation in intuitively salient strokes, rather than with technical precision, one can think of it as asking three successive questions. First, what is the taxpayer’s U.S. source income that *might* have been from exports? Second, what portion of such income actually *was* from exports? Third, what portion of the taxpayer’s income from exports should be deemed to have come from selling intangibles? The amount determined by answering the third question then gets the 37.5 percent FDII deduction.

1) What is the taxpayer’s U.S. source income that might have been from exports? – The statute’s technical term for what I call “U.S. source income that might have been from exports”

<sup>166</sup> See *EU Finance Ministers*, *supra* note 127.

<sup>167</sup> Starting in 2026, the FDII deduction is scheduled to be reduced to 21.875 percent. This would raise the effective corporate rate for qualifying FDII from 13.125 percent to 16.4025 percent.

is “deduction eligible income.” Its computation by a given U.S. taxpayer involves two conceptually distinct steps. The first is to subtract from its global taxable income all of the main categories of FSI.<sup>168</sup> Second, one also reduces the measure by one’s U.S. source financial services income, and one’s domestic oil and gas extraction income.<sup>169</sup>

2) What portion of such income actually was from exports? – The statute’s technical term for what I call “income that actually was from exports” is “foreign-derived deduction-eligible income.” This generally is the amount of the taxpayer’s deduction-eligible income that is derived in connection with selling property or services to a foreign person for foreign use.<sup>170</sup>

To illustrate these computations in a very simple example, suppose that Acme-US has \$100X of deduction-eligible income, of which \$40X of it comes from exports. As we will see next, it will prove relevant both that Acme-US’s foreign-derived deduction-eligible income totals \$40X, and that this amount is 40 percent of its deduction-eligible income.

3) What portion of the taxpayer’s income from exports should be deemed to have come from exporting intangibles? – FDII uses the same mechanism as GILTI to back out deemed returns from using tangible property, thereby indirectly identifying the residual, presumptively from intangibles, that gets the deduction.<sup>171</sup> To this end, a U.S. company that may benefit from FDII determines its QBAI, which generally equals the sum of the adjusted tax bases of all of the tangible assets that it uses in trades or businesses in the United States. It then computes the 10

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<sup>168</sup> More specifically, one starts with the taxpayer’s global gross income, and subtracts from it all gross income from subpart F, GILTI, foreign dividends (which have not, at this stage, been reduced by the 100 percent dividends received deduction for their FSI content), and foreign branch income. One then attributes to this FSI all of the deductions that are properly allocable to it. I.R.C. § 250(b)(3).

<sup>169</sup> § 250(b)(3)(A)(i)(III); (V).

<sup>170</sup> § 250(b)(4).

<sup>171</sup> However, under FDII being presumptively from intangibles is good for the taxpayer, rather than bad as under GILTI. It means that one gets the deduction for income that is includable in any event, whereas under GILTI the deduction serves only to mitigate includability that is by reason of being deemed to come from intangibles.

percent deemed return on QBAI, which is deemed to have been split pro rata between domestic and foreign sales.

To illustrate, suppose that Acme, in addition to having \$100X of deduction-eligible income that is 40 percent from exports, also has QBAI in the amount of \$200X. The 10 percent deemed return on the QBAI is \$20X. Of that amount, 40 percent, or \$8X, is deemed to have related to Acme's exports. Therefore, the amount of Acme's income from exports that presumptively involved intangibles, and therefore qualifies for the FDII deduction, is reduced by \$8X, to \$32X. Acme's FDII deduction is therefore \$12X (i.e., 37.5 percent of \$32X). At a 21 percent corporate rate, this reduces Acme's U.S. tax liability by \$2.52X.<sup>172</sup>

Policing the Border – One of the key problems faced by FDII is what, in the context of destination-based VATs, is sometimes called that of “policing the border.” If one is treating domestic sales differently than exports, one needs to be able to tell them apart. Under a VAT, for example, amounts received by a domestic producer from foreigners on exports are not included. However, it is also the case under a VAT – lacking a parallel under FDII – that amounts paid to foreigners for imports are not deductible. In this sense, VATs treat imports and exports symmetrically, ignoring cross-border cash flows in both directions with the aim of consistently taxing domestic consumption.

