

SPECIAL REPORTS

Territoriality in Search of Principles and Revenue: Camp and Enzi

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I. Introduction

In October 2011 House Ways and Means Committee Chair Dave Camp, R-Mich., published a discussion draft proposal to shift the United States from its cur-

rent system of deferring U.S. taxation of active foreign income earned through a foreign corporation to substantially exempt that income from U.S. tax. In February 2012 Senate Finance Committee member Michael B. Enzi, R-Wyo., released a more limited exemption proposal as S. 2091.

Publication of these proposals moves the discussion of an exemption or territorial system from broad descriptions of design features to legislative language for specific provisions.¹ Camp has also promised a more comprehensive reform of individual and business taxes, including individual and corporate tax rate reductions to top rates

¹Prior proposals to exempt foreign business income have been prepared by the staff of the Joint Committee on Taxation and President Bush's Advisory Panel on Federal Tax Reform. JCT, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, at 191 (Jan. 27, 2005); President's Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System," at 240 (Nov. 1, 2005). Neither proposal was developed to the point of draft statutory language. President Obama has proposed establishing a new minimum tax on foreign earnings to encourage domestic investment, but the proposal lacks details. See White House and Treasury Department, "The President's Framework for Business Tax Reform," at 12 (Feb. 22, 2012).

of 25 percent, and unspecified provisions to broaden the tax base to pay for these rate reductions.²

We believe that it does not make policy sense for Congress to undertake significant international business tax reform independently from related changes to corporate, shareholder, and business passthrough taxation. Changes in the taxation of domestic business income earned through domestic corporations and passthrough entities, as well as the taxation of shareholders (in domestic and foreign corporations), would critically affect decisions regarding where and how to invest and carry on business. Of course, international tax rules do not operate in a vacuum and are only one important part of the overall tax structure; reforms must be evaluated in relation to the effects on economic activity of the income tax as a whole as well as its parts.³ We nonetheless review these proposals in their current form to understand how they would structurally change U.S. tax law.

The major contributions of the Camp proposal lie in its recognition of the need to make the treatment of foreign branches and foreign subsidiaries more neutral, and to protect the U.S. tax base from excess interest deductions and the base-eroding incentives of very low foreign tax environments that stimulate U.S. income shifting. These improvements over current law would not outweigh the material weaknesses of the proposal, which include (1) providing exemption from U.S. corporate tax for foreign income not subject to any foreign tax, (2) underallocation of expenses to exempt income, (3) material loopholes in the antiabuse rules for protecting the U.S. tax base, (4) an apparent failure to tax gain on transfers of appreciated assets into the exemption regime, (5) foreign tax credit changes that would result in additional erosion of the U.S. tax base, and (6) a misguided proposal for a reduced tax rate on royalties earned from foreign persons. The Enzi proposal has similar weaknesses while lacking the strengths of the Camp proposal.

²On January 24, 2013, Camp released a second discussion draft on the taxation of financial products, and on March 12, 2013, Camp released a third discussion draft on the taxation of small businesses and passthrough entities. Those proposals do not include provisions that would increase revenues in amounts necessary to reduce either corporate or individual tax rates to 25 percent on a revenue-neutral basis.

³See Jane G. Gravelle, "Reform of U.S. International Taxation: Alternatives," Congressional Research Service, at 19-20 (Dec. 17, 2010). If Congress had no intention of reforming related corporate or individual provisions, we could support either less fundamental tax reform legislation in the directions described later in this article or more fundamental international reforms in the directions we have described in our earlier writings. See, e.g., Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 *SMU L. Rev.* 455 (1999). We would, of course, update earlier proposals to take into account changes in circumstances and in our thinking about relevant issues.

In a recent article, we described how a principled exemption system should be designed to protect the U.S. tax base.⁴ It would be possible to modify the Camp and Enzi proposals to address their weaknesses in ways consistent with a principled exemption system. We recognize that those changes would make them unattractive to many in the multinational corporate community; however, that likely is true of any exemption system that would be a material improvement over current law. Unless a shift to an exemption system would constitute a material improvement over current law, the likely revenue losses from and transition costs of such a change would outweigh the benefits. If it is impossible to make progress on comprehensive tax reform, elements of the Camp and Enzi proposals that would improve aspects of current law, or that if modified would do so, could be pursued independently in legislation adopting important but more incremental tax law changes.⁵

II. The Proposals

A. Camp Proposal

The centerpiece of the Camp proposal is a deduction for 95 percent of dividends received out of foreign business income from controlled foreign corporations, or from some foreign corporations treated as CFCs, by domestic C corporations that qualify as 10 percent U.S. shareholders and that satisfy a greater-than-one-year holding requirement.⁶ The effect of the deduction is to

⁴See Fleming, Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty," 13 *Fla. Tax Rev.* 397 (2013). In contrast, this report primarily evaluates the Camp and Enzi proposals against current law.

⁵We do not in this report consider which incremental changes could be effected by regulation under existing regulatory authority. The scope of regulatory authority under the Internal Revenue Code is broad generally, and in relation to specific international provisions, for example, the source of income and allocation and apportionment of expenses, is very expansive. See, e.g., sections 7805(b), 863(a). In light of the relative dearth of statutory specification of structurally important international tax provisions, there is substantial scope for exercise of regulatory authority under the governing *Chevron* standard. See *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011); *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984); see also *Swallows Holding Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008) (reversing the Tax Court and applying *Chevron* deference analysis to uphold the regulatory time limit for a foreign corporation to file a tax return in order to be eligible for deductions under section 882(c)). We recognize that there are institutional, budgetary, and political considerations in determining whether to pursue a regulatory versus legislative change when both are possible. In the face of extended legislative paralysis, however, consideration should be given to achieving policy objectives through regulatory changes.

⁶Camp proposal, section 301(a). As discussed below, most foreign branches of a domestic corporation would be deemed a CFC. Virtually all the rates in the Camp proposal are enclosed in brackets, including the 95 percent exemption rate, presumably to

(Footnote continued on next page.)

exempt 95 percent of the dividend payer's foreign active income from U.S. income taxation. The dividends received deduction would not apply to earnings attributable to U.S.-source effectively connected income or U.S.-source dividends. Nor would it apply to subpart F inclusions, thereby mimicking current law's refusal to apply qualified dividend income (QDI) treatment to those inclusions.⁷ There is no requirement that exempted income bear or be subject to any foreign corporate tax.

Under the Camp proposal, neither a credit nor a deduction is allowed for foreign taxes on any dividend for which the dividends received deduction is allowed.⁸ This includes foreign withholding taxes on actual distributions of earnings previously taxed as subpart F income. The Camp proposal makes additional FTC changes, including repeal of the section 902 indirect FTC while retaining the section 960 indirect credit for current-year subpart F inclusions.⁹ The Camp proposal would limit the allocation of expenses for purposes of the FTC limitation to direct expenses¹⁰ and would eliminate the separate FTC limitation baskets so that only the section 904(a) overall limitation would remain.¹¹ It would also repeal the recently enacted section 909 rule suspending credits for foreign taxes until the related foreign income is taken into account for U.S. tax purposes.¹²

Exemption and its consequences are mandatorily extended to foreign branches of a domestic corporation. The mechanism used is to deem each foreign branch carrying on a trade or business to be a CFC and to apply the dividends received deduction to "distributions" from the branch. Further, a domestic corporate shareholder owning (directly or indirectly through a qualified corporate group) at least 10 percent of the stock of a foreign corporation that is not a CFC (a noncontrolled 10/50 corporation) may elect to treat the corporation as a CFC whose distributions are eligible for the dividends received deduction. Because the indirect credit for foreign corporate-level taxes, previously allowed for a 10 percent corporate shareholder in a noncontrolled 10/50 corporation, would be repealed, it is likely that this election would be made by almost all

qualifying 10 percent corporate shareholders in a non-controlled 10/50 corporation.

Gain of a corporate U.S. shareholder on the sale of stock in a qualified foreign corporation also would be eligible for a 95 percent deduction if a one-year holding requirement were met. Conversely, no deduction would be allowed for losses from those sales. For these purposes, a qualified foreign corporation is a foreign corporation whose distributions are eligible for the dividends received deduction if, in addition, 70 percent of its assets were active assets under a three-year lookback test.¹³

The Camp proposal is intended to be revenue neutral.¹⁴ It provides for a top corporate tax rate of 25 percent (once income exceeds \$50,000).¹⁵ Assuming a 25 percent corporate rate, the maximum effective rate of U.S. tax on foreign earnings or gain eligible for the 95 percent deduction would be 1.25 percent.¹⁶

The Camp proposal sets out three alternative anti-base-erosion options for consideration without indicating which one, or which combination of the three, would be preferred. The proposal would not modify the existing subpart F rules, other than to repeal the investment in U.S. property rules of section 956 and the previously taxed earnings exclusion of section 959, so it appears that the anti-base-erosion options, if adopted, would exist alongside subpart F.

Under the first anti-base-erosion option, if a U.S. person transfers intangible property from the United States to a related CFC, some excess income from transactions benefiting from or connected with the transferred intangible property would be currently includable in income as a new category of subpart F income.¹⁷ For this purpose, excess income would be income attributable to the use or exploitation of intangibles that has not been subject to a minimum 15 percent effective rate of foreign income tax (included pro rata starting at 0 percent and increasing to 100 percent as the rate scales down from 15 percent to 10 percent), to the extent that that income exceeds 150 percent of costs attributable to the income.¹⁸ However,

indicate that they are tentative. To avoid distracting the reader, this report does not show the brackets in its discussion.

⁷See *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd*, 722 F.3d 306 (5th Cir. 2013).

⁸Camp proposal, section 301, adding new section 245A(e). As discussed below, however, foreign corporate-level taxes reduce earnings eligible for exemption and therefore effectively partially reduce the U.S. income tax on the nonexempt portion of the dividend.

⁹Camp proposal, section 311(a)-(b). In other words, foreign taxes paid by a CFC will be creditable if they are attributable to subpart F income.

¹⁰Camp proposal, section 312.

¹¹Camp proposal, section 313.

¹²Camp proposal, section 314.

¹³Camp proposal, section 302(a), adding new section 1247.

¹⁴Ways and Means Committee, "Highlights of Ways and Means Discussion Draft: Participation Exemption (Territorial System)" (Oct. 26, 2011) ("Includes a number of anti-abuse rules to prevent erosion of the U.S. tax base and help make the participation exemption system a revenue neutral component of tax reform.").

¹⁵Camp proposal, section 201(a), amending section 11(b).

¹⁶Five percent x 25 percent = 1.25 percent.

¹⁷This option appears to be based on a proposal in the Obama administration's budgets and proposals to the Joint Select Committee on Deficit Reduction. Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," at 269 (Sept. 2011).

¹⁸Camp proposal, section 331A.

excess income would not include income from the use, consumption, or disposition of property in the CFC's country of incorporation or income from services performed in that country.

The second anti-base-erosion option would require cross-border income earned by a CFC that is not derived from the conduct of an active trade or business in the home country of the CFC and is not subject to a 10 percent effective rate of foreign tax to be currently included in a U.S. shareholder's income in accordance with subpart F.¹⁹ This latter requirement is analogous to the subject-to-tax requirement found in the exemption systems of some countries. As discussed more fully below, the same-country exception in this low-tax option is more narrowly drawn than in the excess intangible income option.

The third anti-base-erosion option creates a new category of foreign base company income — foreign base company intangible income. This is defined as intangible income of the CFC. Intangible income, in turn, is defined as any gross income, whether U.S.- or foreign-source, from the sale, lease, license, or other disposition of property in which an intangible is used, directly or indirectly, or from services related to intangible property or property in which an intangible is used, but in each case to the extent that the gross income is “properly attributable to the intangible property.” Intangible property is defined by cross-reference to section 936(h)(3)(B), which includes patents, know-how, copyrights, trademarks, and any similar item that has substantial value independent of the services of any individual.

Foreign base company intangible income is privileged compared with other foreign base company income categories in that the section 954(b)(4) high-taxed income exception requires that other foreign base company income categories bear an effective foreign tax rate “greater than 90 percent of the maximum rate of tax specified in section 11” to qualify for exclusion from subpart F, whereas the Camp proposal provides that this requirement “shall be applied [to foreign base company intangible income] by treating the maximum rate of tax specified in section 11 as being 60 percent of such rate.” This effectively means the foreign base company intangible income classification is relevant only to income that bears a foreign effective tax rate of 13.5 percent or less.²⁰ That income is attributed to U.S.

¹⁹Camp proposal, section 331B, adding new section 952(e). For the same-country trade or business exception to apply, goods must be sold for use, consumption, or disposition in the same country, and services would have to be provided for persons or property in the same country.

²⁰Sixty percent of the maximum section 11 rate under the Camp proposal is $0.60 \times 0.25 = 0.15$. When the section 954(b)(4) 90 percent factor is applied, the result is $0.90 \times 0.15 = 0.135$. The description of the provision in the Camp proposal technical

(Footnote continued in next column.)

shareholders and subjected to current taxation under the same rules that apply to other items of foreign base company income.

In addition to creating a new category of foreign base company income, the third option of the Camp proposal would establish a new income category that is independent of subpart F: foreign intangible income. This category is effectively defined as the portion of subpart F foreign base company intangible income that is “derived in connection with — (1) property which is sold for use, consumption, or disposition outside the United States, or (2) services provided with respect to persons or property located outside the United States.” Thus, foreign intangible income is roughly the foreign base company intangible income remaining after any U.S. items have been eliminated.²¹

The significance of this new foreign intangible income category is that a U.S. corporation is allowed to deduct 40 percent of that income that it earns directly. Further, if the U.S. corporation is a U.S. shareholder of one or more CFCs, it is also allowed to deduct 40 percent of the lesser of (1) its subpart F inclusions of foreign base company intangible income or (2) its subpart F inclusions of foreign base company intangible income with any U.S. items eliminated. Assuming adoption of the 25 percent maximum corporate rate in the Camp proposal, the 40 percent deduction would impose a 15 percent tax rate cap²² on both directly earned foreign intangible income and subpart F inclusions of foreign base company intangible income.

The Camp proposal would limit interest deductions to address the use of debt to earn exempt income. It would suspend the deductibility of net interest expense of a U.S. corporation that is a U.S. shareholder of any CFC in the same worldwide affiliated group to the extent of the lesser of (1) a percentage determined with reference to the relationship between the U.S. group members' debt-to-equity ratio and the worldwide group's debt-to-equity ratio, and (2) an unspecified percentage of the U.S. corporation's adjusted taxable income (under rules of section 163(j)(6)(A)).²³ Disallowed interest may be carried forward to subsequent tax years.

explanation states that intangible income is eligible for the high-taxed-income exception if the income has been taxed at a rate greater than 60 percent of the maximum federal income tax rate, which would be 15 percent ($60 \text{ percent} \times 25 \text{ percent} = 15 \text{ percent}$). Ways and Means Committee, “Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income,” at 35 (Oct. 26, 2011) (“Camp proposal technical explanation”).

²¹Camp proposal, section 331C.

²² $(1 - 0.40) \times 0.25 = 0.15$.

²³Camp proposal, section 332, adding new section 163(n).

The Camp proposal provides that immediately before the effective date of the exemption regime, accumulated deferred foreign earnings of a CFC or a non-controlled 10/50 corporation will be included pro rata in the income of all U.S. shareholders. A U.S. shareholder will be entitled to an 85 percent deduction, and the taxable portion of these earnings may be reduced by FTCs. The tax on this income may be paid annually in two to eight installments.²⁴

B. Enzi Proposal — S. 2091

The Enzi proposal is a stand-alone international tax reform proposal that effectively provides a dividend exemption for some foreign dividends. It does not propose a reduced U.S. corporate tax rate. The Enzi proposal adopts a number of modifications in relation to the Camp proposal that are taxpayer friendly to many U.S. multinationals.

The Enzi proposal provides a 95 percent dividends received deduction for the qualified foreign-source portion of dividends from a CFC. The maximum effective rate of U.S. tax on a dividend eligible for the 95 percent dividends received deduction would be 1.75 percent.²⁵

The qualified foreign-source portion of a dividend is the ratio of the CFC's post-2012 undistributed qualified foreign earnings to total post-2012 undistributed earnings. For this purpose, qualified foreign earnings are earnings that are not effectively connected with a U.S. business or received from an 80-percent-owned U.S. corporation.²⁶

The 95 percent deduction would be allowed only to a U.S. shareholder that has held the stock for one year, as determined under modified section 246(c) rules. The Enzi proposal would not allow an FTC for any foreign tax paid on the qualified foreign-source portion of a dividend, and it would treat the 5 percent taxable portion of the dividend as U.S.-source income.²⁷ Like the Camp proposal, the Enzi proposal allows a U.S. shareholder to make a one-time election to treat a non-controlled 10/50 corporation as a CFC.

The Enzi proposal has a special rule for a hybrid dividend — that is, a dividend for which a deduction is allowed under foreign law. That dividend is ineligible for the dividends received deduction when received by a U.S. shareholder and is treated as subpart F income to a CFC that is ineligible for a section 960 credit (and also is treated as U.S.-source income).²⁸

Any portion of the sale of stock in a CFC that would be treated as a dividend under section 1248 is treated as a dividend for purposes of the dividends received deduction.²⁹ Moreover, any qualified foreign portion of dividend income arising under section 964(e) from gain realized on the sale by a CFC of stock in a CFC will be subpart F income but is eligible for the dividends received deduction.

Unlike the Camp proposal, the Enzi proposal does not extend exemption treatment to foreign branches of a U.S. corporation (and therefore does not deem those branches to be converted to CFCs).

The Enzi proposal provides each U.S. corporation a deduction equal to 50 percent of its qualified foreign intangible income for the year. The proposal generally defines qualified foreign intangible income as all intangible income derived by a U.S. corporation through U.S. business activity in connection with property sold, leased, licensed, or transferred in any other way for use, consumption, or disposition outside the United States, or through U.S. business activity in connection with services provided for persons or property located outside the United States. However, the intangible property giving rise to the income either must have been developed, created, or produced within the United States by the U.S. corporation claiming the 50 percent deduction or must be acquired property to which the U.S. corporation added substantial value through the conduct of its U.S. business activities. For purposes of the 50 percent deduction, intangible income is all income from the sale, lease, license, or other transaction in which intangible property is used directly or indirectly, as well as all income from providing services related to intangible property or in connection with property in which intangible property is used. Nevertheless, income is intangible income only to the extent that it is properly attributable to the intangible property. Intangible income is to be calculated by subtracting allocable deductions, and intangible property has the meaning given by section 936(h)(3)(B). The effect of this complex provision is to subsidize foreign exploitation of intangibles developed within the United States by U.S. resident corporations that are actively engaged in U.S. business operations.