FDII's lack of requisite symmetry potentially opens the door to tax planning opportunities not presented by a destination-based VAT – for example, involving what is called “round-tripping.” To illustrate, suppose that, in the absence of FDII, a U.S. company would sell a widget to a U.S. unrelated party, generating taxable income of \$1,000, and therefore incurring a \$210 U.S. tax liability. If the company instead sold the widget to a foreign unrelated party for

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<sup>172</sup> As noted above, the FDII deduction, like that for GILTI, cannot be used to create or increase a current year NOL. This may raise design issues similar to those discussed above with respect to GILTI

\$1,000, generating a FDII deduction of \$375, its U.S. tax liability would decline by \$78.25 (to \$131.25), whereas there would be no U.S. (and perhaps no foreign) income tax consequences to the foreign party's then reselling the widget to the U.S. unrelated party.

One might initially think that this problem is even worse under a VAT than under FDII, since sales to foreigners are not taxed at all. In fact, however, a well-functioning VAT's symmetric treatment of exports and imports actually eliminates the round-tripping problem – other than if there is fraud, or in special cases caused by, say, zero-rating particular commodities or taxpayers. With export-import symmetry, round-tripping offers U.S. taxpayers no net advantage, under a VAT, from engaging in the above transaction. The exporter receives \$100 and pays no VAT, while the importer pays \$100 and gets no VAT credit. Thus, the two U.S. parties, considered together, have not just a zero net cash flow, but zero net (as well as gross) tax consequences under the VAT. This stands in sharp contrast to the case under FDII, where, as noted above, the exporter saves \$78.25 and the importer faces no detriment.

FDII addresses round-tripping by requiring that foreign use, the precondition for having foreign-derived deduction-eligible income that can benefit from the 37.5 percent deduction, be “establishe[d] to the satisfaction of the Secretary” of the Treasury. In the above example, immediate, pre-planned re-importation of the widget would presumably prevent any such satisfaction from arising, at least if properly comprehended by the Internal Revenue Service.

However, the 2017 act's conference report suggests that this adverse result can be avoided by having the foreign intermediary do just enough to avoid being merely a conduit. It states that, “[i]f property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing ... outside the

United States by such person, then the property is for a foreign use.”<sup>173</sup> Round-tripping therefore works, for FDII purposes, so long as just enough happens outside the United States before the item at issue is re-imported.

Two specific statutory rules in FDII further address the statutory definition of an export that qualifies for the 37.5 percent deduction. The first pertains to “domestic intermediaries,”<sup>174</sup> and the second to foreign related parties.<sup>175</sup> Each, however, is best understood in terms of the border issues raised by an export subsidy.

Rule for domestic intermediaries – Under FDII, “[i]f a taxpayer sells property to ... [an unrelated party] for further manufacture or other modification within the United States, such property shall not be treated as sold for a foreign use even if such person subsequently uses such property for a foreign use.”<sup>176</sup> Read precisely as written, this verges on being gibberish, and appears to have little if any realm of possible application.<sup>177</sup> However, at least two commentators have assumed that it should be read as if its last-quoted words were: “even if such person subsequently *sells* such property for a foreign use.”<sup>178</sup>

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<sup>173</sup> See H.R. REP. NO. 115-466, at 497 n.1522 (2017) (Conf. Rep.). “Other processing” that so qualifies “includ[es] the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly.” *Id.*

<sup>174</sup> I.R.C. § 250(b)(5)(B).

<sup>175</sup> § 250(b)(5)(C).

<sup>176</sup> § 250(b)(5)(B)(i). There is a parallel rule for services. § 250(b)(5)(B)(ii).

<sup>177</sup> Since only sales to a foreign person can qualify under FDII, the contemplated situation, under the provision’s literal words, appears to be a sale to the unincorporated U.S. branch of a foreign person, which then manufactures or modifies the property within the U.S., before shifting the property abroad in order to engage in its own foreign use of the property. One imagines this would be an extremely rare situation. The 2017 conference committee report then adds to the confusion by irrelevantly repeating language from the separate FDII rule for related party transactions. See H.R. REP. NO. 115-466, at 497 (2017) (Conf. Rep.). This sentence is immediately followed by a footnote that, as I discuss below, may have some bearing on the provision as evidently intended, but not as actually drafted. See *id.* at 497, n.1523.