The Enzi proposal would modify subpart F by repealing the foreign base company sales and services income provisions and replacing them with a low-taxed-income test.³⁰ Under that test, any income that is not qualified business income and is not subject to an effective rate of foreign tax greater than half of the highest U.S. corporate rate (now 35 percent, so the low-tax test rate would be 17.5 percent under existing law) would be taxed currently under subpart F. Qualified business income is income from a foreign country

²⁴Camp proposal, section 303, amending section 965. It is unclear whether the revenue from this one-time transition provision is taken into account in determining whether the Camp proposal is revenue neutral.

²⁵Five percent x 35 percent = 1.75 percent.

²⁶S. 2091, section 101, adding new section 245A.

²⁷S. 2091, section 101, new section 245A(d).

²⁸S. 2091, section 101, new section 245A(e).

²⁹S. 2091, section 102, new section 1248(j).

³⁰S. 2091, section 201, adding new section 952(e).

that is attributable to the active conduct of a trade or business in the foreign country if the corporation has an office or fixed place of business in that country where officers and employees conduct “or significantly contribute to the conduct of activities . . . which are substantial in relation to the activities necessary for the active conduct of the trade or business to which such income is attributable.” Qualified business income does not include a CFC’s intangible income, with intangible income being defined the same as under the foreign intangible income deduction. The active business test and the effective rate test are applied on a country-by-country basis and take into account all the activity in a particular country.

The Enzi proposal would establish a separate FTC limitation for foreign taxes on foreign intangible income. It also would treat export sales income as U.S.-source income for purposes of the FTC limitation and would accelerate the effective date of the worldwide interest allocation rules.³¹

The Enzi proposal would retain subpart F’s foreign personal holding company income provisions but would make permanent the active finance and active insurance exceptions.³² It would also make permanent the section 954(c)(6) look-through rule exception to foreign personal holding company income.³³

Unlike the Camp proposal, the Enzi proposal would not require, but would allow, a one-time election for accumulated deferred foreign earnings of a CFC to be included in the subpart F income of a domestic corporation that is a U.S. shareholder, subject to a 70 percent (instead of 85 percent) dividends received deduction.³⁴ Thus, the maximum effective tax rate on these pre-effective-date earnings would be 10.5 percent instead of 3.75 percent.³⁵ The election appears to be allowed separately for each CFC but would not be allowed for a noncontrolled 10/50 corporation that a U.S. shareholder has elected to treat as a CFC. Unlike in the Camp proposal, the taxable portion may not be reduced by FTCs. The tax on the increased subpart F income may be paid annually in up to eight installments.

A corporation must make the election for accumulated foreign earnings in the first year it is treated as a CFC. Otherwise, it will have untaxed pre-effective-date earnings that are ineligible for the 95 percent dividends received deduction. Consequently, an ordering rule for post-effective-date distributions is required. Post-effective-date distributions are treated as coming first

out of pre-effective-date earnings and then out of post-effective-date earnings eligible for exemption. U.S. corporations that are U.S. shareholders will be allowed section 902 credits for foreign taxes on pre-effective-date earnings.

III. Structural Elements of the Proposals

A. Shareholder Exemption

1. 10 Percent Domestic C Corporation Shareholders

After a greater-than-one-year holding period requirement is met, the foreign-source portion of any dividend received from a CFC by a U.S. corporation that is a U.S. shareholder will be subject to a 95 percent dividends received deduction under both the Camp and Enzi proposals. Therefore, that portion of the dividend will be subject to an effective 1.25 percent U.S. C corporation tax under the Camp proposal and a 1.75 percent U.S. tax under the Enzi proposal, except to the extent it is attributable to the CFC’s U.S.-source ECI or to specified U.S. dividends.³⁶ Under the Camp proposal, the new section 245A dividends received deduction for the portion of a dividend that is from undistributed foreign earnings of a CFC parallels the dividends received deduction allowed under current section 245 for the U.S.-source portion of a dividend received from a 10-percent-owned qualified foreign corporation. A dividend subject to section 245 and new section 245A would come out of a CFC’s foreign- and U.S.-source undistributed earnings pro rata. Undistributed earnings include foreign earnings that have been previously taxed under subpart F.

The Camp proposal would repeal section 959, thus eliminating the exclusion for undistributed earnings that have been previously taxed under subpart F.³⁷ Accordingly, under the Camp proposal, all distributions of foreign-source earnings, whether or not previously taxed under subpart F, are taxable, and if the 95 percent dividends received deduction is allowed, those distributions are subject to U.S. tax at a 1.25 percent effective rate. If the dividends received deduction is not allowed, which would be the case for non-C-corporation shareholders, the previously taxed subpart F earnings would be taxed a second time in full. It is unclear why this additional tax is necessary or appropriate under a dividend exemption system. Why not just treat distributed previously taxed earnings as entirely exempt rather than tax them a second time in whole or in part?

The remainder of the discussion in this part focuses on the treatment of income (earnings) that is not subpart F income and therefore is eligible for exemption.

³¹S. 2091, sections 212, 213, and 221.

³²S. 2091, section 203.

³³S. 2091, section 202.

³⁴S. 2091, section 104, amending section 965.

³⁵Thirty percent x 35 percent = 10.5 percent; 15 percent x 25 percent = 3.75 percent.

³⁶Five percent x 25 percent = 1.25 percent.

³⁷Camp proposal, section 332. Under section 959, any distribution comes first from previously taxed earnings that were included under subpart F, and those earnings are excluded from gross income. Section 959(c).

The proposals' scope of current taxation under subpart F is important, however, because it sets out the limits on income that is eligible for exemption. The proposed expansion of subpart F to address anti-base-erosion concerns is discussed in Section III.B, below.

The Camp and Enzi proposals do not allow a credit for foreign taxes that are imposed on income (or earnings) eligible for the 95 percent exemption. Under U.S. international tax rules, exempting a foreign subsidiary dividend would take the place of an FTC.³⁸ A "subject to tax" condition for exemption, found in the exemption systems of some countries, signals that exemption is adopted as a mechanism to avoid double taxation of income.³⁹ Under the Camp proposal, however, there is no requirement that exempted income bear or be subject to a foreign corporate tax or a withholding tax.⁴⁰ The dividends received deduction is allowed whether or not a foreign tax is actually imposed.⁴¹

If income can be exempt even though it would never be subject to a foreign tax, and if other limits on exemption are not imposed or readily avoided (principally, the CFC subpart F rules discussed below), it is possible to earn exempt income in a country that does not impose tax on the income (for example, in a pure tax haven). If no foreign tax need be incurred, there will be an incentive for U.S. taxpayers to earn zero-taxed foreign income. The absence of a subject to tax

condition, however, does not automatically mean that an exemption system is unmoored from a rationale that it is intended to avoid double taxation. That conclusion depends on how other elements of the overall system are constructed.⁴²

The effect of the 95 percent dividends received deduction may be seen with a simplified example. Assume a foreign subsidiary (CFC) earns \$1,000 of income qualifying for exemption and that it distributes its entire income to its U.S. parent (USP). Assume that USP is subject to a 25 percent U.S. corporate tax rate and that CFC is alternatively subject to (1) a 25 percent foreign corporate tax rate and a 5 percent dividend withholding tax or branch profits tax, and (2) a 10 percent foreign corporate tax rate and a 0 percent withholding or branch profits tax rate. Table 1 shows the results.

Note that the small (1.25 percent) residual U.S. tax is on the CFC dividend, which is after foreign corporate-level taxes. In other words, given that there is no section 78 gross-up under the Camp and Enzi proposals, the foreign corporate-level tax is in effect permitted as a deduction in computing the residual U.S. tax because it reduces the earnings and profits from which dividends can be paid.⁴³

In this example, when the U.S. and foreign corporate tax rates are each 25 percent, the 5 percent foreign withholding tax becomes what under current law would be an excess FTC. The withholding tax is an out-of-pocket cost, but it is not allowed as a deduction to USP. Consistent with what one would expect, in the scenario of a 25 percent U.S. corporate tax and an equal foreign corporate tax and a 5 percent withholding tax (columns 1 and 2), the overall effective tax rate is higher under the Camp and Enzi proposals' dividend exemption than under current law because there is no

³⁸Section 901. See, e.g., Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," 54 *Nat'l Tax J.* 771, 772 (2002) ("Most of the issues raised by an exemption system parallel those that have been debated over the years under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad.")

³⁹A subject to tax condition can be more or less substantive. The Netherlands requires that exempt income be subject to tax in principle, even if it is not taxed in the specific case. See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation* 468 (2010). Generally, the Dutch participation exemption does not apply to income earned in a tax haven, but it permits exempt income to be distributed through tax haven subsidiaries.

⁴⁰It used to be routinely accepted that an exemption system had as its objective avoiding international double taxation. See Graetz and Oosterhuis, *supra* note 38. The effects of international tax competition have eroded the linkage of dividend exemption systems to avoidance of double taxation. This is evidenced by the increasing scope of exemption for income that is not subject to any foreign tax.

⁴¹The role of a subject to tax requirement in a principled exemption system and considerations for the design of that requirement are discussed in Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 413-426. The objectives of a subject to tax requirement can be achieved through a comparable low-taxed-income category of subpart F income if it is comprehensive in its coverage. As discussed in the text at sections III.B.2 and III.B.4, *infra*, the low-taxed-income subpart F proposals in the Camp and Enzi proposals are flawed in that they allow significant opportunities to avoid current inclusion for low-taxed income.

⁴²See Ault, "U.S. Exemption/Territorial System vs. Credit-Based System," *Tax Notes Int'l*, Nov. 24, 2003, p. 725 ("In an exemption system, it is tax now or tax never. If an income item is in the exempt category, it is exempt forever and there is no second bite on repatriation. Taking this dimension into account, the move to an exemption system might actually lead to greater complexity.")

⁴³The Camp proposal denies a credit and a deduction for any foreign tax paid or accrued on a dividend for which the dividends received deduction is allowed. However, the dividends received deduction is allowed for the foreign-source portion of a dividend, which is in turn based on the foreign share of undistributed E&P. These E&P are after foreign taxes. See Rev. Rul. 63-63, 1963-1 C.B. 10 (reduction in E&P for federal taxes after accounting for investment tax credit); and Boris Bittker and James Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 8.03 (2006 and supp. 2012-2013). Note also that there is no deduction for foreign withholding taxes. Camp proposal, new section 245A(e)(2); Enzi proposal, new section 245A(d)(2).

Table 1. 10 Percent U.S. C Corporation Shareholder

Assumptions	25% U.S. Corporate Tax Rate		U.S. Foreign Tax Rate	
	Current Law	Camp/Enzi Subsidiary	Current Law	Camp/Enzi Subsidiary
CFC (branch) pretax earnings	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
Foreign corporate tax rate	25.00%	25.00%	10.00%	10.00%
Foreign withholding (branch profits tax) tax rate	5%	5%	0%	0%
Dividends received deduction	0%	95%	0%	95%
U.S. corporate tax rate	25.00%	25.00%	25.00%	25.00%
CFC				
CFC pretax earnings	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
Foreign tax	-\$250.00	-\$250.00	-\$100.00	-\$100.00
CFC after-tax earnings	\$750.00	\$750.00	\$900.00	\$900.00
Dividend to USP	\$750.00	\$750.00	\$900.00	\$900.00
Foreign withholding tax	-\$37.50	-\$37.50	\$0.00	\$0.00
USP				
Gross dividend income	\$1,000.00 ^a	\$750.00 ^e	\$1,000.00	\$900.00
Dividends received deduction	0	-\$712.50 ^f	0	-\$855.00
Taxable income	\$1,000.00	\$37.50	\$1,000.00	\$45.00
U.S. corporate tax (tentative)	-\$250.00	-\$9.38	-\$250.00	-\$11.25
Creditable foreign taxes	-\$287.50	\$0.00	-\$100.00	\$0.00
Residual U.S. tax (-) or credit (+)	\$37.50	-\$9.38	-\$150.00	-\$11.25
After-tax cash	\$750.00 ^b	\$703.13 ^g	\$750.00	\$888.75
Effective foreign tax rate	28.75% ^c	28.75%	10.00%	10.00%
Overall effective tax rate	25.00% ^d	29.69% ^h	25.00% ⁱ	11.13% ^j

^aGrossed-up dividend under section 78.

^bPretax earnings of \$1,000, less foreign tax (\$250), withholding tax (\$37.50), U.S. tax after credits (\$0), and cross-credit benefit of excess foreign tax credit (\$37.50).

^c(\$250 + \$37.50)/\$1,000.

^d\$250 (tax after cross-credit)/\$1,000.

^eThere is no foreign tax gross-up and no deduction for foreign withholding tax.

^f\$750 x 95 percent. Under new section 245A, there would be no deduction for the foreign dividend withholding tax.

^g\$750 - \$37.50 (foreign withholding tax) - \$9.38 (U.S. corporate tax).

^h(\$250 + \$37.50 + \$9.38)/\$1,000.

ⁱ(\$100 + \$150)/\$1,000.

^j(\$100 + \$11.25)/\$1,000.

opportunity to cross-credit the foreign withholding tax against U.S. tax on other foreign-source income.⁴⁴

The alternative showing a 10 percent foreign tax rate (columns 3 and 4) illustrates the advantage of ex-

emption under the Camp and Enzi proposals in eliminating 95 percent of the residual U.S. tax on repatriation. As shown in Table 1 (columns 3 and 4) and below in Table 3 (columns 2 and 3), there would be a materially reduced tax cost of repatriating low-taxed foreign earnings from CFC to USP under the Camp and Enzi proposals, the value of which increases as the foreign effective tax rate is reduced below the U.S. effective rate. However, the tax on reinvestment of the

⁴⁴See generally Fleming, Peroni, and Shay, "Worse Than Exemption," 59 *Emory L.J.* 79, 132-144 (2009).

repatriated earnings would be at the higher U.S. tax rate.⁴⁵ This example illustrates the potential taxpayer benefit of a substantially reduced tax on repatriation, if repatriation of earnings is desired. The example also points out that the incentive to achieve a lower tax on reinvested earnings by retaining earnings in a lower-foreign-tax subsidiary remains under an exemption system.⁴⁶

2. U.S. Non-C Corporation 10 Percent Shareholders

Under current law, a U.S. tax resident non-C corporation shareholder is not taxed on a foreign corporation's earnings until they are distributed as a dividend, subject to application of the subpart F rules to a 10 percent U.S. shareholder in a CFC and the passive for-

ign investment company rules to all U.S. shareholders. These shareholders also are not permitted to claim an indirect FTC for foreign corporate-level taxes.⁴⁷ The Camp and Enzi proposals would retain deferral and not extend exemption to non-C corporation shareholders.

As under current law, there would be a stark difference in the taxation of a resident individual's foreign income, depending on whether it is earned directly, through a foreign corporation owned by the individual, or through a foreign corporation that is owned by a U.S. corporation owned by the individual. This discussion focuses on how the proposals might affect how a non-C corporation shareholder decides to hold a foreign corporate investment: directly or through a C corporation.

Under current law, an individual U.S. shareholder is taxed at a reduced rate on QDI, defined to include a dividend from a U.S. C corporation if holding period requirements are satisfied. Further, dividends from a qualified foreign corporation may be eligible for QDI treatment.⁴⁸ In 2013, for high-income individual taxpayers, the tax rate for QDI is 20 percent (and the top marginal individual rate for those taxpayers is 39.6 percent).⁴⁹ An FTC is allowed for a withholding tax on QDI received by a U.S. resident individual, but it is subject to a "rate differential" reduction under section 904(b) to take into account the lower U.S. tax rate on QDI. If QDI treatment is unavailable, a dividend from a foreign corporation is taxed at an individual's graduated tax rates and an FTC is allowed for foreign withholding tax subject to a usual FTC limitation.

The conditions for QDI treatment of dividends from a foreign corporation raise many of the same issues as the Camp and Enzi proposals. The theory behind adoption of QDI treatment for dividends from U.S. C

⁴⁵Under a deferral system, assuming the same pretax rates of return in the United States and abroad and unchanging tax rates, the benefit of postponing repatriation is not from avoiding the tax on repatriation but from reinvesting the deferred earnings at a higher after-tax return (than if repatriated) so they grow faster (before the U.S. tax is imposed). Under an exemption system, a taxpayer obtains the same benefit from reinvestment abroad at a higher after-tax return and also is not subject to any U.S. tax on repatriation. See Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 409 n.37. The tax incentive to reinvest in the foreign country might be offset if sufficient investment is attracted by the lower foreign taxes so that returns in the foreign country are lowered to the point that after-tax returns are equal to those in the United States. This is what is referred to as an implicit tax, although the reduced return is not attributable to a tax paid to a government. Whether or the extent to which a reduced return occurs is an empirical question that will vary from case to case depending on the supply-demand characteristics of the item in question.

⁴⁶It is beyond the scope of this report to discuss the so-called lockout effect of deferral. However, analysts recognize that in theory, under the "new view" of dividends, the presence of a tax on repatriation held at a constant rate for the period of earnings retention abroad should not itself provide an incentive to retain earnings. The understanding that under assumptions of a constant tax rate and a constant return, the timing of a corporate distribution should be unaffected by a shareholder tax, derives from analysis of classical corporate tax systems that impose a separate shareholder tax. The application of this new view of dividends to the timing of foreign subsidiary distribution was first discussed in David Hartman, "Tax Policy and Foreign Direct Investment," 37 *J. Pub. Econ.* 107, 115-116 (1984). For a discussion of this analysis, see Fleming, Peroni, and Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income," 5 *Fla. Tax Rev.* 299, 304 n.10 (2001); James R. Repetti, "Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform," 8 *Fla. Tax Rev.* 303, 307 (2007). Notwithstanding the theory, there appears to be a rapid increase in foreign retained earnings of U.S. multinationals. An obvious explanation is that earnings could in the future be subject to a lower rate of tax on repatriation. Recently, however, analysts also are attributing the buildup in retained foreign subsidiary earnings more to the incentive under accounting rules, as opposed to tax rules, to retain lower-taxed earnings abroad. Michael P. Donohoe, Gary A. McGill, and Edmund Outslay, "Through a Glass Darkly: What Can We Learn About a U.S. Multinational Corporation's International Operations From Its Financial Statement Disclosures?" 65 *Nat. Tax J.* 961, 975 (2012).

⁴⁷An exception to the statement in the text is that an individual may elect under section 962 to be taxed on CFC income inclusions under section 951 at a corporate tax rate and claim a credit for corporate-level taxes against that tax. When these CFC earnings are actually distributed as a dividend, however, the earnings (reduced for the U.S. tax paid under section 962) are not treated as previously taxed earnings and are taxed again at the individual's marginal rate. Section 962(d). Section 962 is almost never elected.

⁴⁸Section 1(h)(11)(b)(i)(II). The conditions for QDI treatment of dividends from a foreign corporation not incorporated in a U.S. possession are (1) the security on which the distribution is made is equity, rather than debt, under U.S. tax principles; (2) the distribution is a dividend for the corporation's tax year in which it is paid; (3) either (a) the stock on which the dividend is paid is readily tradable on an established securities market in the United States or (b) the foreign corporation is eligible for benefits of a comprehensive income tax treaty with the United States (for the tax year in which the dividend is paid); and (4) the foreign corporation is not a PFIC for the tax year of the corporation in which the dividend is paid or in the preceding year.

⁴⁹Section 1(a)-(e), (h)(1), (h)(11).

corporations is that the lower tax rate mitigates the double taxation of corporate earnings. Applying the same rule to foreign corporations in essence treats a foreign corporate tax the same as the domestic corporate tax. The conditions for QDI treatment, however, do not include a minimum level of U.S. corporate taxation of the earnings from which the dividend is paid in the case of a U.S. corporation and, similarly, no minimum foreign tax is required as a condition for QDI treatment of a dividend from a foreign corporation.⁵⁰ Conversely, the conditions for QDI treatment produce many cases in which QDI treatment does not apply even though there has been a material foreign corporate tax imposed on the earnings.⁵¹

If the Camp and Enzi proposals are adopted and QDI treatment applies to a foreign dividend, it generally is not advantageous to insert a U.S. C corporation to be a 10 percent U.S. shareholder in a foreign corporation. If QDI treatment was unavailable for a foreign dividend but was available for a domestic dividend, however, it *would* be advantageous for a U.S. individual to hold the foreign stock through a U.S. C corporation under the Camp and Enzi proposals. This is because the U.S. C corporation (but not the U.S. individual) would be eligible for a 95 percent dividends received deduction, and the U.S. individual shareholder would be eligible for a reduced QDI tax rate on dividends from the U.S. C corporation. (Moreover, often the withholding rate under a treaty on a dividend to a 10 percent shareholder corporation is 5 percent while the treaty withholding rate to an individual generally is 15 percent.) Variations on the example in Table 1 illustrate these relationships.

Assume that a CFC earns \$1,000 of pretax income qualifying for exemption and that it distributes its en-

⁵⁰Accordingly, a publicly traded qualified foreign corporation can be organized in the Cayman Islands or another zero-tax country, and its dividends can qualify for the QDI rate. Even when a foreign corporation is eligible for all the benefits of a comprehensive income tax treaty, there are circumstances in which no corporate tax is imposed. For example, it is standard practice for private equity structures to insert a Luxembourg holding company that qualifies for the U.S. treaty with Luxembourg as a holding entity in case a leveraged recapitalization requires distribution of a substantial dividend to investors (including U.S. individual taxpayers). It is unnecessary for any Luxembourg tax to be imposed and, indeed, under the Luxembourg participation exemption regime, often none is. There are a variety of ways to avoid Luxembourg dividend withholding tax.

⁵¹Thus, dividends from nonpublicly traded companies resident in non-treaty countries, including, for example, Brazil and Taiwan, cannot qualify for QDI treatment. See American Bar Association Section of Taxation, "Report of the Task Force on International Tax Reform," 59 *Tax Law* 649, 698-699 (2006) (ABA task force report) (calling for reconsideration of the scope of QDI treatment for a dividend from a foreign corporation); see also Graetz and Rachael Doud, "Technological Innovation, International Competition, and the Challenges of International Income Taxation," 113 *Colum. L. Rev.* 347, 361 (2013).

tire income alternatively to an individual U.S. shareholder (USI) and an intermediary U.S. C corporation (USP) owned by USI. Also assume that the foreign and U.S. tax rates are as stated in Table 2.⁵² Table 2 shows the results (1) if a CFC dividend to USI is eligible for QDI treatment (column 1); (2) if a dividend from CFC to USP is 95 percent exempt and the dividend from USP to USI is eligible for QDI treatment (column 2); (3) if a CFC dividend to USI is not eligible for QDI treatment (column 3); and (4) if a dividend from CFC to USP is 95 percent exempt and the dividend from USP to USI is not eligible for QDI treatment (column 4).⁵³

A comparison of columns 1 and 2 of Table 2 shows that when QDI is available for both dividends distributed directly by a CFC to a U.S. individual (column 1) and CFC dividends distributed to the U.S. individual through a U.S. corporate parent (column 2), the U.S. individual is better off without the corporate intermediary even though elimination of the intermediary also eliminates the Camp/Enzi dividends received deduction. This results primarily from the U.S. residual tax that applies to the U.S. individual in column 2 but that is avoided in column 1 because the absence of the corporate intermediary (with its dividends received deduction) allows the individual to claim a U.S. FTC for the foreign withholding tax. Likewise, if QDI is *unavailable* for both direct dividends from a CFC to a U.S. individual (column 3) and CFC dividends distributed to the U.S. individual through a U.S. corporate parent (column 4), a comparison of columns 3 and 4 shows that the corporate intermediary scenario is again disadvantageous for the U.S. individual. If, however, QDI is available for domestic but not CFC dividends,⁵⁴ a comparison of columns 2 and 3 shows that the U.S. individual is better off receiving CFC dividends through the CFC's U.S. parent corporation (column 2) instead of directly from the CFC (column 3). But if the QDI benefit is unavailable for the domestic dividend so that the U.S. dividend tax rate was 39.6 percent (column 4), the U.S. residual tax would rise to \$278.44 and the after-tax cash would shrink to \$424.69. Column 3 (without the corporate intermediary) would then be the preferred scenario. This is a result of the individual shareholder being able to credit the 15 percent portfolio dividend withholding tax, which is more beneficial

⁵²We do not discuss the personal holding company tax (section 541) but note that it would be avoided by distribution of a dividend by the U.S. corporation (USP). See sections 545(a) and 547. The examples below assume distribution of the dividend from CFC.

⁵³The results described in the text in relation to Table 2 do not change if the foreign corporate tax rate is 10 percent and the dividend withholding tax is either zero or the usual treaty rate of 15 percent for individuals and 5 percent for corporations.

⁵⁴This assumption makes columns 1 and 4 irrelevant.

than having a lower but not creditable 5 percent intercorporate withholding tax *and* a Camp/Enzi dividends received deduction.⁵⁵

These comparisons show that the availability or not of QDI from a CFC is the principal variable in determining whether a U.S. individual shareholder should elect into or out of the Camp/Enzi dividends received deduction by choosing to use, or not use, a U.S. corporate intermediary to hold stock in a CFC. More importantly, these comparisons demonstrate that the Camp and Enzi proposals are inextricably intertwined with the QDI tax benefit and that for individual shareholders, the proposals cannot be evaluated without also evaluating the extent to which QDI should be available for dividends paid by CFCs (and the rate of tax on QDI).⁵⁶

The Joint Committee on Taxation staff's explanation of the QDI provision indicates that it was intended to reduce the tax burden on corporate income that resulted from the "classical" double-tax system.⁵⁷ Arguably then, QDI treatment should be available only for dividends paid out of income that has borne a significant corporate income tax. Indeed, the JCT staff's explanation states that "Congress noted that economically, the issue was not that dividends were taxed twice, but rather the magnitude of the total tax burden on income from different investments."⁵⁸ This leads inexorably to the suggestion that CFC dividends paid to U.S. individuals should not be eligible for QDI treatment unless a subject to tax requirement is satisfied for the earnings that provide the source of the dividends. That standard is automatically satisfied for dividends paid by profitable domestic C corporations, except when corporate tax liability is eliminated by various corporate-level tax preferences, which generally are intended to stimulate U.S. economic growth (although their efficacy often is subject to question). Those tax preferences generally do not extend to CFCs. Thus, for CFCs, there is no assurance that the corporate income has borne a meaningful tax or been excused (appropriately or not) from taxation because of deliberate U.S. policies. In our view, if the Camp/Enzi approach is adopted, QDI treatment should not be retained for CFC dividends unless a subject to tax requirement is grafted on to section 1(h) for CFC dividends.⁵⁹

⁵⁵The same result holds if the intercorporate dividend withholding tax rate were zero. The after-tax cash in column 4 would be \$447.34, which is still less than column 3's after-tax cash of \$453.

⁵⁶The same analysis also applies to individual investors holding CFCs through major categories of investment funds, including private equity and hedge funds.

⁵⁷JCT, "General Explanation of Tax Legislation Enacted in the 108th Congress," JCS-5-05, at 23 (May 31, 2005).

⁵⁸*Id.* at 24.

⁵⁹If QDI were retained for foreign dividends, it should be modified to key off the rate of foreign corporate tax. This could

(Footnote continued in next column.)

Whether or not QDI is modified in relation to distributions from a foreign corporation, our second observation is that if the Camp or Enzi proposals were adopted, QDI should be modified so that there is no benefit from inserting the C corporation into the structure. If QDI treatment in relation to dividends from a CFC were restructured as described above, it should be allowed only on a similarly limited basis for a U.S. corporation's distributions of earnings attributable to exempt foreign dividends under the Camp or Enzi proposals. If the QDI provision is not restructured as described, the limitations on QDI should not be permitted to be circumvented through the insertion of a U.S. C corporation.

B. Anti-Base-Erosion Limits on Exemption

Under the Camp and Enzi proposals, the dividends received deduction is not allowed for subpart F inclusions even though the code calculates the amount of those inclusions by analogizing them to dividends.⁶⁰ Instead, both proposals would tax subpart F income to U.S. shareholders as under current law, including allowing the section 960 indirect FTC when the U.S. shareholder is a U.S. corporation. Under the Camp proposal (but not the Enzi proposal), the protection against a second tax on previously taxed earnings would be repealed. When actual distributions are made out of previously taxed subpart F inclusions, the Camp proposal would make the 95 percent dividends received deduction available on the same terms that apply to other actual distributions. Thus, 5 percent of dividends distributed from subpart F inclusions could be taxable if the U.S. shareholder is a U.S. corporation and, in all other cases, 100 percent could be taxable. Under the Camp proposal, then, actual distributions out of earlier subpart F inclusions would suffer an additional maximum 1.25 percent tax if the dividends received deduction is available,⁶¹ and a tax of up to 39.6 percent in

be done with more or less precision but should not allow a combined foreign and U.S. tax on distributed earnings that is lower than the lowest combined U.S. corporate and individual shareholder rate on earnings distributed from a U.S. corporation. *See generally* Daniel Halperin, "Mitigating the Potential Inequity of Reducing Corporate Rates," *Tax Notes*, Feb. 1, 2010, p. 641. QDI treatment also should be permitted only when information exchange is allowed. QDI should not be permitted merely because the CFC is resident in a country with a comprehensive income tax treaty with the United States and would qualify for U.S. treaty relief for U.S.-source income. Nor should QDI treatment be allowed merely because the foreign corporation is publicly traded in the United States. *See also* Graetz and Doud, *supra* note 51, at 433 (suggesting that shareholder-level tax should not be reduced if there has been no U.S. corporate-level tax).

⁶⁰*See* sections 951(a)(2), 952(c)(1). Inclusions under section 951, however, are not dividends when determining QDI. *Rodriguez*, 137 T.C. 174, *aff'd*, 722 F.3d 306.

⁶¹Twenty-five percent (Camp proposed maximum corporate rate) x 0.05 = 1.25 percent.

Table 2. U.S. Resident Individuals

Assumptions	1 (CFC Distributes to USI With QDI)	2 (CFC Distributes to USP, Which Distributes to USI With QDI)	3 (CFC Distributes to USI Without QDI)	4 (CFC Distributes to USP, Which Distributes to USI Without QDI)
CFC (branch) pretax earnings	\$1,000	\$1,000	\$1,000	\$1,000
Foreign corporate tax rate	25.00%	25.00%	25.00%	25.00%
Foreign withholding (branch profits) tax rate	15%	5%	15%	5%
Dividends received deduction	0%	95%	0%	95%
U.S. corporate tax rate	25.00%	25.00%	25.00%	25.00%
U.S. individual tax rate on ordinary income	39.60%	39.60%	39.60%	39.60%
U.S. individual tax rate on dividends	20.00%	20.00%	39.60%	39.60%
CFC	Current Law	Camp/Enzi Subsidiary	Current Law	Camp/Enzi Subsidiary
	Direct Distribution to USI	Distribution to USP	Direct Distribution to USI	Distribution to USP
CFC pretax earnings	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
Foreign tax	-\$250.00	-\$250.00	-\$250.00	-\$250.00
CFC after-tax earnings	\$750.00	\$750.00	\$750.00	\$750.00
Dividend to USI or USP	\$750.00	\$750.00	\$750.00	\$750.00
Foreign withholding tax	-\$112.50 ^a	-\$37.50	-\$112.50	-\$37.50
USP				
Gross dividend (branch) income		\$750.00		\$750.00 ^e
Dividends received deduction		-\$712.50		-\$712.50
Taxable income		\$37.50		\$37.50
U.S. corporate tax		-\$9.38		-\$9.38
Cash for distribution		\$703.12		\$703.13 ^f
U.S. Individual	CFC QDI	USP QDI	CFC Non-QDI	USP Non-QDI
Dividend	\$750.00 ^b	\$703.12	\$750.00 ^b	\$703.13
Tentative U.S. tax	-\$150.00	-\$140.62 ^g	-\$297.00	-\$278.44 ^j
Foreign tax credit	\$112.50 ^c	\$0.00	\$112.50	\$0.00
Residual U.S. tax	-\$37.50	-\$140.62	-\$184.50	-\$278.44
After-tax cash	\$600.00 ^d	\$562.50 ^h	\$453.00 ⁱ	\$424.69 ^k

^a\$750 x 0.15.

^bThe dividend is not reduced by the foreign withholding tax. See section 275(a)(4).

^cWe make the simplifying assumption that the dividend accounts for 100 percent of the individual shareholder's foreign-source income for the year.

^d\$1,000 minus \$250 foreign corporate tax, \$112.50 foreign withholding tax, and \$37.50 residual U.S. tax.

^eNo deduction or credit is allowed for the foreign withholding tax.

^f\$750 minus \$37.50 foreign withholding tax and \$9.38 U.S. corporate tax.

^g\$703.12 x 0.20.

^h\$1,000 minus \$250 foreign corporate tax, \$37.50 foreign withholding tax, \$9.38 U.S. corporate tax, and \$140.62 U.S. individual tax.

ⁱ\$1,000 minus \$250 foreign corporate tax, \$112.50 foreign withholding tax, and \$184.50 U.S. individual tax.

^j\$703.13 x 0.35.

^k\$1,000 minus \$250 foreign corporate tax, \$37.50 foreign withholding tax, \$9.38 U.S. corporate tax, and \$278.44 U.S. individual tax.

other cases. The Enzi proposal would prevent this double tax result by retaining section 959.⁶²

The Camp proposal also would repeal the section 956 investment in U.S. property rules, because a CFC's income either would be taxed currently under subpart F or be eligible for 95 percent exemption. Either way, there would no longer be deferral of significant U.S. residual tax and a need to defend against repatriation without taxation.

Under current law, subpart F is largely toothless as it relates to base company sales and services income of a CFC. There are numerous reasons for this, but among them are that (1) subpart F is based on a country of incorporation paradigm that disregards other bases for corporate tax residency and in most cases does not take appropriate account of branches; (2) elective U.S. entity classification rules, including the ability to elect to disregard foreign legal entities, allow transactions and income between related entities to be eliminated ("disappear") for U.S. tax purposes; and (3) successive legislative and regulatory changes have limited subpart F's scope to the point that it is readily avoided for business income shifted to a base company.⁶³ Stated differently, the existing subpart F regime that would be preserved by the Camp proposal does not provide a material limit on the extent to which

foreign-source income qualifies for exemption, except for passive income earned by a nonfinancial institution.⁶⁴ Moreover, the Enzi proposal expressly repeals much of subpart F. To fill the gap, the Camp and Enzi proposals include anti-base-erosion provisions that apparently are intended to restrict the incentive for income shifting that is inherent under an exemption regime and, by comparison to deferral with section 956 rules, that are subject to materially reduced frictions in relation to shifting income out of the U.S. tax base.

The Camp proposal includes three anti-base-erosion alternatives. It is unclear what theory unifies the three alternatives or indeed what theory distinguishes the proposals.⁶⁵ One of them, the excess intangibles income proposal, is drawn from the Obama administration's fiscal 2013 budget proposals but is watered down by significant modifications.⁶⁶ The other two are a new low-taxed-income category within subpart F and a reduced tax on foreign intangible income derived from foreign sales and services whether earned by a CFC or a U.S. corporation. The Enzi proposal would repeal the foreign base company sales and services income rules and substitute a new porous low-taxed-foreign-income category of subpart F income. For foreign intangible income, it would adopt a carrot-and-stick approach by taxing that income currently and at a full U.S. tax rate, under the subpart F rules that govern foreign personal holding company income, if earned by a CFC. In contrast, a reduced rate would apply to foreign intangible income earned by a U.S. corporation.

In considering these anti-base-erosion proposals, it is useful to take into account how they would affect what has become garden-variety international tax planning designed to strip income out of residence and source countries and locate it in a tax haven. A standard structure is to conduct manufacturing or services in Ireland in a two-tier structure. The top company is an Irish incorporated company that is tax resident in Bermuda. It wholly owns an Irish incorporated subsidiary company that is tax resident in Ireland and therefore is eligible for benefits under Irish treaties and European

⁶²The Camp proposal would not affect noncorporate tax rates. See David G. Noren, "The Ways and Means Committee International Tax Reform Discussion Draft: Key Design Issues," 41 *Tax Mgmt. Int'l J.* 167 (Apr. 2012). John Harrington points out that repeal of the previously taxed income exclusion of section 959 means that U.S. shareholders that would be taxed under subpart F but that would not be entitled to the dividends received deduction would be taxed again on the distribution of the previously taxed earnings. Statement of John L. Harrington, hearing on international tax reform discussion draft, Ways and Means Select Revenue Measures Subcommittee, at 9 (Nov. 17, 2011). We believe that the better approach would be to preserve section 959 for previously taxed subpart F income rather than subject it to an additional 1.25 percent or 39.6 percent tax.

⁶³See, e.g., JCT, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10, at 122-127 (July 20, 2010) ("In each of the six case studies, the taxpayers manage their exposure to the subpart F anti-deferral rules and minimize the incidence of current U.S. taxation on their foreign earnings. The primary aspects of subpart F planning exhibited in the case studies are (1) avoiding foreign personal holding company income with respect to any intra-group royalty payments; and (2) avoiding the triggering of foreign base company sales income with respect to intra-group sales."); ABA task force report, *supra* note 51, at 712-713. As we observed in an earlier article, "The active finance and active insurance exceptions of section 954(h) and (i), the look-through exception of section 954(c)(6), the regulatory adoption of check-the-box entity classification rules in 1996, the reduction in scope for foreign base company services income in Notice 2007-13, 2007-1 C.B. 410, and the contract manufacturing regulations adopted in 2008 are examples of legislative, regulatory, and administrative developments limiting the scope of the anti-deferral rules of current law." Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 410 n.39.