<sup>178</sup> See LOWELL D. YODER, DAVID G. NOREN & JONATHAN LOCKHART, MCDERMOTT, WILL & EMERY, THE NEW DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME 3 (2018), <https://www.mwe.com/en/thought-leadership/publications/2018/01/the-new-deduction-for-foreign-derived-intangible> (quoting the provision as written, but suggesting that it be avoided by “hiring the domestic manufacturer to finish the goods on a consignment manufacturing basis, and then *the taxpayer* can sell the finished goods for foreign use” (emphasis added); BAKER MCKENZIE, THE TAX CUTS AND JOBS ACT 20 (2017), <https://www.bakermckenzie.com/-/media/files/insight/publications/2017/12/client-alert--us-tax-reform--the-tax-cuts-and-jobs-act-congress->

Thus effectively rewritten, the provision makes a coherent contribution to FDII interpretation, by clarifying that only the actual seller of property for foreign use, as distinct from unrelated parties that owned the property earlier in the productive process, can claim the deduction. While this seems plausible as a matter of legislative intent – for example, in light of the statutory heading’s reference to “domestic intermediaries”<sup>179</sup> – theories of statutory interpretation may differ as to whether or not one can get there, given the apparent drafting error.<sup>180</sup>

Rule for foreign related parties – In general, the sale of property to a foreign related party, such as a corporate affiliate of the U.S. taxpayer, does not qualify for the FDII export subsidy, even if the related party then uses the property abroad. Accordingly, sales to foreign affiliates are effectively disfavored relative to sales to third parties. (I discuss possible rationales for this below.) However, such a sale can so qualify if the property is “ultimately sold” by the foreign related party to an *unrelated* foreign party that then makes the requisite foreign use of the property.<sup>181</sup> Accordingly, where the ultimate user is an unrelated foreign party, one need not take care to structure the sale so that the U.S. affiliate makes it directly.

### 3. Assessment

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[passe.pdf?la=en](#) (“Essentially, a sale of products or services to an unrelated US intermediary will not qualify as foreign-derived deduction eligible income even if that intermediary on-sells to a foreign person for a foreign use.”).<sup>179</sup> Its plausibility as a matter of intent is further aided by the misplaced footnote in the Joint Explanatory Statement which states: “In other words, the fact that a component is included in a piece of property that is eventually sold for a foreign use is insufficient for the sale of the component to be considered for a foreign use.” H.R. REP. NO. 115-466, at 497 n.1523 (2017) (Conf. Rep.). This, too, is sloppily written. It probably shouldn’t say “In other words” given that the example of component inclusion is only instance of further U.S. manufacture or modification, rather than being coextensive with it. Also, the word “insufficient” seems poorly chosen, as it implies that additional facts might support a finding of foreign use, whereas in the provision as rewritten requisite foreign use apparently *cannot* be established. Nonetheless, it does give an example of sale to an unrelated U.S. person that then on-sells the modified property to a foreign person for foreign use.

<sup>180</sup> The result yielded by this interpretation of the provision seems likely to follow, at least in most cases, even if one deems the drafting error to be binding. Even without the provision, upstream U.S. producers that sell to downstream U.S. producers that modify the products before exporting must establish both foreign use and sale to a foreign party.

<sup>181</sup> I.R.C. § 250(b)(5)(C)(i)(I). There is also a parallel rule for services. § 250(b)(5)(C)(ii).

Of the three new international tax provisions discussed in this paper, FDII is the hardest to defend, even under the low bar of demanding only that it respond meaningfully, and not entirely unreasonably, to important tradeoffs that lack clear answers. However, if FDII earns a failing grade even under that forgiving standard, this is largely a function of how in particular it was implemented. Some of its apparent aims could have been pursued in more defensible ways. I therefore start by examining two possible rationales for a hypothetical, somewhat FDII-like rule that advanced such aims by alternative means.

Rationale #1: patent box – Given that FDII is “patent box-like,”<sup>182</sup> in that it treats intangible income favorably in the hope of attracting IP firms’ reported profits or actual substantive activity to the United States, it is worth noting that patent boxes can reasonably be defended (whether or not one ultimately favors them). Peter Merrill, for example, notes both that “lower taxation of patent income may be justified by the Ramsey principle” if it is unusually mobile,<sup>183</sup> and that U.S. policymakers might want to make the United States more appealing to IP firms as a residence jurisdiction and/or a situs for manufacturing operations.<sup>184</sup> Patent boxes can potentially advance these aims, although Michael Graetz and Rachel Doud discern a “lack of convincing evidence about the[ir] effectiveness”<sup>185</sup> in encouraging local IP activity.