⁶⁴See generally sections 954(c), (h); Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 410.

⁶⁵See Noren, *supra* note 62, at 171-172.

⁶⁶The Camp excess intangibles income proposal does not include an important element of the Obama administration proposal — namely, that the income be subject to a separate FTC limitation. This is a significant difference, particularly in the context of the Camp proposal's relaxation of the FTC limitation rules, which are discussed below at Section III.E. The Camp proposal also includes a same-country income exception from excess intangible company income, which was not in the administration's original budget proposal but was added later. This exception, discussed below, is a significant escape hatch from application of the rule, which undercuts its effectiveness. See Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," at 88-89 (Feb. 2012) (fiscal 2013 green book); OMB, "Living Within Our Means," *supra* note 17.

interest and dividend directives. The Irish subsidiary elects to be disregarded for U.S. tax purposes. For purposes of this discussion, we will assume that the Irish subsidiary either manufactures products or produces software in Ireland or sells advertising from Ireland.⁶⁷ We will consider how the anti-base-erosion rules would apply to income earned from this economic activity and, if they would apply, whether it would be possible with fairly straightforward planning to frustrate their application.

The following sections review the anti-base-erosion proposals.

1. *Camp Option A: Excess Intangible Income*

The excess intangible income proposal would use the subpart F framework to currently tax a U.S. shareholder under the subpart F provisions on CFC income that (1) is attributable to the use or exploitation of a covered intangible; (2) exceeds 150 percent of the costs attributable to the income; and (3) is not subject to foreign tax at an effective rate of at least 15 percent (the portion of the income included currently in a U.S. shareholder's income increases from 0 to 100 percent as the foreign tax rate declines from 15 percent to 10 percent). A covered intangible is broadly defined as an intangible that is transferred directly or indirectly (by sale, license, lease, or other means) from a U.S. person to a related CFC or is subject to a shared risk or development agreement.⁶⁸ The intangible need not be developed in the United States as long as it is transferred from the United States.

Income is attributable to use or exploitation of a covered intangible if it is realized from transactions connected with or benefiting from the intangible property, including income from the sale, lease, license, or other disposition of property in which the covered in-

tangible is used (directly or indirectly) and income from providing services related to the covered intangible or in connection with property in which the covered intangible is used (directly or indirectly).⁶⁹ Income from sales, leasing, licensing, or other disposition of property for use, consumption, or disposition in the country under the laws of which the CFC is created or organized and income from covered intangible-related services performed in that country are excluded from the scope of the excess intangible income.

The explanation for this proposal in the Obama fiscal 2013 budget was that it is intended to protect the U.S. tax base by reducing the incentive for shifting intangible income offshore.⁷⁰ In its application to so-called active income, subpart F historically has been understood to backstop transfer pricing rules by eliminating the transfer pricing issue in relation to specific prescribed transactions.⁷¹ The Camp proposal's excess intangible income option (option A), like other foreign base company rules, applies to income earned by the CFC in an amount that would satisfy the arm's-length standard. The proposal uses proxy measures to identify potential tax avoidance and precludes application of the exemption regime in circumstances in which the proxy tests are met.

The proposal is underinclusive in that it would not affect a case in which capital, tangible property, and services, but no intangibles, have been transferred. Nor would it affect cases in which an intangible is not transferred from the United States. Forest Laboratories Inc., for example, earned generous returns in its Irish manufacturing subsidiary from sales in the United States of a pharmaceutical product for which it acquired rights to the pharmaceutical compound from an

⁶⁷The facts are roughly based on public disclosures regarding low-taxed foreign operations of various companies, as part of hearings before the Ways and Means Committee (July 22, 2010), the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations (Sept. 21, 2012), and the United Kingdom's House of Commons Public Accounts Committee (Nov. 12, 2012).

⁶⁸Camp proposal section 331A(b), adding new section 954(f). A covered intangible refers to intangible property as defined in section 936(h)(3)(B), which includes any (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, or literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item that has substantial value independent of the services of any individual. The use of a broad definition of intangible is appropriate in Camp option A because it is an antiabuse provision. As discussed below regarding Camp option C, use of the same broad definition is inappropriate because the low-tax relief accorded to intangible income is unjustified for this category of intangibles. To invoke the carrot-and-stick metaphor used for Camp option C, the stick does not justify the scope of relief for the carrot.

⁶⁹Camp proposal, section 331A(b), new section 954(f)(1)(A)(i). The income included under this provision is income from transactions in which the intangible is used. Unlike Camp option C, the provision does not attempt to deconstruct a transaction in which a return to the intangible is embedded in a sales or services transaction. All the income from a transaction involving an intangible is tested to determine whether it results in an excess return. This approach should reduce the incentive for a CFC to charge a separate royalty instead of including the intangible return as part of the cost of goods sold. This would mitigate a transfer pricing problem, highlighted in *Bausch & Lomb*, that arises when bifurcating a transaction allows one part of an integrated transaction to be priced by inappropriate reference to a purported comparable. See *Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

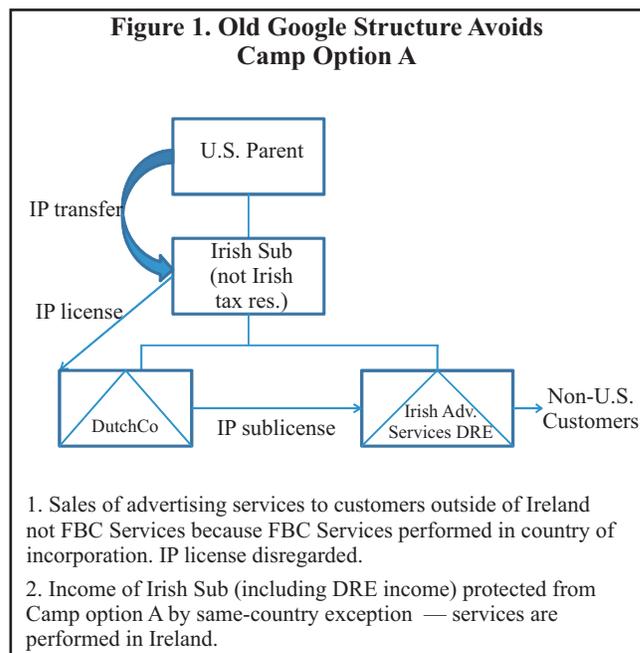
⁷⁰Fiscal 2013 green book, *supra* note 66, at 88 ("There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions.")

⁷¹See H.R. Rep. No. 87-1447, at 58 (1962).

unrelated non-U.S. licensor.⁷² Other than the fact that the right to use the drug compound was initially acquired by the CFC from a non-U.S. licensor, the Irish subsidiary was capitalized by its U.S. parent and operated in the same manner as any other subsidiary of a U.S. multinational in Ireland. Unless Forest Laboratories' Irish subsidiary's income benefited from an intangible licensed from the United States (which it may have), under Camp option A, income attributable to the intangible licensed from the non-U.S. licensor would be outside the scope of the rule even though the licensed intangible is predominantly exploited in the United States. This highlights the problem that the effect of the proposal is limited to capturing specified income for intangibles transferred from the United States irrespective of where the intangible is exploited. In contrast, Camp option C would accelerate inclusion of income from an intangible subject to a low foreign tax rate, but it would give tax rate relief only for income from foreign exploitation of the intangible.

The same-country exception as included in Camp option A could further materially undermine the effectiveness of the excess intangibles income provision. As just one example, Google is publicly reported to have used a cost-sharing agreement to transfer rights for use of its intangibles outside the United States to an Irish organized entity that is resident in Bermuda.⁷³ If this Irish company earns income from the sale of advertising services into the United Kingdom or other countries outside Ireland, using employees in Ireland, the income would be considered income from within Ireland and would not be taken into account in determining excess intangible income under proposed section 954(f) in the Camp proposal (just as it is excluded from foreign base company services income under section 954(e) of current law).⁷⁴ Google's 2011 financial statements in its annual report on Form 10-K to the U.S. SEC reported pretax non-U.S. earnings of \$7.63 billion and foreign taxes of \$140 million. Testimony at the hearing before the U.K. House of Commons Committee for Public Accounts indicated that 90 percent of Google's revenue was from advertising and substantially all non-U.S. advertising was sold through Ireland. When viewed in this context, the same-country exception of section 954(e) and proposed section 954(f) in

the Camp proposal can only be considered a major loophole that substantially undermines the effectiveness of the proposal. (See Figure 1.)



Other techniques may be used to avoid application of the excess intangibles income provision to income from manufacturing, for example, by restructuring manufacturing to change the income characterization from sales income to income from manufacturing services (performed in the CFC's country of incorporation). If these same-country manufacturing services involving use of a covered intangible (high-margin services) are provided by a CFC to a same-country sales affiliate and the sales affiliate's margin is kept below 150 percent of cost, the manufacturing services income would be excluded from the reach of the excess intangibles income provision under the same-country exception *and* the sales affiliate's income would not be subject to the provision because of having a sufficiently modest profit margin — that is, less than 150 percent of costs. The sales affiliate would avoid the foreign base company sales income rule under current law because the sales income is from property produced in the country of incorporation.⁷⁵ This structure is illustrated in Figure 2 in which Irish Sub is organized as an Irish company that is not tax resident in Ireland.⁷⁶ Irish

⁷²See Jesse Drucker, "U.S. Companies Dodge \$60 Billion in Taxes With Global Odyssey," Bloomberg, May 13, 2010.

⁷³See Drucker, "Google 2.4 Percent Rate Shows How \$60 Billion Lost to Tax Loopholes," Bloomberg, Oct. 21, 2010; Drucker, "IRS Auditing How Google Shifted Profits Offshore to Avoid Taxes," Bloomberg, Oct. 11, 2011.

⁷⁴The advertising income would be considered to have its source where the employees are located. See *Piedras Negras Broadcasting Co. v. Commissioner*, 127 F.2d 260 (5th Cir. 1942) (income from advertising paid by U.S. advertisers to a broadcaster based in Mexico for advertisements broadcast into U.S. markets was treated as sourced in Mexico from where the broadcasts were made).

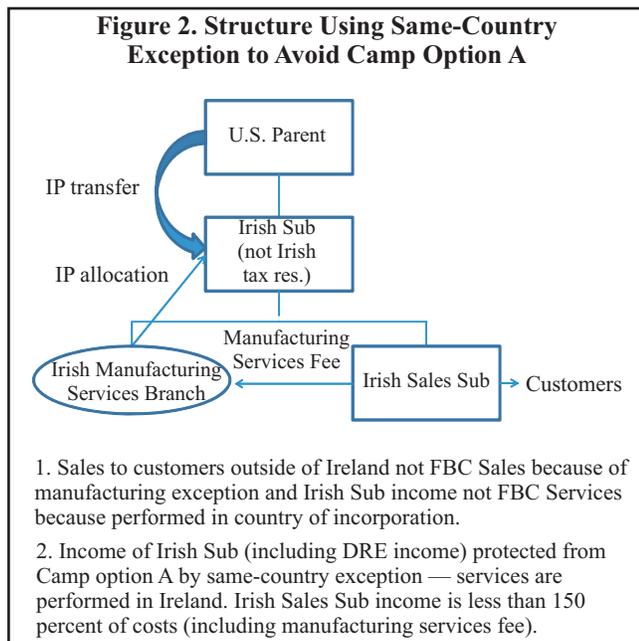
⁷⁵Section 954(d). Alternatively, foreign base company sales income would be avoided under current law if the sales affiliate were organized in the same country as the customer.

⁷⁶It is customary to cause a nonresident Irish company to satisfy the Irish conditions to be tax resident in another country, such as Bermuda (which does not have an income tax), as long as the company is not resident in a country that would impose

(Footnote continued on next page.)

Sub operates a manufacturing branch in Ireland that provides manufacturing services to a separate Irish-incorporated and tax resident sales affiliate (Irish Sales Sub). Irish Sales Sub sells to customers.⁷⁷

Figure 2. Structure Using Same-Country Exception to Avoid Camp Option A



The flaw in this same-country exception derives in part from privileging services performed in the country of incorporation instead of applying the exception only when the ultimate beneficiary of the services is located

tax on the non-Irish income. For example, at a recent hearing involving Apple Inc., it was disclosed that some of Apple's non-resident Irish subsidiaries held board of director meetings with participants primarily located in the United States and took the position that those companies were not tax resident anywhere. See Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, Hearing on Offshore Profit Shifting and the U.S. Tax Code — Part 2 (Apple Inc.), Exhibits: Excerpt from July 6, 2012, information supplied by Apple to the Permanent Subcommittee on Investigations, APL-PSI-000100 (reporting Apple Operations Ireland's "location for tax purposes" as "-"). Although the same exhibit listed Ireland as the place of tax residency for Apple Sales International (ASI), a footnote in Apple CEO Timothy Cook's testimony changed this response, stating, "Like AOI, ASI is incorporated in Ireland, is not tax resident in the U.S., and does not meet the requirements for tax residency in Ireland." Statement of Timothy D. Cook, Apple CEO, before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, hearing on offshore profit shifting and the U.S. tax code, part 2 (Apple Inc.) (May 21, 2013).

⁷⁷It is unnecessary in this discussion to address whether Irish Sales Sub sells to customers directly through "commissionaires" or affiliated strip distributors. As demonstrated in the JCT staff presentations on the hypothetical Bravo Co. case, it generally is possible to leave little income in the market country (2 percent of sales in the Bravo case). See JCT, "Income Shifting and Transfer Pricing," *supra* note 63, at 66-70.

in the country where the services are performed. The latter approach is taken in the second anti-base-erosion proposal, but, as discussed below, it also is susceptible to avoidance if an exception is added to exclude income from services provided for property in the same country (and the property is sold for use, consumption, or disposition outside the same country).

When first introduced in the Obama administration budget for fiscal 2011, the excess intangible income proposal was a partial replacement for removal under multinational lobbying pressure of a proposal to restrict international use of a disregarded entity under the U.S. entity classification rules.⁷⁸ It was defended politically on the grounds that it was targeting transfers of intangibles from the United States and taxed only "excess" intangible income. The underinclusiveness of the proposal is attributable to its origin as a sound-bite response to a much more substantial problem of income shifting and to its role of raising limited revenue to meet a budget target. The evolution of that proposal into Camp option A has added loopholes and further weakened an already inadequate proposal in relation to the seriousness of the income shifting problem.

2. Camp Option B: Low-Taxed Foreign Income

The second anti-base-erosion option in the Camp proposal takes a different approach to protecting the U.S. tax base, one that is not directly linked to intangible property or to transfers from the United States. This option would use the subpart F structure to currently tax a U.S. shareholder under the subpart F provisions on CFC income that is subject to a foreign effective tax rate of 10 percent or less, unless it qualifies for a home-country exception.⁷⁹ The low-tax test is an appropriate criterion for restricting the scope of exemption because the issue a principled exemption system seeks to address is the threat of double taxation. Absent a meaningful level of foreign tax, there is no principled justification for exemption.⁸⁰

However, the home-country exception provides that low-taxed income otherwise taxable by the United States under Camp option B is not subject to U.S. tax if (1) it is earned in a trade or business conducted by the CFC in the CFC's country of organization; (2) the

⁷⁸See Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," at 28 (May 11, 2009) (the provision later removed was labeled "Reform Business Entity Classification Rules for Foreign Entities"); Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," at 43 (Feb. 2010) (provision labeled "Tax Currently Excess Returns Associated With Intangibles Transferred Offshore").

⁷⁹Importantly, the effective tax rate test is applied separately for each country in which the CFC conducts a trade or business. We refer to income that does not satisfy this test as low-taxed income.

⁸⁰See Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 412-426.

CFC has an office in that country; and (3) the income is derived in connection with the sale of property for use, consumption, or disposition in that country⁸¹ or in connection with services “provided with respect to persons or property located in such country.” Note that the services rule in Camp option B generally looks to the location of the consumer of the services and ignores the place where services are performed. Instead, the services rule is met if services are provided “with respect to persons or property” located in the CFC’s country of organization. As described below, the “property” services aspect of this rule appears to open up an exception for high-margin manufacturing services.

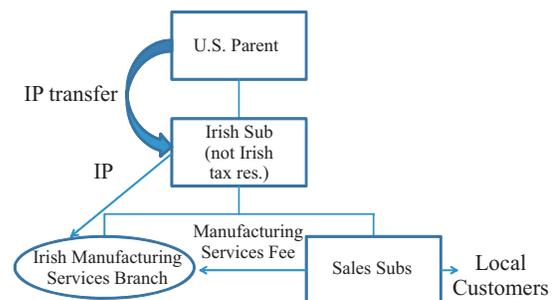
This low-taxed income antiabuse rule would appear to cause low-taxed income realized in a principal structure from manufacturing property that is sold for use, consumption, or disposition outside the principal’s country to be ineligible for the home-country exception and therefore ineligible for exemption. This would be irrespective of the use of intangibles, whether the principal is engaged in or responsible for manufacturing, or the place of the product’s manufacture. This would be an improvement over Camp option A. However, the same-country exception to the low-taxed income rule in Camp’s option B may be circumvented in various circumstances by manipulating the income characterization rules and taking advantage of transfer pricing. Again, this appears to be a significant loophole that substantially undermines the effectiveness of the proposal.

The same-country exception to the low-taxed income rule in Camp option B provides that the rule is avoided if the same-country trade or business and office requirements summarized above are met and if the “income is derived in connection with . . . services provided with respect to persons or property located in such country.”⁸² This is significant because a CFC’s manufacturing activity may be classified as a service if a party that purchases manufactured property from the CFC owns the raw materials, the work in progress, and

the final product and also engages in modest supervision of the CFC’s manufacturing work.⁸³ When those requirements are met, the CFC’s manufacturing income morphs into services income within the meaning of the preceding quotation and an opportunity arises to avoid the Camp low-taxed income rule even if the manufactured property is sold for use, consumption, or disposition outside the CFC’s home country. The following example illustrates the use of this tactic.

An Irish manufacturing CFC could conduct its activity as a full-risk service for tax purposes and demand a full-risk manufacturing services fee that also includes a return to an intangible embedded in the service. In that way, income earned by a sales affiliate will be minimized and the low-taxed income maximized without triggering the Camp low-taxed income rule. This structure is illustrated in Figure 3 in which Irish Sub (which is organized as an Irish company but is a tax nonresident in Ireland) has an Irish branch that provides manufacturing services to Sales Sub, which is a corporation for U.S. tax purposes organized in the country (other than Ireland) where its customers are located.