While these rationales may not be wholly inapplicable to FDII, the problem with relying on them too strongly is that it isn’t actually a patent box. In this respect, arguably the key departure isn’t so much its eschewing the effort to identify IP income directly (which presents an administrative tradeoff if direct identification is difficult), as its focusing on exports. Existing patent boxes generally do not do this. Thus, while subject to potential challenge as “harmful

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<sup>182</sup> Sullivan, *supra* note 94.

<sup>183</sup> Peter Merrill, *Innovation Boxes: BEPS and Beyond*, 69 Nat’l Tax J. 847, 857 (2016).

<sup>184</sup> *Id.* at 858–59.

<sup>185</sup> Graetz and Doud, *supra* note 165.

preferential tax regimes” under OECD standards,<sup>186</sup> they have generally been immune from any WTO challenge as illegal export subsidies.

This distinction matters, not only because WTO violations have concrete legal consequences, but also under the view that engaging in “harmful” or “unfair” tax competition is more likely to be unilaterally beneficial than subsidizing exports. Thus, viewing FDII as unfair tax competition would not immediately contradict viewing it as unilaterally optimal. Export subsidies, by contrast, do not need to draw return fire from other countries in order to fail by this criterion.

Under the classic view of free trade, one generally should engage in it even if other countries are not doing so. As the economist Joan Robinson reportedly put it, “[e]ven if your trading partner dumps rocks into his harbor to obstruct arriving cargo ships, you do not make yourself better off by dumping rocks into your own harbor.”<sup>187</sup> This argument is most intuitive when applied to rebut protectionism, such as through the imposition of import tariffs. However, it equally applies to mercantilism, such as subsidizing exports. Indeed, given that exports are traded for imports over the long run, import tariffs and export subsidies are effectively the same in this regard.<sup>188</sup> This suggests that one need not invoke strategic considerations, such as the threat of WTO sanctions, in order to conclude that FDII’s export subsidy is bad policy.

A particular administrative problem that export subsidies almost inevitably raise relates to round-tripping, as in the widget example that I discussed above. In a sense, all exports are ultimately round-tripped, i.e., exchanged for imports. All that makes the widget example distinctive is its involving an export and import of the same or a closely related item, presumably

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<sup>186</sup> See Merrill, *supra* note 183, at 860.

<sup>187</sup> This particular paraphrase of Robinson’s reported observation is in LAWRENCE H. WHITE, *THE CLASH OF ECONOMIC IDEAS* 360 (2012).

<sup>188</sup> See, e.g., D.J. Horwell, *On Export Subsidies and Import Tariffs*, 33 *ECONOMICA* 472 (1966).

close together in time. But even if one can explain why an especially close relationship between a given export and an import should make the allowance of an export subsidy worse than it generally is, one still faces the administrative and line-drawing question of how to define and identify impermissible round-tripping in practice. This leads to complexity and distortions that might be more tolerable, as part of a tradeoff, if the underlying policy made more sense to begin with.

Rationale #2: broader problems in defining source – FDII’s export subsidy might also be viewed as an attempt to rationalize, without necessarily worsening, implicit export subsidies under prior U.S. international tax law. As background, a country with an origin basis income tax should in principle tax all domestic production, including that which is exported. However, it need not tax resident taxpayers’ foreign production that yields FSI. Suppose, however, that exports can in practice distinctively be labeled as producing FSI that avoids domestic taxation either explicitly or (under pre-2017 U.S. law) by reason of one’s exploiting deferral. Then one may have an export subsidy in fact, whether or not it is legally detectable and sanctionable through the use of tools such as WTO litigation.

Pre-2017 U.S. international tax law made this possible through multiple mechanisms. For example, one could treat an export that reflected domestic production as giving rise to FSI, by causing the passage of legal title to occur abroad.<sup>189</sup> Likewise, a U.S. multinational that was domestically creating valuable IP that it expected to trigger worldwide sales could use the cost-sharing rules, under IRS transfer pricing regulations, to cause the profits from foreign sales to yield FSI that was treated as earned by its CFCs. Indeed, creation of the IP, insofar as it

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<sup>189</sup> See I.R.C. § 861(a)(6); § 862(a)(6); Treas. Reg. 1.861-7.

pertained to subsequent exporting, could be treated as occurring abroad even if all of the development work was done in the United States by employees of the U.S. affiliates.<sup>190</sup>

The 2017 act eliminated the title passage rule, requiring instead that the locus of production generally determine source.<sup>191</sup> In addition, it augmented Treasury discretion to override adverse judicial precedents regarding the cost-sharing rules.<sup>192</sup> It thus might be viewed as substituting an express export subsidy, under FDII, for these implicit versions that create various arbitrary tax planning incentives on their own.