Figure 3. Structure Using Same-Country Exception to Avoid Camp Option B



1. Sales Sub sales to customers outside of Ireland not FBC Sales because of manufacturing exception and same-country sales rule. Irish Sub manufacturing services not FBC Services because performed in country of incorporation.
2. Income of Irish Sub protected from Camp option B by same-country exception — services are performed on property in Ireland. Sales Sub sales income also protected from option B because the sales are for use, consumption, or disposition in Sales Sub’s country of organization.

It also would be possible to deconstruct the functions of a sales affiliate to hive off services that might be provided “with respect to property” in a low-tax

⁸¹The standard in the existing foreign base company sales regulations that is used to determine when a sale is for use, consumption, or disposition in a country is rigorous, even if difficult to administer in practice. It looks to the ultimate destination of the property, not its place of sale. If a sale is to an unrelated person, the property will be considered sold for use, consumption, or disposition at the property’s destination unless at the time of sale the CFC knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination. In the latter case, the CFC must determine the final destination or the sale will be presumed to be for use, consumption, or disposition outside the CFC’s country of organization. The rules presume that a sale to a related person is for use, consumption, or disposition outside the CFC’s country of organization unless the seller establishes otherwise. See reg. section 1.954-3(a)(3)(ii).

⁸²Camp proposal, section 331B (emphasis added).

⁸³See reg. section 1.954-3(a)(4)(iv); Scott M. Klein, Michael R. Perez, Patricia M. Iribarren, and Michael J. Beeman, “International Tax: A Quest to Resolve Overlap Between Foreign Base Company Sales and Foreign Base Company Services,” 32 *ABA Tax’n Sec. NewsQuarterly* 1, 27-28 (Spring 2013).

country where the service is provided. In the past, the Netherlands offered favorable effective tax rates for warehousing functions to attract distribution and fulfillment centers. These would seem to meet the requirement of providing services with respect to the property that is housed in the storage location and thereby achieve stripping of income from the country of destination into a low-taxed service arrangement.

Strategies for avoiding the effect of the low-taxed income rule through the current-law same-country exception could be addressed through statutory drafting or by delegating to Treasury and the IRS authority to issue anti-avoidance rules in the regulations. Indeed, if the avoidance possibilities of the same-country exception are successfully frustrated, it likely will be of minimal interest to multinational corporations and could be eliminated altogether. This would simplify the provision and avoid the otherwise inevitable games of “whack-a-mole” between tax authorities and tax-avoidance artists.

More fundamentally, if the same-country exception is eliminated and the political pressures for creating other exceptions are resisted, the low-taxed income anti-base-erosion option (Camp option B), unlike the Camp proposal’s other two anti-base-erosion options, could be developed into a robust protection against earning stateless income in low-tax or tax haven countries. But if the same-country exception is retained and the pressures to create other exceptions are not resisted, the loopholes would perpetuate a system in which the complex tax planning opportunities available to multinational businesses achieve low effective tax rates and result in tax-induced distortion of business decisions.⁸⁴

3. Camp Option C: Foreign Intangible Income

The Camp proposal’s third anti-base-erosion proposal would cause a CFC’s low-taxed intangible income (both U.S.-source and foreign-source) to be taxed currently to a U.S. shareholder as subpart F income (foreign base company intangible income). Nevertheless, through the Camp modifications to the section 954(b)(4) high-taxed-income exception, a CFC’s intangible income would be eliminated from subpart F income if it bears a foreign effective tax rate of greater than 13.5 percent.⁸⁵ Thus, only intangible income that is subject to a foreign effective tax rate of 13.5 percent or less would be affected by Camp option C’s subpart F inclusion. Under the Camp proposal, however, a U.S. corporation would be permitted a deduction equal to

40 percent of the U.S. corporation’s foreign intangible income and, for any CFC in which it is a U.S. shareholder, the lesser of its share of the CFC’s (1) foreign base company intangible income or (2) foreign intangible income. Assuming Camp’s proposed 25 percent section 11 rate were enacted, the 40 percent deduction would impose a 15 percent U.S. rate cap (before FTCs) on both directly earned foreign intangible income and subpart F inclusions of foreign base company intangible income attributable to foreign intangible income.⁸⁶

Under these complex rules, a CFC’s intangible income that bears a foreign effective tax rate of greater than 13.5 percent benefits from deferral. A U.S. corporation’s share of a CFC’s foreign intangible income taxed at a foreign rate of 13.5 percent or less is currently taxed, but at a maximum U.S. rate of 15 percent, less any FTC. A U.S. corporation’s share of a CFC’s foreign base company intangible income that is not foreign intangible income (and is therefore ineligible for the 15 percent rate) would be currently taxed at a full section 11 rate, less any FTC.⁸⁷ In essence, the rule would increase the tax on foreign intangible income shifted to low-tax (that is, 13.5 percent or less) countries to 15 percent, but would reduce, to a maximum of 15 percent, the U.S. tax rate on foreign intangible income derived in connection with a U.S. corporation’s share of a CFC’s foreign sales, services, or licensing income. Intangible income from serving the U.S. market, other than intangible income earned by a CFC taxed at a foreign effective rate greater than 13.5 percent, would be taxed currently at a full section 11 rate.

This option is attempting to both create a U.S. tax advantage for intangible income earned (directly or through a CFC) from foreign markets and protect against U.S. tax base erosion through the use of intangibles held in a low-tax country by the CFC.⁸⁸ The proposal is flawed from a tax policy, tax administration, and tax base protection perspective.

⁸⁶We assume, but it would be important to clarify, that the 40 percent deduction would be directly allocated to the foreign income.

⁸⁷Generally, a CFC’s foreign base company income that is not foreign intangible income would be attributable to U.S. exploitation of an intangible. If the income from U.S. exploitation were in the form of a royalty, it would be U.S.-source income under section 861(a)(4). A subpart F inclusion attributable to the royalty would, under section 904(h), be U.S.-source income, the U.S. tax on which could not be offset by FTCs. If the intangible income was earned in the form of sales or services income, however, it would be possible, by embedding the return to the intangible in the price for the property or service being sold, to cause the income to have a foreign source. The U.S. tax on that foreign-source income could be offset by FTCs.

⁸⁸The reduced effective tax rate on intangibles used for export of goods or services would have to be tested for conformity with U.S. obligations under international trade agreements.

⁸⁴We do not consider in this report the possibility of designing a low-taxed anti-base-erosion proposal to be a form of minimum tax. In our view, it would be important that such a tax (at a rate less than the otherwise applicable U.S. rate) not be a final tax. It is beyond the scope of this report to describe how that tax might be designed.

⁸⁵For the definition of intangible income and foreign intangible income, see text accompanying *supra* note 21.

The policy justifications usually asserted for providing incentives to research and development are that market failures impede companies from investing the socially optimal amount in R&D. Companies cannot capture the full social surplus from their inventions, because R&D results in knowledge spillovers and social returns that are not captured by innovators' profits. The Camp proposal's option C tax relief, however, does not target these market failures, nor does it target research that fosters innovation.

The scope of the Camp proposal's reduced rate for foreign intangible income is astonishing. It would apply to income "attributable to" any section 936 intangible, which includes: a patent; invention; formula; process; design; pattern; know-how; copyright; literary, musical, or artistic composition; trademark; trade name; brand name; franchise; license; contract; method; program; system; procedure; campaign; survey; study; forecast; estimate; customer list; technical data; or any similar item that has substantial value independent of the services of any individual.⁸⁹

The economic justifications for subsidizing innovative research activity do not extend to marketing intangibles, such as trademarks and brand names or franchises, the value of which results largely from advertising rather than technological innovation. Sensible rationales for subsidizing investment in these intangibles are not apparent. Moreover, under the Camp proposal, there is no required linkage between the intangible and "activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product."⁹⁰

For patents and non-marketing intangibles, there is no requirement in the provision that the development of the intangible be the result of work in the United

States.⁹¹ The presumed spillover benefits from intangible development outside the United States encouraged by this subsidy would accrue to other countries, not the United States. Further, even assuming that the benefit was targeted at U.S.-located R&D activity, it is questionable whether a benefit for income from successful R&D is a cost-effective mechanism for inducing expenditure on risky innovation.⁹²

The intangible income relief applies only to intangible income embedded in sales and services income to the extent that the gross income from sales of property or services, in which an intangible is used, is properly attributable to the intangible property.⁹³ There is no indication how "income attributable to" an intangible that is embedded in the sale of property or the provision of services is to be separated out when applying the benefit of the lower rate.⁹⁴ This will be difficult for taxpayers to administer and for the IRS to monitor and enforce. The likely result will be to overstate the amount of intangible income qualifying for the lower rate.

The incentives created by this web of rules are worth noting. A U.S. corporation would favor characterization of income as intangible income if the use or customer is outside the United States — that is, the intangible is exploited outside the United States. In that case, the 40 percent deduction would be available

⁹¹See Graetz and Doud, *supra* note 51, at 361 (citing economic evidence that "geographic spillovers are significant to firm productivity, but that such spillovers decay rapidly with distance").

⁹²*Id.* at 355, 406-410 ("There is scarce evidence, however, that even the most successful innovation tax incentives are cost effective in accomplishing the goals of countries that have adopted them.").

⁹³The draft language of the provision could be read to exclude income that is from the license or sale of intangible property itself, as opposed to income from property in which the intangible "is used directly or indirectly." It is possible that since royalties are covered by the definition of foreign personal holding company income in section 954(c)(1) and the exception for active royalties in section 954(c)(2)(A), they were not intended to be within the scope of the provision. The technical explanation says that the provision "creates a new category of subpart F income for worldwide income derived by CFCs from intangibles and provides a deduction for a domestic corporation of [40] percent of its income from foreign exploitation of intangibles." Camp proposal technical explanation, *supra* note 20, at 34. We take this to mean that all income from exploitation of the intangible itself, including royalties, is intended to be covered. It would be helpful for this to be clarified.

⁹⁴The United Kingdom's approach to identifying income attributable to a patent is to start with a broad concept of income benefiting from the relevant patents (relevant intellectual property income (RIPI)) and to then subtract from RIPI a routine return on deductions for personnel, plant and machinery, and miscellaneous services to reach "qualifying residual profit." A further step is taken to reduce qualifying residual profit by a return on marketing assets used to derive RIPI. See Finance Act 2012, ch. 14, section 19.

⁸⁹The definition of intangible income is based on a cross-reference to the definition of intangible property in section 936(h)(3)(B). This is a definition that in the principal contexts in which it is used is intended to be expansive because the purpose of those provisions is to increase, not reduce, U.S. tax. See, e.g., sections 367(d), 482. This proposal is much broader than the U.K. patent box regime, which would apply only to patents, and even then only to patents granted by the U.K. Intellectual Property Office, the European Patent Office, or specified European Economic Area countries. See Finance Act 2012, ch. 14, section 19.

⁹⁰This is the minimal U.S. standard for allowance of a deduction for research and development under section 174. See reg. section 1.174-2. The U.K. test for R&D tax relief requires that the activity be directed at an advance in science or technology through the resolution of scientific or technological uncertainties. We leave for discussion elsewhere the fact that overall U.S. tax policy toward R&D is very expansive and extends beyond articulated policy justifications for an R&D subsidy. See, e.g., Calvin H. Johnson, "Capitalize Costs of Software Development," *Tax Notes*, Aug. 10, 2009, p. 603.

for the foreign intangible income.⁹⁵ Whenever foreign intangible income is a part of an integrated transaction, a taxpayer will seek to attribute maximum returns to the intangible portion of the transaction. The administration of this aspect of the option C proposal would be difficult for taxpayers and the IRS.⁹⁶ This appears to be inherent in most so-called patent box proposals.

The Camp proposal's option C fosters incentives for avoidance efforts. A U.S. corporation will have an incentive to disguise U.S. exploitation as foreign exploitation. If an intangible is licensed for foreign manufacturing or services, it likely would constitute foreign intangible income, whereas a license for U.S. manufacturing or services would yield a higher tax rate. When the foreign purchaser is reselling in whole or in part to customers in the United States, the classification of the intangible income as foreign or not will be more difficult to monitor if the intangible return is embedded in the price for a sale of property or services to the foreign purchaser.

A CFC's strategies for avoidance will vary according to its effective foreign tax rate and whether the intangible is being exploited abroad or in the United States. If the CFC's effective foreign tax rate is 13.5 percent or less and the intangible is exploited in the United States, the CFC has an incentive to avoid or minimize characterization of income as intangible income to preserve eligibility of the non-intangible portion for exemption. If the CFC has intangible income subject to that low foreign tax rate and it is impossible to avoid intangible income characterization, the intangible income will be subpart F income. In that case it is preferable for the intangible to be exploited outside the United States so that the 40 percent deduction is available. To prevent use of foreign accommodation resellers to U.S. customers, it will be necessary to expand the look-through characterization of intangible income beyond resale of property to include services and royalties that are earned from ultimate U.S. customers.

⁹⁵As drafted, it might appear that foreign intangible income relief would not apply to a transfer to a U.S. customer, even if the U.S. customer were using the intangible or intangible-related product in an export to a foreign customer. We understand that the definition of foreign intangible income is intended to look to the ultimate place of exploitation, following the concept used in the subpart F rules for use, consumption, or disposition of property. See reg. section 1.954-3(a)(3)(iii) and text accompanying *supra* note 81.

⁹⁶See Phillip D. Morrison, "Chairman Camp's Territorial Proposal and the Potential Expansion of Subpart F," 41 *Tax Mgmt. Int'l J.* 90 (Feb. 2012) ("Requiring segregation of the return to intellectual property will result in significant controversy during the examination process as taxpayers and the IRS attempt to subdivide the returns on transactions. Such a theoretical subdivision of income from a single transaction is considerably more complex than adjusting the transfer prices for actual transactions based on other, actual transactions among uncontrolled taxpayers.").

If the CFC's foreign effective tax rate is between 13.5 and 22.5 percent (that is, 90 percent of the top corporate rate of 25 percent under the Camp proposal), the CFC generally would favor intangible income characterization even if the intangible is exploited in the United States. The reduced high-tax exception from subpart F applies to all foreign base company intangible income, regardless of whether it is foreign intangible income in the form of sales or services income is taken out of the reach of foreign base company sales or services income, so once that foreign base company intangible income bears a foreign effective tax rate of 13.5 percent or more, the availability of the 95 percent dividends received deduction for actual dividend distributions by the CFC is ensured.⁹⁸ In that case, it would not matter whether the intangible is exploited in the United States, as long as it does not give rise to ECI. If the CFC's foreign effective tax rate is at least 22.5 percent, its income would be eligible for deferral and it would be neutral regarding the character and source of the exempt income.

To summarize, Camp option C has no sound policy justification; it does not require that R&D activity that gives rise to the benefited intangibles take place in the United States, but it does require that the beneficiaries of the intangibles be outside the United States. Moreover, it benefits intangibles that do not involve scientific or technological innovation. Further, option C would be complex and difficult for the IRS to administer, and it would be readily susceptible to gaming to the advantage of taxpayers and the disadvantage of the fisc. Option C has only its political attributes to recommend it.

Option C would help technology and pharmaceutical companies that, as leading practitioners of the arts of base erosion and income shifting, otherwise would be hit hard by real anti-base-erosion proposals. It serves as a sop to exporters that otherwise might not benefit materially from the dividend exemption regime or would be hit by any of the anti-base-erosion proposals.

⁹⁷Camp proposal, section 331C(c)(1), modifying section 954(b)(4) to treat the maximum rate of tax under section 11 as 60 percent of that rate when determining foreign base company intangible income.

⁹⁸Camp proposal, section 331C(c)(3), adding new section 954(b)(7) providing that foreign base company intangible income is not treated as foreign base company sales, services, or oil-related income. It is unclear why there is no stacking rule in relation to foreign personal holding company income. In our view, the better reading is that foreign base company intangible income that is excluded under the high-tax exception (which is elective) would not be currently included even if it also were foreign personal holding company income described in section 954(c). We acknowledge that contrary to our conclusion at *supra* note 93, it is possible that foreign base company intangible income does not include royalties and that they are governed exclusively by the foreign personal holding company rules of section 954(a)(1) and (c).

It seeks to reassure revenue estimators that it will not expose the U.S. tax base to the use of intangibles to take advantage of an exemption system to erode the U.S. tax base (taking a naive view that transfer pricing games are limited to intangibles and that the foreign income bases have been exhausted). It panders to the administration's export initiative, perhaps in hopes that the White House will bargain away tax policy for a fiscal deal (which is not virgin territory for this or other administrations). Camp option C is a triumph of politics over policy.

A final point about Camp option C is that its characterization as an anti-base-erosion provision is utterly misleading. In fact, it would create a large, incoherent, and complicated new tax expenditure that is lacking a sound policy justification. Substantially more empirical analysis and evidence of efficacy are needed before proceeding to enact such an open-ended subsidy.⁹⁹

4. Enzi Proposal: Subpart F, Intangible Income Deduction

As discussed above, the Enzi proposal would (1) repeal the foreign base company sales and services income rules, (2) make permanent the active finance and insurance subpart F exceptions and the section 954(c)(6) look-through rule, and (3) adopt a low-taxed-income category of subpart F income that includes a broad exception for business income attributed to an active business carried on through an office in the low-tax country. The Enzi proposal also would adopt a new intangible income deduction. This discussion focuses on the low-taxed-income proposal.

The Enzi proposal would use the subpart F regime to currently tax a U.S. shareholder on income that is not subject to an effective rate of tax equal to at least half the highest U.S. corporate rate (17.5 percent under current law, 12.5 percent if the corporate rate were reduced to 25 percent) — that is, the effective foreign tax rate test — and is not qualified business income. The qualified business income exception from the new low-taxed-income category of subpart F income would apply to income from a foreign country if (1) it is attributable to the active conduct of a trade or business in the foreign country, (2) the corporation has an office or fixed place of business in the country, and (3) officers and employees located at the office “conduct or significantly contribute to the conduct of activities . . . which are substantial in relation to the

activities necessary for the active conduct of the trade or business to which such income is attributable.”¹⁰⁰ The active business test and the effective foreign tax rate test are on a country-by-country basis and take into account all the activity in a country.

Unlike the Camp proposal's favorable tax rate for a CFC's foreign intangible income, under the Enzi proposal, qualified business income of a CFC would not include intangible income.¹⁰¹ Accordingly, intangible income that otherwise would qualify for an exception from foreign base company income as active royalty income would nonetheless be currently taxed under subpart F if it did not meet the effective foreign tax rate test.