FDII might therefore be defended as no worse in principle than features of prior law that were apparently WTO-permissible. Suppose, moreover, that it turns out to be less distortionary overall than the prior law export subsidies, and that straight-out repeal of those provisions, without any replacement, would have been politically unfeasible. Then one might actually have a defense, of a sort, of FDII, albeit one that is very politically second-best. Yet even this defense runs into strategic objections if FDII is more vulnerable than the rules it replaced to retaliation by foreign governments.

Likely WTO violation – Article 3 of the Agreement on Subsidies and Countervailing Measures (the SCM), which is part of the WTO, bars subsidies that are contingent, in law or in fact, upon export performance.<sup>193</sup> FDII clearly violates this, by causing exports to be taxed at a 13.125 percent rate, in lieu of the generally applicable 21 percent corporate rate. Accordingly,

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<sup>190</sup> See Alstott et al, Ninth Circuit Amicus Brief of 19 Tax Law and Administrative Law Professors, *Altera v. Commissioner*, Nos. 16-70496, 16-70497 (2016), available online at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2805432](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805432).

<sup>191</sup> See § 863(b); H.R. REP. NO. 115-466, at 502–03 (2017) (Conf. Rep.).

<sup>192</sup> See I.R.C. 936(h)(3)(B). More broadly, the US source rules have an incoherent mix of origin-basis and destination-basis source rules, which may result in export subsidies when the latter are used in particular instances while taxing domestic production remains the general rule.

<sup>193</sup> Agreement on Subsidies and Countervailing Measures, art. 3, Marrakesh Agreement Establishing the World Trade Organization annex 1A, Apr. 15, 1994, 1869 U.N.T.S. 14.

“there is little doubt that ... [it] is [a] prohibited subsidy in violation of the SCM.”<sup>194</sup> It thus entitles U.S. trading partners to respond by imposing sanctions.<sup>195</sup>

This has happened multiple times before. Prior U.S. export subsidies, known as DISC, FSC, and ETI, succeeded each other in the 1970s through the early 2000s, in each case being held a WTO violation that caused Congress to recede and try again until finally, in 2004, it gave up altogether.<sup>196</sup> The only real questions this time are, first, how long it will take for the WTO to decide against FDII, and, second, whether the United States will recede again. While trading partners could respond by adopting retaliatory tariffs that are designed to maximize the U.S. political pain, it is conceivable that the United States would respond by instigating a major clash with its WTO trading partners, potentially triggering a broader trade war, if there is not already one in progress when the FDII verdict comes down.<sup>197</sup> In the interim, taxpayer uncertainty about FDII retention and/or the consequences of its drawing WTO sanction may significantly influence behavior.

Policing the border and discouraging round-tripping – As noted above, an export subsidy that treats exports and imports asymmetrically creates administrative challenges that reflect the underlying opacity of what exactly might be the underlying purpose. Undesired round-tripping is hard, not just to detect, but even to define. Broader line-drawing choices similarly resist coherent analysis and resolution.

Thus, consider the suggestion in the 2017 act’s conference report that one can engage in tax-effective round-tripping, so long as the foreign intermediary does just enough to avoid being

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<sup>194</sup> Reuven S. Avi-Yonah and Martin G. Vallespinos, *The Elephant Always Forgets: US Tax Reform and the WTO* (Jan. 28, 2018) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3113059](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3113059), at 6.

<sup>195</sup> *Id.*

<sup>196</sup> *See id.* at 6-8. In 2004, Congress replaced ETI with a domestic manufacturing subsidy (repealed in 2017) that did not violate the SCM as it was not contingent on export performance. *See id.* at 8.

<sup>197</sup> *See id.* at 10-11.

treated as a conduit.<sup>198</sup> This is a recipe for otherwise pointless overseas economic activity. Likewise, consider the rule for domestic intermediaries (assuming that it can be made coherent by ignoring the drafting error).<sup>199</sup> It is not clear why only the last independent party in a multi-stage production process should get the export subsidy, thereby creating tax-driven incentives for otherwise inefficient vertical integration of domestic production for ultimate export.<sup>200</sup> Finally, consider the denial of FDII benefits upon the sale of property or services to a foreign related party. While perhaps there is concern here that, for tax planning reasons, the transfer price is likely to be understated (already creating a kind of intra-group export subsidy), the consequence may be to discourage cross-border vertical integration that would be economically efficient.