The qualified business income exception to the Enzi proposal's low-taxed-income category would swallow the rule. It would be easy to exploit and difficult to administer. In the international context, the standard for when a trade or business exists is oriented toward being a low bar under U.S. concepts. For example, relatively nominal activity, including the performance of any services, can constitute a trade or business and subject a foreign person to U.S. net basis taxation. Further, there is no clear standard for when a trade or business is active, and the only analogous standard for when income is attributable to a business is factual and undefined, except that its amount is determined under arm's-length transfer pricing principles.¹⁰²

The added requirement of an office and significant contribution by company personnel would be modest hurdles indeed if reference is made to the sadly inadequate standards adopted in the subpart F contract manufacturing regulations.¹⁰³ The low-taxed-income category would be readily avoidable by using existing principal structures that satisfy the contract manufacturing standards, and it therefore would do little to prevent erosion of the U.S. tax base.¹⁰⁴ Although the Enzi low-taxed-income proposal is not in its current form a

¹⁰⁰S. 2041, section 103(a), adding new section 954(f).

¹⁰¹Intangible income is defined as gross income from (1) “the sale, lease, license, or other disposition of property in which intangible property is used directly or indirectly”; or (2) services related to intangible property or in connection with property in which intangible property is used directly or indirectly, “to the extent that such gross income is properly attributable to such intangible property.” Foreign intangible income means any intangible income derived in connection with (1) property sold, leased, licensed, or disposed of for use, consumption, or disposition outside the United States; or (2) services provided with respect to persons or property located outside the United States. Intangible property is defined by cross-reference to section 936(h)(3)(B).

¹⁰²See, e.g., reg. section 1.367(a)-2T(b)(3); OECD, Model Tax Convention on Income and Capital, article 7(1).

¹⁰³See reg. section 1.954-3(a)(4)(iv).

¹⁰⁴This tax structuring strategy has become so ubiquitous that it is discussed in publications of government policy staffs and international organizations. See JCT, “Income Shifting and

(Footnote continued on next page.)

⁹⁹See Stephanie Soong Johnston and David D. Stewart, “Germany on Patent Box Regimes: Put a Lid on It,” *Tax Notes Int'l*, July 29, 2013, p. 395 (German finance minister calls for ban on patent boxes in the EU). The OECD has recently observed that the effective tax rate on returns to R&D may be well below that intended by tax authorities. See OECD, “New Sources of Growth: Knowledge-Based Capital Driving Investment and Productivity in the 21st Century — Interim Project Findings,” at 13 (May 2012); see generally Graetz and Doud, *supra* note 51; Martin A. Sullivan, “Time to Scrap the Research Credit,” *Tax Notes*, Feb. 22, 2010, p. 891; Government Accountability Office, “Tax Policy and Administration: Review of Studies of the Effectiveness of the Research Tax Credit,” GAO/GGD-96-43 (May 1996).

robust protection against earning low- or zero-taxed income, it, like the Camp option B anti-base-erosion proposal, could be developed into one.

The Enzi proposal would allow a deduction to a domestic corporation for 50 percent of its qualified foreign intangible income. Qualified foreign intangible income is foreign intangible income that is derived from the conduct of an active trade or business *in the United States* regarding the intangible property.¹⁰⁵ Once again, intangible income covers income from sales and services to the extent that the gross income is properly attributable to intangible property. For intangible income embedded in the sale of a property or service, it would be necessary to bifurcate the return from the transaction to identify the intangible component. This so-called patent box proposal has the same policy and administrative flaws as the Camp proposal's deduction for a U.S. corporation. The treatment of intangible income earned by a CFC, however, is quite different from that under the Camp proposal's option C.

As noted above, the qualified business income exception from the low-taxed-income category would not apply to intangible income of a CFC. Thus, under the Enzi proposal, a U.S. shareholder's interest in intangible income embedded in a CFC's sales or services income would be the opposite of the same taxpayer's interest in intangible income for determining qualified foreign intangible income of an affiliated U.S. person. In the case of the CFC, the U.S. shareholder would seek to minimize intangible income in determining qualified business income. But the same shareholder would seek to maximize its qualified foreign business income from exports of sales and services.

The effect of the Enzi proposal's rules for intangibles appears to be to encourage holding foreign intangible rights in the United States to generate income taxed at half the U.S. corporate rate (or 17.5 percent) instead of in a CFC where the income would be subpart F income, taxed at 35 percent, unless it otherwise was not subpart F income and was taxed at a foreign rate above 17.5 percent.¹⁰⁶ On the other hand, the Enzi proposal would make it easy to earn low-taxed income

Transfer Pricing," *supra* note 63, at 9-10; OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," ch. 9 (2010). For a description of the kind of tax planning discipline routinely used to effect a tax-efficient corporate structure, see T. Timothy Tuerff, Gretchen T. Sierra, Christopher Trump, and Maruti R. Narayan, "Overview of Outbound Tax Planning for U.S. Multinational Corporations," 40 *Tax Mgmt Int'l J.* 371 (July 2011).

¹⁰⁵S. 2041, section 103(a), adding new section 250 (emphasis added).

¹⁰⁶A royalty would have to avoid being foreign personal holding income as well as the low-taxed-income category of subpart F income.

from sales and services without triggering the low-taxed-income rules.¹⁰⁷

C. Gain and Loss on Sale of CFC Stock

The Camp proposal would exclude 95 percent of a corporate U.S. shareholder's gain on the sale of stock in a qualified foreign corporation, which is a CFC for purposes of the dividends received deduction, if 70 percent of its assets were active assets at the time of sale and under a three-year lookback test.¹⁰⁸ Any loss on the sale of that stock would be completely disallowed.

A rationale for exempting gain on the sale of CFC stock in an exemption system is that in addition to serving as a shareholder realization of preexisting earnings, the gain is an alternative mechanism to recognize appreciated value that is equivalent to a sale of assets and distribution of the gain from the asset sale. The argument is that if the distribution as a dividend of gain from the sale of assets would be exempt, the gain on a stock sale should be exempt as well. Rather than impose a look-through rule to determine the nature of the CFC's deemed gain on a sale of assets, the Camp proposal characterizes the gain as either eligible for exemption or not, depending on whether the CFC satisfies the 70 percent active asset test.

Moreover, when there is a foreign corporate-level tax on earnings, there would be at least one level of tax on a sale of corporate assets. Consequently, the exemption of stock sale gain also may be justified as avoiding a second level of corporate taxation. However, this justification lacks credibility under the U.S. classical income tax system, which treats two levels of tax on C corporation income as the norm.

The overriding point is that the source country generally does not tax stock sale gains.¹⁰⁹ Accordingly, exempting stock sale gain will often mean that no U.S.

¹⁰⁷The low-taxed-income category of subpart F income would affect high-profit businesses that today use intangibles to attract income into low-tax countries (such as successful pharmaceutical and high-tech companies). The test rate of 17.5 percent is higher than effective foreign tax rates that are achieved under current law.

¹⁰⁸Technically, this could include a branch deemed a CFC (for all purposes of the title); however, such a CFC does not issue actual stock. The technical explanation, while not addressing the issue directly, suggests that is not intended. This could be made clearer; however, the more important point is that gain or loss on the sale of a branch trade or business that does not benefit from the 70 percent threshold presumably would be analyzed on an asset-by-asset basis.

¹⁰⁹A foreign shareholder generally is not subject to U.S. tax on a sale of stock in a U.S. corporation if the corporation is not a U.S. real property holding company and the gain is not effectively connected with a U.S. business. A tax-exempt organization generally is not taxed on stock sale gain unless the debt-financed-income rules apply.

tax would apply on the disposition of the entire enterprise even though the stock sale gain has not borne a meaningful foreign tax.¹¹⁰

To the extent that the Camp proposal's dividend exemption system is more onerous than that of other countries, there would be an incentive for a foreign acquirer to acquire a U.S. corporation with foreign subsidiaries. Applying the 95 percent exemption to all of a U.S. corporation's section 331(b) and section 336(a) gain would facilitate redeployment of foreign subsidiaries out of U.S. corporate solution to a foreign parent at a small U.S. tax cost upon the distribution of the foreign subsidiary to the foreign parent. There would be a potential shareholder-level withholding tax on the distribution to the foreign acquirer; however, some important U.S. treaties provide a zero rate of dividend withholding for 80 percent or greater treaty-resident corporate shareholders meeting specified conditions.¹¹¹ Moreover, most other treaties provide a 5 percent direct dividend rate.¹¹²

Under the Camp proposal, the 95 percent exemption of sale gain also would apply to a distribution of CFC stock to shareholders in a nonrecognition transaction otherwise subject to section 1248(f). This would permit distribution of active foreign subsidiary groups to public shareholders in a tax-free spinoff transaction and thereby remove a CFC from the scope of subpart F altogether.¹¹³

In summary, the Camp proposal's approach to stock sale gain would allow corporate-level unrealized appreciation to go completely untaxed by allowing gain from some stock sales to qualify for the 95 percent deduction. In light of the laxity of the antiabuse rules described above, this treatment extends the reach of the loopholes in the Camp proposal. Moreover, the relief from section 1248(f) gain is particularly problematic

¹¹⁰Even if there is no actual realized corporate-level gain, a buyer presumably discounts its price to account for the future tax on unrealized gain such that the seller suffers an implicit tax. As we have discussed elsewhere, however, implicit taxes are not a substitute for actual taxes for this purpose. See Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 421-424.

¹¹¹U.S. treaties with the following countries have such a provision: Australia, Belgium, Denmark, Finland, France, Germany, Mexico, New Zealand, Sweden, and the United Kingdom.

¹¹²U.S. treaties with a higher than 5 percent direct dividend rate are with Bangladesh, China, India, Israel, Jamaica, Korea, Morocco, Norway, Pakistan, the Philippines, Romania, Spain, Sri Lanka, Thailand, Trinidad and Tobago, Tunisia, and Turkey.

¹¹³Stapled entity rules would prevent tying the shares to the shares of the distributing corporation. See section 269B. It is not clear that as drafted, section 7874 would apply to a preexisting foreign corporation distributed in a section 355 spinoff since there would be no acquisition by the foreign corporation directly or indirectly of substantially all of the properties owned by the U.S. corporation. See section 7874(a)(2)(B)(i).

because it would allow low-cost prospective avoidance of subpart F altogether in a significant range of cases.

The Enzi proposal takes a different approach and limits exemption on a sale to the qualified foreign portion of a section 1248 dividend — that is, stock sale gain attributable to active foreign earnings. The Enzi proposal would extend this treatment to subpart F income from gain on a CFC's sale of stock in another CFC to the extent the gain is characterized as a dividend under section 964(e).¹¹⁴ We have supported this approach, but, crucially, in a context in which exempt earnings have been subject to a meaningful foreign tax. As explained earlier in this report, this is not required under the current draft of the Enzi proposal.

We conclude regarding both the Camp and Enzi proposals that it would be a mistake to exempt stock sale gains even to the extent of earnings qualifying for the 95 percent deduction unless there is a strong subject-to-tax requirement or a reliable low-taxed-income exception from exemption (without the loopholes identified above).¹¹⁵

D. Foreign Branches and 10/50 Corporations

1. Foreign Branches

The Camp proposal would apply the 95 percent exemption to income earned through a foreign branch of a U.S. corporation that carries on a trade or business by deeming the branch to be a CFC.¹¹⁶ The Enzi proposal would treat a foreign branch the same as under current law — that is, branch income would be subject to current taxation, and the U.S. corporation owning the branch would be allowed a credit for foreign income taxes and a deduction for branch losses (subject to the section 904(f) limitations).

The mandatory treatment of a foreign branch of a U.S. corporation as a CFC if it carries on a trade or business attempts to reduce the disparity in taxation of a foreign branch and a foreign subsidiary. This would restrict the scope for tax planning, available under current law, to locate foreign loss operations in a foreign branch to offset U.S. taxable income while placing

¹¹⁴This follows the approach of the 2005 JCT staff exemption proposal. See JCT, "Options," *supra* note 1, at 191.

¹¹⁵We have discussed elsewhere other alternatives for the treatment of stock sale gains and losses. These include a look-through treatment of stock gain that would allow exemption only to the extent the appreciation in underlying assets, if realized, would qualify for exemption. In our view, such a tracing approach would be impractical to administer. We also have expressed a preference for symmetrical treatment of stock losses. See Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 439-441.

¹¹⁶This approach to foreign branches was proposed by the JCT staff in 2005. See JCT, "Options," *supra* note 1, at 191.

profitable operations in a foreign subsidiary.¹¹⁷ The Camp proposal's approach of deeming the branch to be a CFC "for purposes of this title" addresses a series of important domestic tax base protection issues in a way that would be more manageable than alternative approaches (such as imputing or deeming royalties from an exempt branch). It also has practical and transition implications that deserve discussion.

Whether foreign branches are treated as CFCs or not, neutrality between taxation of a branch and a subsidiary is highly desirable from a policy and U.S. tax base protection perspective. To accomplish these objectives, the income of a foreign branch should be exempted to the same extent as income of a CFC. The Camp proposal's deemed CFC approach addresses the difficult problem of foreign branches using or having transferred to them U.S. intangibles or other income-ripe assets without a royalty or appropriate charge and then earning exempt income, thereby diminishing the U.S. tax base.

Deeming the branch to be a CFC also brings the outbound asset transfer rules of section 367 into play, and in practice would make it easier to apply section 482 to ensure that the U.S. tax base includes its fair share of the branch's income. For use of an intangible in the sale of property, treating the branch as a CFC essentially transforms what would be a sale by the branch with an embedded intangible into a sale with a royalty back to the home office. This approach is consistent with the OECD's effort to conform transfer pricing for a branch to transfer pricing for a subsidiary.¹¹⁸

Adopting a deemed CFC approach will involve a one-time transition adjustment that is material. Absent special rules, the Camp proposal would cause each foreign branch to have a deemed incorporation event that would have to be tested under the outbound asset transfer rules of section 367(a).¹¹⁹ Under current law, the deemed incorporation would trigger recapture of prior branch losses under sections 904(f)(3) and 367(a)(3)(C). Section 367(d) would apply to establish a deemed royalty for any section 367(d) intangibles treated as assets of the branch, and, under section 482, a royalty would need to be imputed for any intangibles retained by the domestic corporation but used by the branch.

We note that in addition to being appropriate from a policy perspective in a properly designed exemption system, treating foreign branches as CFCs, together with the collateral aspects of the deemed incorporation

of foreign branches, would yield revenue that presumably is an important part of a revenue-neutral estimate for the Camp proposal. The same acceleration of tax liability issues arise for income and realization resulting from the deemed incorporation, however, as arise from the deemed inclusion of a CFC's pre-effective-date earnings, discussed in Section IV below. It would be possible to make the same extension of payment opportunity available to taxpayers with pre-effective-date branches without affecting the overall revenue estimate.

The Camp proposal does not include modifications to section 367. To the extent that section 367 relies on deferral of tax as a justification for postponing recognition of realized gain in situations in which assets become eligible for exemption, deferred recognition would no longer be justified. Clearly, the rules of section 367 will need to be fundamentally altered if there is a shift from current-law deferral to a dividend-exemption or territorial system. The very important and fundamental question of how to treat transfers of appreciated and depreciated assets, from the U.S. corporate solution to a foreign corporation eligible for exemption, highlights the substantial work that remains to create a complete and practically workable exemption (or territorial) proposal.

2. Noncontrolled 10/50 Corporations

Under the Camp proposal, a 10 percent U.S. corporate shareholder may elect to treat its stock interests in all noncontrolled 10/50 corporations in which it has a 10 percent or more stock interest as stock in CFCs and claim the 95 percent exemption (deduction) for dividends from that corporation. The indirect credit under section 902 that otherwise would apply to relieve double taxation would be repealed under the Camp proposal, whether or not the election is made, so repeal would be a strong inducement to make the election. Moreover, pre-effective-date accumulated deferred foreign income of a noncontrolled 10/50 corporation must be included in the 10 percent U.S. corporate shareholder's income whether or not an election is made. Thus, it would be expected that most of those shareholders would make the election in order to claim the 95 percent exemption. Thus, omission of the election will apparently occur only in cases of error or in a small number of unusual situations. This raises the question of why the Camp proposal uses an election approach rather than a mandatory rule requiring that all noncontrolled 10/50 corporations be treated as CFCs for their 10 percent U.S. corporate shareholders.

While the election approach presumably reflects a concern that a 10 percent shareholder may be unable to obtain the information required to apply subpart F, this is incorrect in many, if not most, cases in which the issue is known in advance (because access to information can be negotiated at the time of purchase) and is even less likely to be true as ownership increases above 10 percent. Therefore, in our view, treatment of the noncontrolled 10/50 corporation should be mandatory, leaving some scope for transition and for Treasury

¹¹⁷See Gravelle, "Moving to a Territorial Income Tax: Options and Challenges," Congressional Research Service, at 35 (July 25, 2012).

¹¹⁸See OECD, Model Tax Convention on Income and Capital, article 7(2) (2010).

¹¹⁹We assume that the rules of section 7874, if applicable to the circumstances of the branch incorporation, would be turned off and not cause the deemed CFC to be treated as a U.S. corporation.

and the IRS to provide for reference to financial statements or comparable sources for information in the relatively rare cases in which U.S. tax accounting information is unavailable.

E. Foreign Tax Credit Changes

The Camp proposal's FTC changes include repealing the indirect FTC of section 902 (while retaining the indirect FTC of section 960 for current-year subpart F inclusions), limiting the allocation of deductions for purposes of the FTC limitation to deductions directly related to the foreign income, eliminating multiple FTC limitations, and repealing the new section 909 "splitter" rules that suspend the allowance of an FTC until associated income is taken into account. The Camp proposal, however, makes no changes to existing source rules, so the royalty and export sales source rules remain unchanged.

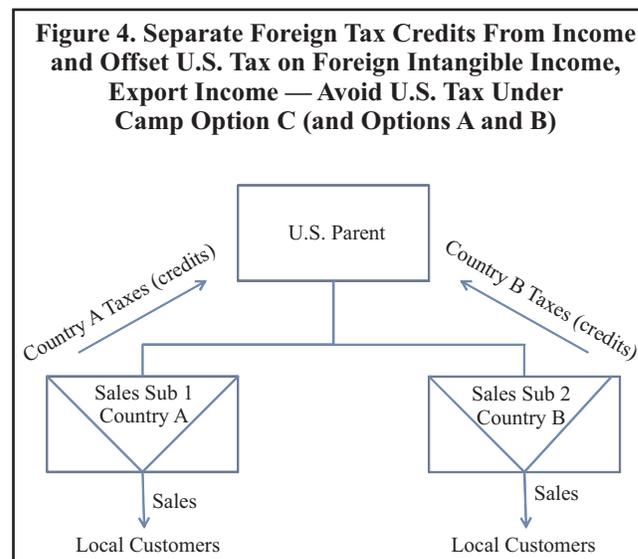
Under the Camp proposal, subpart F income and foreign-source income that is not a dividend from a CFC or deemed CFC (that is, a foreign branch or non-controlled 10/50 corporation) is subject to current taxation with a credit for foreign income taxes. The Camp proposal FTC changes would allow unlimited cross-crediting against U.S. tax on foreign-source income. Thus, under the Camp proposal, once creditable foreign taxes are on a U.S. tax return, they can be used against any foreign-source income, including royalties, foreign-source interest, income from export sales that pass title outside the United States, and even manufactured foreign-source income from investing in foreign passive assets.