Defects shared with GILTI – FDII also shares several defects with GILTI, albeit in the pursuit of aims that are harder to rationalize. Under FDII no less than GILTI, the NOL limitation on allowable deductions disfavors taxpayers with volatile earnings, and can induce otherwise pointless timing-related tax planning that aims at self-smoothing. Likewise, the use of QBAI with a 10 percent deemed return can have anomalous tax planning consequences where this differs from the expected return. Low-return domestic QBAI reduces the FDII deductions that would otherwise be available with respect to one’s exports. Tax planning responses might include, for example, transferring one’s lower-return domestic tangible assets to be used by one’s foreign affiliates (which GILTI likewise encourages), and spinning off one’s lower-return domestic assets so that they are held by non-exporters. And again, the efficiency costs of all this might be easier to view tolerantly if the positive arguments for FDII were stronger.

#### IV. CONCLUSION

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<sup>198</sup> See *supra* note 173 and accompanying text.

<sup>199</sup> See *supra* note 174 and accompanying text.

<sup>200</sup> There would not be a “reverse cascading” problem if each party got the FDII subsidy just for its share of the profit.

2017 was supposed to be the year in which the United States would adopt a territorial tax system, if major tax legislation actually transpired. Instead, it became the year in which deferral was repealed, but only in combination with current taxation of U.S. MNCs' FSI being significantly expanded. Thus the prior-law approach of taxing such FSI *now or later* – albeit, with “later” potentially being just hypothetical – became that of taxing it *now or never*, but with post-enactment FSI from the newly eliminated “later” category being split between the two surviving forks. This was a promising direction of change, given how deferral not only distorted U.S. firms' internal capital markets, but gave undue tax planning importance to expectations regarding future repatriation tax rates.

A core problem in attempting to design an improved U.S. international tax system is that many of the important choice parameters are hard to resolve crisply or confidently. Even in a purely unilateral setting, where one ignores how other countries might respond, the important issues often have a Goldilocks character, in which it is hard to define the adjoining categories of “too hot,” “too cold,” and “just right.” Any effort to assess strategic considerations can make the analysis harder still.

The key parameters that the international provisions in the 2017 act addressed, in one way or another, include at least the following:

Effective tax rate on U.S. source income earned by MNCs – At a 21 percent corporate tax rate, no less than at a 35 percent rate, a question arises as the tax burdens to be faced by MNCs, as distinct from purely domestic companies. MNCs' profit-shifting opportunities may permit them to face significantly lower effective tax rates than purely domestic companies, potentially leading to undesired base erosion. However, even apart from the costliness of combating profit-shifting (inevitably inaccurately, given the difficulty of defining the “true” source of income), one

may conceivably want to let MNCs lower their effective tax rates on domestic source income, relative to the rates faced by purely domestic companies, on the view that they are unusually mobile in multiple dimensions.<sup>201</sup> In practice, one may view MNCs' effective rates as being either too low or too high, although the grounds supporting either judgment remain poorly specified.

In the 2017 tax act, the BEAT appears to address too-low effective tax rates that MNCs may enjoy, in particular by reason of transfer pricing. FDII addresses the concern that highly profitable U.S. activity, including that in relation to intangibles, might be overtaxed, given its presumed mobility, in the absence of a targeted rate reduction. GILTI addresses this same concern indirectly, by raising the tax rate for reported FSI that might reflect profit-shifting.

Profit-shifting by resident versus non-resident MNCs – In principle, absent pertinent firm-level differences, one presumably would want to address profit-shifting by resident and nonresident MNCs with the same degree of stringency (be it high or low). However, if we assume a greater ability to target particular categories of FSI with respect to resident than nonresident MNCs, and that such targeting is desirable due to an underlying distinction between relatively “good” and “bad” FSI, then a tradeoff emerges. Use of the superior tool as to resident MNCs may support more robustly challenging their profit-shifting (e.g., indirectly, via CFC rules) but comes at the price of giving nonresident MNCs an undesired competitive advantage with respect to U.S. investment.

Under the pre-2017 act U.S. international tax regime, U.S. MNCs may have been excessively disfavored in this regard, relative to foreign MNCs, independently of whether the

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<sup>201</sup> For example, MNCs may be unusually mobile in where they raise funds, where they engage in economic activity, and where they report profits as arising.

overall response to profit-shifting was too strong or too weak.<sup>202</sup> The 2017 act improved U.S. MNCs' relative position by enacting dividend exemption, worsened it by enacting GILTI, and appears to have at least aimed at improving it via the BEAT.