By repealing the current-law separate limitation for passive income, the Camp proposal also opens for use the whole panoply of financial instruments to maximize FTC use through shifting earnings or taxes by base erosion or hybrid instrument techniques. Moreover, the foreign-source income that may be offset by FTCs will not be reduced by anything but direct deductions. In contrast, a 95 percent exemption applies to dividends from a CFC or from a deemed CFC. These two regimes, one involving full U.S. taxation of foreign income with an offsetting FTC and the other allowing a 95 percent exemption, invite tax planning to maximize the after-tax use of credits and the 95 percent exemption, whichever is more favorable.

This configuration of rules provides incentives, which in many situations would be greater than under current law, to separate CFC earnings into low-taxed and high-taxed groups so that low-taxed earnings can be 95 percent exempt and high-taxed foreign earnings can bring back foreign taxes to the U.S. tax return to be cross-credited against U.S. tax on other foreign income. If there are excess foreign income tax credits available, there is a greater incentive to generate easy-to-manufacture foreign-source income by shifting from U.S.-source to foreign-source income-producing assets to make immediate use of excess FTCs.

Under current law, there is no rule other than section 909 that is effective in preventing the use of a re-

verse hybrid partnership structure (a foreign partnership treated as a corporation for U.S. tax purposes) to cause foreign taxes to be direct section 901 FTCs, even though the related foreign-source income is distributed as a dividend eligible for the 95 percent exemption or retained by the foreign entity. Yet, as noted above, the Camp proposal would repeal section 909. Consequently, one potential planning idea under the Camp proposal would be for a U.S. parent corporation to establish reverse hybrid partnerships in each country of operation so that neither the anti-base-erosion rules nor the subpart F rules are tripped but FTCs are accelerated. Figure 4 illustrates this approach.



Under the technical taxpayer rule,¹²⁰ the foreign taxes would be section 901 credits, available to the U.S. parent for immediate cross-crediting against active or passive foreign income. The income earned by the reverse hybrid local law partnership/U.S. tax law C corporation from carrying on a business in the country of organization and earning income there would be 95 percent exempt, and U.S. tax on the 5 percent taxable portion would be deferred. To cut off this type of planning and related planning maneuvers, we recommend that the FTC limitations not be modified as proposed in the Camp proposal and that section 909 not be repealed. To restrict planning that creates subpart F inclusions of high-taxed foreign income carrying excess FTCs that are then cross-credited,¹²¹ we recommend that the high-taxed-income

¹²⁰See reg. section 1.901-2(f)(1).

¹²¹For example, under current law it is common in a multinational structure to plan to have high- and low-taxed pools of earnings in different affiliates. Before the enactment of section 909, that could be achieved using several techniques, including using a hybrid debt instrument between foreign affiliates to cause earnings for U.S. purposes to be in an affiliate different from the

(Footnote continued on next page.)

exception from subpart F be made mandatory (not elective as under current law¹²²) if the foreign effective tax rate exceeds the U.S. tax rate.

The Enzi proposal does not include modifications to the FTC that allow such substantial cross-crediting. Indeed, it adds a new separate limitation for intangible income and does not allow the inventory sales source rule to apply for purposes of the FTC. However, it still would be necessary to prevent credit-hyping techniques that would cause high-taxed foreign income to be currently taxed while causing low-taxed income to be exempted.¹²³

The Camp and Enzi proposals generally require interest and royalty income earned by a U.S. person to be included in gross income and allow credits for withholding taxes on the income. However, as previously discussed, the Camp proposal would allow extensive cross-crediting of foreign taxes against the U.S. tax on these categories of income, and the Enzi proposal would allow cross-crediting for active interest income as permitted under current law. Under both the Camp proposal's option C and under the Enzi proposal, foreign intangible income would be eligible for a reduced rate of U.S. tax even though it is deductible and therefore nontaxable in the source country.¹²⁴ In our view, full U.S. tax should be imposed on income that is de-

ductible in the other country, subject to the allowance of a credit for foreign withholding tax legitimately imposed on the income.

The preceding discussion highlights the tensions in having to maintain two parallel systems to avoid double taxation, one using exemption and the other using FTCs. It is theoretically possible to subject foreign income to U.S. taxation without the complexities of the FTC mechanism by limiting U.S. taxation to categories of foreign income for which it would be unnecessary to allow a credit for corporate-level taxes (that is, low-taxed foreign income). It also is conceptually possible to eliminate the FTC for any foreign taxes imposed on foreign business income and allow all that income to be exempt. These alternatives do not appear feasible in the face of the consensus that this would leave too much room for tax avoidance through transfer pricing and the use of stateless or homeless income planning — that is, earning business income in countries with low taxes or shifting income to be subject to low taxes. The incentives from exemption to avoid tax are too strong and demand a protective response in the form of taxation under subpart F. In light of U.S. commitments to mitigate double taxation under income tax treaties, it likely is impractical for the United States to disavow allowing a credit for more than a de minimis amount of treaty partner tax on foreign income that the United States also taxes under subpart F.¹²⁵ On balance, we agree with the decision to use the FTC for foreign income ineligible for the dividends received deduction. It must be recognized by proponents of exemption, however, that the need to use a credit mechanism is inconsistent with claims that exemption can achieve substantial simplification without exposure to material revenue loss. In a properly designed territorial system, allowance of an FTC should be limited to what is necessary to mitigate double taxation and should not be permitted to continue being a tool for tax avoidance. This should largely be achieved by adopting the modifications described above, although there would need to be rigorous post-enactment monitoring of taxpayer responses.

affiliate that has foreign income and tax for foreign law purposes. See Yaron Z. Reich, "International Arbitrage Transactions Involving Creditable Taxes," 85 *Taxes* 53, 55-56, Example 3 (Mar. 2007). Under the Camp proposal, it would be possible to cause the affiliate with a high-taxed pool of earnings to engage in a buy-sell transaction with affiliates and generate foreign base company sales income that brings with it disproportionate FTCs for cross-crediting. See reg. section 1.954-1(d)(3), which associates foreign taxes with an item of foreign base company income using the taxes that would be deemed paid under section 960, thereby taking into account the relevant tax pool for the CFC's general limitation.

¹²²See reg. section 1.954-1(d)(1)(i).

¹²³Under the Enzi proposal, high-taxed foreign income could be earned through a foreign branch. Any excess credits could be used to offset U.S. tax on a CFC's low-taxed general limitation income that is subpart F income (that is, that does not satisfy the qualifying foreign income exception from the low-taxed income category of subpart F). It remains possible to use a foreign partnership to allocate income from a business bearing a higher tax to one affiliate and income from a business bearing low or no tax to another affiliate and satisfy the substantial economic effect rules.

¹²⁴Several countries have adopted so-called patent boxes with lower rates of domestic tax on royalty income. We have addressed this matter in the discussion at Section III.B.3 above. See generally Peter R. Merrill, James R. Shanahan Jr., José Elias Tomé Gómez, Guillaume Glon, Paul Grocott, Auke Lamers, Diarmuid MacDougall, Alina Macovei, Rémi Montredon, Thierry Vanwelkenhuyzen, Alexandru Cernat, Stephen Merriman, Rachel Moore, Gregg Muresan, Pieter Van Den Bergh, and Andrea Linczer, "Is It Time for the United States to Consider the Patent Box?" *Tax Notes Int'l*, Apr. 2, 2012, p. 67. But see "Germany Calls on EU to Ban 'Patent Box' Tax Breaks," *The Guardian*, July 9, 2013 (German Finance Minister Wolfgang Schäuble calls for a ban on patent box tax break offered by Britain, the Netherlands, and some other EU members).

¹²⁵For 2011, the most recent year for which the OECD has separate-country foreign direct investment data, more than 70 percent of U.S. outbound investment was in OECD countries, each of which is a party to a treaty with the United States. Some commentators argue that foreign taxes should be allowed only as a deduction and not as a credit. See Kimberly Clausing and Daniel Shaviro, "A Burden-Neutral Shift From Foreign Tax Creditability to Deductibility?" 64 *Tax L. Rev.* 431 (2011) (arguing for superiority from a national welfare perspective of deducting rather than crediting foreign taxes). In light of U.S. treaty commitments, allowing only a deduction for foreign taxes, even on a burden-neutral basis, is not a plausible policy option in the reasonably foreseeable future.

A separate issue that arises in relation to the Camp proposal's 95 percent exemption is whether it is necessary to use an FTC mechanism to address double taxation concerns on the 5 percent of income that remains taxable but bears an effective U.S. tax rate of only 1.25 percent (if the top corporate tax rate is lowered to 25 percent under the Camp proposal). Or, instead, would a deduction for foreign corporate-level taxes suffice? Whether a treaty would require allowing a credit for the 5 percent of a dividend that is taxable after a dividends received deduction merits careful analysis, which we do not undertake here.

F. Expenses

1. Allocation of Indirect Expenses to Exempt Income

The question whether to allow deductions for expenses that generate tax-exempt income arises in any income tax system that exempts some types of income, including exempt foreign dividends. Allowing a deduction for expenses allocable to exempt income effectively creates a negative tax on (that is, subsidizes) the exempt income.¹²⁶

In the cross-border case, if the expense related to the exempt income is allowed to be deducted in the source country, there is no risk of double taxation resulting from the expense being treated as nondeductible in the residence country. The argument is made, however, that if a deduction for interest, stewardship, or other indirect expense is not allowed by the source country, and the residence country does not allow the deduction because it relates to exempt income, the resulting taxation will penalize foreign investment.¹²⁷ We are unaware of an empirical cost benefit analysis of a policy of residence country deference to source countries.¹²⁸ As discussed below, the analysis should differ somewhat for interest, general and administrative expense, and R&D expense. In each case, allowing a deduction under the residence country's

tax system for the costs of earning exempt foreign income cannot be justified on any neutrality ground. Accordingly, the subsidy should be analyzed in relation to each category of expense to determine whether any other factors justify it. We make the general observation, however, that there is no equity or efficiency norm that requires the United States (or any other residence country) to allow deductions for expenses related to exempt foreign-source income merely because the source country disallows the deductions. Stated differently, the United States has no obligation to grant tax subsidies to mitigate other countries' tax system errors.

The 5 percent haircut on exemption in the Camp and Enzi proposals is intended to serve as a modest proxy for the disallowance of deductions of the U.S. group that are related in an economic sense (but that are indirect in a tracing sense) to the generation of exempt foreign income. There are substantial problems with this approach.

As a threshold matter, the 5 percent expense disallowance that is effected in the Camp and Enzi proposals by limiting the dividends received deduction to 95 percent likely understates the U.S. expenses that properly would be allocable to exempt foreign income under existing allocation rules (and these rules already underallocate deductions to foreign income).¹²⁹ At the individual corporation level, however, the arbitrary 5 percent test will

commentators using a standard welfare function based on maximizing national income have concluded that restrictions on deductibility of costs related to income generated abroad are justified. Johannes Becker and Clemens Fuest, "Foreign Income and Domestic Deductions — A Comment," 63 *Nat'l Tax J.* 269 (2010).

¹²⁹In fiscal 2008, deductions not allocable to specific types of income on Forms 1118, "Foreign Tax Credit — Corporations," totaled \$201 billion, including \$99 billion of interest, \$78 billion of other deductions (such as overhead expense), and \$23 billion of R&D. Total foreign gross income was \$796 billion, including \$226 billion of grossed-up dividends and \$290 billion of foreign branch and oil and gas extraction income (the remainder being interest, rents, royalties, and service income). See IRS Statistics of Income Division, "U.S. Corporation Income Tax Returns With a Foreign Tax Credit: Total Assets, Income, Taxes, and Credits, and Foreign Income, Deductions, and Taxes," Table 1, 2008. In 2008 the total current E&P (after foreign taxes) of CFCs with positive E&P reported on Forms 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Transactions," was \$734 billion. See IRS Statistics of Income Division, "U.S. Corporations and Their Controlled Foreign Corporations: Receipts, Earnings, Taxes Distributions, Subpart F Income, and Related Party Transactions by Industrial Sector and Selected Industrial Subsector of Controlled Foreign Corporation," Table 1, 2008. If all of these earnings were distributed to a U.S. corporate shareholder, 5 percent of the amount would be \$37 billion, far below the amount of indirect expenses allocated to foreign income under current law. Although it is impossible to reach definitive conclusions based on these limited data, it nonetheless appears likely that expenses properly allocable to foreign income but not charged out to foreign affiliates would materially exceed the 5 percent of exempt dividends haircut in the Camp and Enzi proposals. For a discussion of the expense allocation rules, see ABA task force report, *supra* note 51, at 765-771.

¹²⁶Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," 62 *Bull. Int'l Tax'n* 486, 491 (2008) ("Allowing a deduction in a higher-tax country for borrowing to invest in a lower-tax country can produce after-tax returns greater than the investment's pretax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments clearly will decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.").

¹²⁷Graetz and Oosterhuis, *supra* note 38, at 782.

¹²⁸Graetz, *supra* note 126, at 491 ("Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy . . . would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place."). Professor James R. Hines Jr. has made a formal argument for the optimality of home-country allowance of deductions. Hines, "Foreign Income and Domestic Deductions," 61 *Nat'l Tax J.* 461 (2008). Other

(Footnote continued in next column.)

hurt some taxpayers (those with fewer allocable expenses) and be a windfall for others (taxpayers with higher allocable expenses). To hurt as few as possible and help as many as possible (in political terms, to have more winners than losers), a haircut generally will be set at an artificially low percentage. This appears to be the case with the Camp and Enzi proposals. Consequently, the haircut approach not only gives the wrong answer in individual cases, it likely loses revenue.

The arguments in favor of a 5 percent haircut allocation are that it is too difficult and administratively burdensome to more accurately allocate expenses to exempt income, and that other countries apply a haircut approach or do not allocate expenses at all. The first argument is belied by the fact that the existing expense allocation rules have been applied by U.S. multinationals since the late 1970s. The complexity of the current rules is attributable in part to successful lobbying by businesses for exclusions of specific categories of expense from allocation and alternative elective methods of allocation.¹³⁰ Admittedly, the impact of the expense allocation rules in the existing FTC system is on a narrower group of taxpayers than it would be in an exemption system, since their effect is principally limited to U.S. corporations in an excess FTC position. This does not support the view that the rules cannot be administered by taxpayers and the government in an exemption system. Foreign direct investment is largely the province of the largest and most sophisticated taxpayers, which have demonstrated repeatedly in ornate corporate structures and tax stratagems the capacity to handle complexity when it achieves a tax benefit.¹³¹ Thus, in our view, complexity is a red herring when used to justify the 5 percent haircut. If used at all, the 5 percent haircut should be limited as a surrogate for allocating expenses to small and medium-size businesses.¹³²

¹³⁰For a partial history of the watering down of the R&D expense allocation rules, see ABA task force report, *supra* note 51, at 767-771.

¹³¹For a good background discussion of some of these international structures, see JCT, "Income Shifting and Transfer Pricing," *supra* note 63 (figures 6, 7, 13, 17, 20, 22, 26, and 27, and accompanying descriptions). See also *Chemtech Royalty Associates LP v. United States*, 2013 WL 4038992 (M.D. La. 2013) (memorandum opinion) ("The Dow Chemical Company ('Dow') engaged in two series of transactions . . . referred to as Chemtech I, dealing with tax years 1993-97, and Chemtech II, dealing with tax years 1998-2003. Chemtech I was promoted and marketed to large corporate taxpayers by Goldman Sachs . . . and was implemented by Dow with the assistance of tax lawyers at the law firm of King & Spalding. Chemtech II was designed and implemented by the tax lawyers at King & Spalding. Both arrangements are enormously complicated in their construction and operation.").

¹³²The IRS uses \$10 million in assets as a minimum for audit by the Large Business and International Division. That would seem a reasonable limit for companies being allowed a simplified expense allocation regime.

Other countries do not allocate expenses to foreign income in the same manner the United States has since 1977. We assume that the advocates of the 5 percent haircut would argue that other countries are better off as a result because their multinationals are subsidized. Accordingly, these advocates would likely assert that U.S. multinationals need the same tax subsidies given to companies resident in other countries.¹³³ This argument deserves scrutiny as one element of an overall competitiveness argument for an exemption system. We have previously evaluated those competitiveness arguments and found them wanting.¹³⁴ We refer the reader to those discussions.

2. Interest Deductibility and CFC Affiliates

The obvious planning incentive under an exemption system is to maximize interest deductions in the residence country if it is a higher-tax country, and to earn exempt income in a lower-tax country.¹³⁵ This is referred to as hollowing out the residence country tax base. A typical technique would be to debt-finance in the residence country and to create exempt dividend income by using equity financing for lower-tax foreign subsidiaries.

Opportunities to engage in residence country debt financing would be expanded exponentially under the Camp proposal. With the Camp proposal's (but not the Enzi proposal's) repeal of the investment in U.S. property rules in section 956, a CFC would be unrestricted in its ability to make loans to U.S. affiliates and in guaranteeing U.S. group debt. In many cases, interest income earned by a CFC on a loan to a U.S. affiliate would give rise to currently taxable subpart F income that would be U.S.-source income for FTC limitation purposes.¹³⁶ While this inclusion would create a wash that negates the advantage of the U.S. affiliate's interest deduction, a loan of the CFC's earnings to the U.S. parent would not trigger the 1.25 percent tax that would be imposed on a distribution of earnings under the Camp proposal. This is another policy disadvantage

¹³³See Financial Executives International, "Comments on Selected JCT Staff Recommendations on Tax Compliance" (Mar. 1, 2005); Amy S. Elliott, "GE Executive Criticizes Possible U.S. Territorial System," *Tax Notes*, Feb. 28, 2011, p. 998; John M. Samuels, "American Tax Isolationism," *Tax Notes Int'l*, June 29, 2009, p. 1111; Philip R. West, "Across the Great Divide: A Centrist Tax Reform Proposal," *Tax Notes Int'l*, Apr. 11, 2011, p. 131; Sullivan, "The Effects of Interest Allocation Rules in a Territorial System," *Tax Notes Int'l*, Sept. 10, 2012, p. 984.