Taxing resident MNCs' FSI – Countries may have good reason to tax resident MNCs' FSI at a rate that lies between zero and the full domestic rate, and/or to focus on taxing “bad” FSI. Bad FSI, in turn, tends to be defined in terms of its being highly mobile, supporting the surmise that it will end up in a tax haven, and/or its actually being observed to bear low foreign taxes. Observed foreign-to-foreign tax planning may also support an identification of “bad” FSI that appears likely to end up in a tax haven.

The underlying rationale for taxing “bad” FSI presumably relates to its being deemed associated with “excessive” domestic base erosion, given that paying higher rather than lower foreign taxes does not directly serve unilateral national welfare in any obvious way. The 2017 act addressed this concern via GILTI. Under prior U.S. international tax law, while subpart F was clearly aimed at tax haven FSI, deferral was in effect indiscriminate between different categories of FSI, unless perhaps if they differed in how conveniently they could remain indefinitely unrepatriated.

Marginal reimbursement rate for foreign taxes – In a simple unilateral model, the optimal MRR for foreign taxes is zero, given that “the return to [any] country includes taxes paid to the country and not taxes paid to ... [another] country.”<sup>203</sup> Moreover, the most obvious U.S. strategic rationale for offering 100 percent MRRs via foreign tax credits – inducing peer countries to do the same with respect to U.S. income taxes paid by their MNCs – has been greatly weakened by such countries' reduced reliance on foreign tax creditability to address concerns about double

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<sup>202</sup> See Shaviro, *supra* note 41, at 1709.

<sup>203</sup> Slemrod, *supra* note 53, at 479.

taxation. However, the analysis becomes more complicated once one recognizes that low-taxed FSI may be viewed as systematically associated with undesired domestic base erosion. Treating low-taxed FSI less favorably than high-taxed FSI may (directly or indirectly) cause particular foreign taxes paid to have effective MRRs that exceed the marginal tax rate on the associated income, and that may potentially even exceed 100 percent. In general, it seems highly unlikely that MRRs as high as 100 percent (let alone, higher than that) will be unilaterally optimal, as they eliminate resident MNCs' cost-consciousness with respect to foreign taxes paid.<sup>204</sup>

In the 2017 act, GILTI makes foreign taxes better than deductible, although without eliminating resident MNCs' cost-consciousness, in the base case where they offer an 80 percent MRR. Foreign taxes may also, however, be worse than deductible under GILTI where they cannot be claimed even though the associated income is being taxed at a 10.5 percent rate.

Margins not addressed by the 2017 act – While, in each of the above respects, the 2017 act (for better or worse) addressed an important parameter in international tax design, this is not to assert that it left out nothing important. For example, Rebecca Kysar argues that the act's failure to address U.S. law's basing corporate residence determinations purely on the place of incorporation was a serious error, given this factor's manipulability.<sup>205</sup> She likewise criticizes the act for not shifting towards greater reliance on destination-based source rules, which may generally be less avoidable than origin-based rules.<sup>206</sup>

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<sup>204</sup> Shaviro, *supra* note 41, at 1707.

<sup>205</sup> See Rebecca Kysar, Judging the New International Tax Regime: Testimony Before the U.S. Senate Committee on Finance 15 (2018), available online at <https://www.finance.senate.gov/download/04242018-kysar-testimony> .

<sup>206</sup> *Id.* See also Daniel Shaviro, *Goodbye to All That? A Requiem for the Destination-Based Cash Flow Tax*, 72 BULLETIN FOR INT'L TAXATION (forthcoming, 2018), for a discussion of proposals that would have placed U.S. business taxation entirely on the destination basis.

With all this in mind, how might one assess the BEAT, GILTI, and FDII assuming the reasonableness of their underlying objectives, and how might their current structures most fruitfully be modified? My main conclusions in this regard include the following:

The BEAT – Supporters of the BEAT appear to be few though fervent, while its critics are many. Yet it probably is here to stay, given not only its projected ten-year revenue yield of \$150 billion<sup>207</sup> but its raising revenue from foreign MNCs, rather than just those that are U.S. residents. This may be both a political virtue, if foreign MNCs generally have fewer friends in Washington than their domestic peers, and a policy one, if one wants to avoid overly focusing one's anti-base erosion efforts on the latter group. Thus, whatever one's ultimate bottom line judgment, it is perhaps most realistic to ask how the BEAT might best be adapted, rather than whether or not it ought to have been enacted to begin with.

The BEAT's wide-ranging controversiality surely reflects its leaning towards administrability at the expense of attempting accurate income measurement, via its seemingly presuming that purchases by U.S. from foreign affiliates should be treated as having transfer prices as zero. This adverse appearance is also heightened by its minimum tax character, which seemingly nominates modified taxable income, its denominator for applying a 10 percent rate, as an (obviously ill-chosen) stand-in for true economic income. The BEAT's appearance in this regard might be less jarring if it were overtly structured as an excise tax, or as partial deduction disallowance for the intra-group payments that it classifies as base erosion tax benefits.<sup>208</sup> But this would still leave open the question both of what sorts of effective tax rates it generally was

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<sup>207</sup> JOINT COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE "TAX CUTS AND JOBS ACT," JCX-67-17, at 7 (2017).

<sup>208</sup> This might raise treaty compatibility issues, which I ignore for present purposes in order to emphasize the conceptual point about alternative provisions that substantively may function like excise taxes.

imposing, relative to U.S. source economic income, and of whether such effective rates were too high, too low, or just right.

A more gratuitous problem with the BEAT, in the sense of its deriving from design choices that were not similarly inherent to its basic conception, involves its being so harsh yet avoidable. On the one hand, it sometimes may really impose 10 percent gross basis taxation at the margin. On the other, it offers multiple avenues, of varying gratuitousness, for avoiding its reach altogether.

In particular, its 3 percent rule for “base erosion tax benefits” versus total deductions combines the lack of any good rationale with discontinuous notch effects and the creation of broad tax planning horizons. The \$500 million average annual gross receipts threshold has a more plausible rationale, in terms of exempting small companies, but combines notch and tax planning effects with arguably being set too high. Finally, the rationale for its excluding the cost of goods sold may be no stronger than that for excluding other items that it instead includes.

Suppose that one (a) eliminated the 3 percent rule, (b) greatly lowered the \$500 million annual threshold, (c) eliminated the cost of goods sold exclusion, and (d) lowered the BEAT’s tax rate sufficiently to make the overall set of changes revenue-neutral on balance. Perhaps better still, suppose one replaced (d) with converting it, still on a revenue-neutral basis, into an excise tax or partial deduction disallowance for base erosion tax benefits. This might be a significant improvement, at least by reason of its smoothing out the current combination of harshness and avoidability.

GILTI – Like the BEAT, GILTI seems, for better or worse, a vital part of the 2017 package, given both its estimated ten-year revenue yield (\$112 billion) and its replacing deferral as a means of discouraging base erosion by U.S. companies. Once again, whatever its ultimate

merits, in light of the various Goldilocks issues that impede reaching firm international tax policy judgments, its structure could surely be improved in some respects. Suppose, for example, that, among other changes,<sup>209</sup> one (a) lowered the 10 percent deemed return on QBAI, perhaps substituting a measure that varied with observed market interest rates, (b) changed its foreign tax credit rules to be per-country rather than worldwide, but in other respects more forgiving (such as with respect to carryovers, and (c) adjusted its 50 percent deduction rate, and/or its 80 percent foreign tax credit rate, such that the overall set of changes was revenue-neutral.<sup>210</sup> Once again, this might constitute modest structural improvement, without greatly changing the underlying policy judgments.

FDII – It is harder to be enthusiastic about any particular set of FDII changes short of repeal (although, as under GILTI, one might want to modify the 10 percent deemed return on tangible assets). If one still wanted a “carrot” for domestic IP activity, to accompany GILTI’s “stick,” a logical choice would be to replace FDII with a more typical patent box-type structure that did not operate via a WTO-violating, as well as unilaterally unwise, export subsidy.

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<sup>209</sup> Again, the NYSBA Report, supra n. 17, offers a comprehensive account of other technical problems with GILTI, including the provision’s not (at least clearly) treating all affiliated CFCs as a single corporation for purposes of various GILTI calculations, with the consequence that, when a U.S. MNC has loss as well as gain CFCs, particularities of its business structure can have arbitrary effects on its GILTI liability.

<sup>210</sup> In addition, as noted earlier, one might allow excess GILTI deductions that were lost because otherwise they would have created or increased NOLs, to be carried over to other taxable years.

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