¹³⁴See, e.g., Fleming and Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System," *Tax Notes*, Dec. 19, 2005, p. 1557; Fleming, Peroni, and Shay, "Designing a U.S. Exemption System," *supra* note 4, at 456-458.

¹³⁵See Sullivan, *supra* note 133, at 1100.

¹³⁶Interest on the loan generally would be foreign personal holding company income described in section 954(b) and (c) and, unless an exception applied, would be currently taxable under subpart F. The subpart F inclusion would be U.S.-source income under section 904(h).

of using a haircut in lieu of allocating deductions. It also could be tax efficient for the CFC to use its assets and cash flow to support a guarantee of its U.S. affiliates' borrowing.

The Camp proposal attempts to address the concerns regarding excess interest deductions by suspending the deductibility of net interest expense of a U.S. corporation that is a U.S. shareholder in any CFC in the same worldwide affiliated group if (1) the U.S. group has excess domestic indebtedness in relation to the worldwide group or (2) the U.S. corporation's ratio of interest expense to adjusted taxable income exceeds a specified benchmark.¹³⁷

This Camp proposal thin capitalization rule applies to limit deductions of a U.S. corporation that is a U.S. shareholder in a CFC. Accordingly, it would apply to a foreign parent group with a U.S. subsidiary that in turn owns a CFC, and it would take into account the foreign parent's indebtedness in determining the worldwide affiliated group's indebtedness. We note that the Camp proposal thin capitalization rule would not apply to a foreign parent group with a U.S. subsidiary that has no CFC subsidiaries. This is consistent with the limitation of the Camp proposal to taxing foreign income of domestic corporations. Presumably, the drafters are assuming that the anti-earnings-stripping rules of section 163(j), which would apply to the foreign-parent-owned, stand-alone U.S. subsidiary, are sufficient or, if not, will be amended to be comparable to the thin capitalization rule. It is important that the two limitations be aligned. Otherwise, there would be an incentive for a foreign parent group to cause its U.S. affiliates to restructure themselves into stand-alone U.S. subsidiaries by selling or distributing the foreign subsidiaries to the foreign parent.¹³⁸ There is no sound policy reason to limit the Camp proposal's thin capitalization rule to instances in which the U.S. subsidiary has CFC subsidiaries. Indeed, this highlights the fact that a thin capitalization approach is best considered in the broader context of corporate tax reform and the proper tax treatment of debt and equity generally.¹³⁹

Should interest expense that is allowed as a deduction *after* application of thin capitalization limits be subject to allocation and disallowance to the extent it is

allocable to exempt foreign income? A thin capitalization rule like that contained in the Camp proposal is not a substitute for interest expense allocation. A thin capitalization approach may be justified on the basis that it reduces the disparity in the tax treatment generally of debt and equity, but that rationale is unrelated to earning exempt foreign income. There should be a further allocation if foreign income is not to be favored over domestic income. The amount of interest expense potentially subject to allocation is large.¹⁴⁰ To properly protect the U.S. tax base, interest expense allowed as a deduction after application of the thin capitalization rule should be subject to allocation and apportionment, and interest expense properly allocated to exempt foreign income should be disallowed.¹⁴¹

If the source country does not accept that an amount of interest expense should be deducted as a cost of earning source country income, and double taxation results from residence country disallowance of a deduction for interest allocable to exempt income, under what tax policy or economic principle should the residence country be required to alleviate the double taxation by allowing the deduction? As professor Michael Graetz has observed, allowing a deduction to earn exempt income would go beyond avoiding double taxation as a rationale for exemption of foreign income and would amount to subsidizing the production of foreign income.¹⁴²

The argument that the United States has to follow the approaches of other countries regarding the allocation of interest expense must be justified by demonstrating a benefit to the United States that outweighs the revenue and efficiency losses from the subsidy. We are unaware of any empirical evidence that a subsidy for foreign business income related to the extent of leverage used by the U.S. corporate shareholder in a

¹⁴⁰For 2008, the most recent year for which data are public, \$99 billion of interest expense was allocable to foreign income (but not a specific category of foreign income) on Form 1118. See IRS Statistics of Income Division, *supra* note 129.

¹⁴¹See Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," 54 *Nat'l Tax J.* 811, 813 (2001) ("If . . . the parent company could obtain a full interest deduction in the United States while earning exempt income in a low-tax location abroad, the effective tax rate on investing abroad could be negative."); see also Sullivan, "Should the Camp Territorial Plan Include a 5 Percent Haircut?" *Tax Notes*, July 23, 2012, p. 359 (describing situations in which a thin capitalization rule will have the same effect as interest expense allocations).

¹⁴²Graetz recommends seeking a multilateral solution to the allocation of expenses. Graetz, *supra* note 126, at 492-493. We agree that it would be valuable to coordinate expense allocation among major trading partner countries. We also would support coordination to align anti-base-erosion regimes. These topics should be within the scope of the work the OECD has announced it will undertake in response to the G-20's request on base erosion and profit shifting. See OECD, "Action Plan on Base Erosion and Profit Shifting," Action 3 (July 19, 2013).

¹³⁷Camp proposal, section 332, adding new section 163(n).

¹³⁸As discussed in the text accompanying *supra* notes 111-112, to the extent that other countries' exemption systems are more generous than the Camp proposal, there generally would be an incentive to transfer CFCs to foreign parents.

¹³⁹We also note the importance of addressing U.S.-source taxation of foreign persons as well as the taxation of foreign income of U.S. persons. Residence taxation and taxation at source are integrally related. See, e.g., Bret Wells, "What Corporate Inversions Teach About International Tax Reform," *Tax Notes Int'l*, July 26, 2010, p. 281; Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin," 65 *Tax L. Rev.* 535 (2012).

CFC is a rationally designed subsidy that can be justified by a U.S. benefit from the foreign investment. Moreover, residence country disallowance of a deduction for interest allocable to exempt foreign income would provide the appropriate incentive for a U.S. corporate taxpayer to locate the interest expense in the foreign affiliate that should bear the expense.

3. General and Administrative Expense

A U.S. parent corporation's general and administrative expenses properly should be charged to an affiliate in situations in which the affiliate benefits from the expense.¹⁴³ When those expenses are not properly chargeable to affiliates because they benefit only the U.S. parent and not the affiliates, we refer to them in this report as stewardship expenses. How to determine the amount of stewardship expenses that relate to ownership of a subsidiary but do not benefit the subsidiary is a recurring international transfer pricing issue.¹⁴⁴ Residence and source country governments have adverse interests in that residence countries gain from minimizing the scope of general and administrative expenses that are treated as stewardship expenses so that more expenses are charged to foreign affiliates. Conversely, source countries gain from maximizing classification of general and administrative expenses as stewardship expenses that are allocable to the parent corporation, thereby minimizing what is charged to source country affiliates. When investments flow in both directions, the government stakes are decreased by

¹⁴³See Rosanne Altshuler and Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," 54 *Nat'l Tax J.* 787, 789 (2001) (deduction of general and administrative expenses against U.S. income "could result in negative effective tax rates on investment projects placed in low-tax jurisdictions"). Under applicable Treasury regulations, services provided in a controlled services transaction to a commonly controlled taxpayer must be charged to that taxpayer. See reg. section 1.482-9(l). Expenses that are not charged out must still be allocated to gross income categories and apportioned among relevant groupings in a category including foreign-source income. Reg. section 1.861-8(e). The OECD transfer pricing guidelines, reflecting tax relations between developed countries, establish a standard (similar to that in reg. section 1.482-9(l)) for services that are intragroup services required to be charged out. OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," paras. 7.06-7.18 (July 2010) (OECD guidelines). Expenses that do not satisfy the standard are not charged to an affiliate. The OECD guidelines do not address whether the residence country should allow a deduction for expenses that are not intragroup services required to be charged out.

¹⁴⁴Although for ease of exposition, we refer to expenses that are not charged to affiliates as stewardship expenses, the Treasury regulations discuss other categories of expense not charged out that also could be allocable to exempt foreign dividend income. They include legal and accounting expenses and some supportive expenses. Reg. section 1.861-8(e)(4), -8(e)(5), and -8(b)(3).

offsetting factual situations, but taxpayers generally have an interest in locating deductions in the higher-tax country.

The data suggest that under current law, there is a very large amount of general and administrative expense that is properly allocable to foreign income but not charged out.¹⁴⁵ Under current law, including the relatively high top nominal U.S. corporate tax rate, there is little incentive for a U.S. multinational to charge out general and administrative expense unless it is in an excess FTC position and would benefit from reducing high-taxed foreign-source income. A reduction in the top nominal U.S. corporate tax rate to 25 percent (or, more realistically, 28 percent) would increase the incentive to charge out overhead expense, but perhaps not by much because the rate still would be above that of most other countries and substantial income is earned in low-tax countries.¹⁴⁶ U.S. multinationals that defer U.S. tax on low-foreign-taxed income obviously gain from an expansive view of stewardship expenses that need not be charged out.

Regardless of how much general and administrative expense is ultimately treated as non-chargeable stewardship expense, there is the separate tax system issue of whether the residence country should allow a deduction for stewardship expense if that expense is properly allocable to income that is exempt from residence country tax under an exemption system or otherwise.¹⁴⁷ This question arises because even though a cost may be characterized as stewardship expense that does not benefit a subsidiary, it can still be a cost that is proximately related to earning dividends from ownership of the subsidiary's stock. As was discussed regarding interest expense, there is no normative basis on which to say that the residence country must allow the deduction of stewardship expense if the income to which it relates, even indirectly, is not taxed. Allowing

¹⁴⁵For 2008, the amount of indirect expense not directly allocable to specific types of foreign income (other than interest and R&D) was \$78 billion, or approximately 9.8 percent of total foreign income. IRS Statistics of Income Division, *supra* note 129. Only a portion of this is general and administrative expense. The 10-year revenue estimate of the Obama administration's proposal to defer expenses allocable to deferred foreign income in fiscal 2010 was \$60 billion when general and administrative expense was included, and in fiscal 2011 was \$26 billion when it was excluded. See Treasury, fiscal 2011 green book, *supra* note 78, at 150, Table 1; Treasury, fiscal 2010 green book, *supra* note 78, at 128, Table 1. The 2008 data and the evolving revenue estimates are imprecise indicia, but they are consistent in suggesting that the issue of allocating stewardship expense to foreign income is material from a revenue perspective.

¹⁴⁶At the 25 percent top nominal rate in the Camp proposal, the top nominal U.S. corporate rate would be lower than only eight of 33 OECD countries reporting rates for 2012.

¹⁴⁷As mentioned at *supra* note 143, the OECD guidelines do not address whether the residence country should allow a deduction for expenses that are not intragroup services required to be charged out.

that expense as a deduction in effect subsidizes the investment that generates the exempt income.

There are two arguments in favor of allowing a U.S. deduction for stewardship expense allocable to exempt foreign income, in addition to the administrative and competitiveness arguments noted above. First, the United States, as the residence country, may fear that if it does not allow the deduction, the functions that give rise to the expense will be shifted to a country where the expense would be allowed. Second, it is administratively difficult for taxpayers and the government to separate stewardship expenses from other general and administrative costs and then distinguish stewardship expenses that are appropriately related to foreign income from those that are not.

The argument that U.S. headquarters jobs, including those for skilled executives, may be shifted abroad properly concerns policymakers. It also is a politically powerful argument for lobbyists to use against allocation of various types of expenses (including stewardship expenses) to foreign-source income (even though that income would be exempt under an exemption system). No lawmaker wants to be accused of causing headquarters jobs to be shifted overseas. Ultimately, the extent to which headquarters functions actually would be shifted as a result of disallowing the deduction of a portion of stewardship expenses is an empirical question for which there are no compelling data.¹⁴⁸

Clearly, a U.S. multinational's response to disallowance of a deduction for stewardship expense allocable to exempt income would be affected by a range of factors, including the global footprint of its business as well as the preferences of its CEO. The burden of shifting executive management functions can be material in terms of personnel recruitment, costs, and governance.¹⁴⁹ A response that would be less costly to shareholders (and less risky for the business) than shift-

ing people functions to a foreign country would be to minimize nondeductible stewardship expense and increase the extent to which indirect expenses are charged out to, and deducted by, foreign subsidiaries in order to minimize the cost of disallowance in the United States. Other countries may contest those charges and disputes may arise; however, these issues most often are resolved by agreements that are carried over for multiple years.

The second argument for allowing a U.S. deduction for stewardship expense that is properly allocable to exempt foreign income is the practical difficulty of identifying the correct amount of stewardship expense and allocating it to exempt income. However, since those difficult issues concerning stewardship expense must be resolved in any event for transfer pricing purposes, this should not be an added burden. Allocation on the basis of an objective metric is fairly straightforward.¹⁵⁰

The administrative burden argument is insufficient to require the residence country to absorb deductions that generate income not subject to tax in the residence country. Indeed, the benefit of disallowance is that it creates an incentive for taxpayers to properly identify stewardship expense and charge out other expenses. Disallowance of allocable stewardship expense likely would result in more expenses being charged out to foreign income and more accurate identification of expenses that should not be charged out.

4. Research and Development Expense

Under current law, R&D expense is currently deductible and is allocated and apportioned between U.S.- and foreign-source income for purposes of the FTC limitation.¹⁵¹ For a taxpayer in an excess credit position, the reduction of foreign income by the allocated R&D deduction has the effect of denying for that

¹⁴⁸See Clausung, "Should Tax Policy Target Multinational Firm Headquarters?" 63 *Nat'l Tax J.* 741, 761 (2010) ("When possible, it is ideal to target tax policy goals as directly as possible, and it is unlikely that encouraging multinational firm headquarters per se is the most efficient way to encourage their associated positive external efforts.").

¹⁴⁹The Weatherford International 2010 Swiss listing prospectus, issued at the time of its re-domestication to Switzerland and transfer of top management from Houston (where its corporate support staff and principal middle management team remained) to Geneva, described the following risk factors as concerns:

The anticipated benefits of moving our principal executive offices to Switzerland may not be realized, and difficulties in connection with moving our principal executive offices could have an adverse effect on us.

In connection with the Redomestication, we relocated our principal executive offices from Houston, Texas to Geneva, Switzerland. Most of our executive officers, including our Chief Executive Officer, and other key decision makers have relocated or will relocate to Switzerland. We may face significant challenges in relocating our executive

(Footnote continued in next column.)

offices to a different country, including difficulties in retaining and attracting officers, key personnel and other employees and challenges in maintaining our executive offices in a country different from the country where other employees, including corporate support staff, are located. Employees may be uncertain about their future roles within our organization as a result of the Redomestication. Management may also be required to devote substantial time to the Redomestication and related matters, which could otherwise be devoted to focusing on ongoing business operations and other initiatives and opportunities. In addition, we may not realize the benefits we anticipate from the Redomestication, including the benefit of moving to a location that is more centrally located within our area of worldwide operations. Any such difficulties could have an adverse effect on our business, results of operations or financial condition.

Weatherford International Ltd., "Listing Prospectus," at 15 (Nov. 15, 2010).

¹⁵⁰See, e.g., reg. section 1.861-8(e)(4)(ii).

¹⁵¹See sections 174, 864(f); reg. section 1.861-17. The term "research and experimental expenditures" is used in section 174,

(Footnote continued on next page.)

year an FTC against U.S. tax on that amount of income. This is a consequence of using the U.S. determination of foreign income to measure double taxation for purposes of the FTC limitation. Under U.S. principles, the foreign tax would be imposed on income that is completely offset by expenses so there can be no double taxation.

There is no tax policy reason to treat R&D expense differently under an exemption system, except that to the extent the R&D expense is properly allocable to exempt income, the deduction should be disallowed for all purposes of the code. There is no normative tax policy criterion that requires a residence country to allow an R&D deduction even though the foreign income is not taxed by the residence country.

Notwithstanding the logic of that analysis, neither the Camp proposal nor the Enzi proposal would disallow the deduction for R&D expense allocated to foreign income. Instead, both proposals rely on the 5 percent exemption haircut to serve as a surrogate for the allocation and resulting disallowance of all expenses allocable to exempt income, including R&D. The arguments in favor of allowing a deduction for R&D expense allocable to exempt foreign income are based on the same competitive and administrative considerations that we have discussed above regarding interest and stewardship expenses, except there is an economic argument that R&D expense supporting foreign activity is more deserving of subsidy because of the spillover benefits from R&D performed in the United States. Even though the amounts of R&D expense allocable to foreign income under the current taxpayer-favorable expense allocation rules are much smaller (\$22.5 billion in 2008) than interest (\$99 billion) and general and administrative expense (\$78 billion), the treatment of R&D is more politically sensitive.¹⁵²

This economic argument for R&D subsidies asserts that the social value of R&D exceeds the market return on R&D because it is difficult to capture the full ben-

which allows a deduction without regard to whether the expenditure otherwise would be capital. Research and experimental expenditures include costs for R&D “in the experimental or laboratory sense.” Reg. section 1.174-2(a)(1). However, the regulation goes on to provide that research in the experimental or laboratory sense includes “activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.” By dint of this regulatory sleight of hand, the U.S. benefits for R&D are not limited to risky innovation but extend far along the development chain and include mere improvements to existing commercial products. The rules for allocating and apportioning R&D expense are described in the ABA task force report, *supra* note 51, at 767-771. While there may be disagreement over the best way to determine the amount of R&D expense that should be allocated to foreign income, that issue is beyond the scope of this discussion.

¹⁵²See IRS Statistics of Income Division, *supra* note 129.

efits from the research.¹⁵³ This argument is strongest for basic R&D.¹⁵⁴ However, tax policies benefitting R&D have largely given up on distinguishing between basic or other highly speculative innovative R&D and development work that is much more likely to have a near-term commercial payoff.¹⁵⁵ Tax benefits are extended to development or improvement of existing products or the design of a market-ready consumer product (which may be tangible or intangible), including the costs of developing software and attorney fees for making a patent application.¹⁵⁶

There is little empirical evidence that the tax system subsidy from allowing deductions for R&D allocated to foreign income is cost effective or targets research in which there is underinvestment.¹⁵⁷ The most recent Treasury study of R&D expense allocation rules, which accompanied adoption of final regulations in 1995, does not address the effects of the allocation on R&D.¹⁵⁸ A disallowance of foreign-allocated R&D expense would increase the after-tax cost of performing R&D, but it is unclear how much it would affect the amount of R&D performed in the United States.

Another claim is that the additional after-tax cost of R&D resulting from disallowance of deductions for R&D outlays would trigger a relocation of U.S. knowledge personnel to foreign locales or a preference for foreign over U.S. researchers. While the United States certainly does not have a monopoly on research talent, neither is it a fungible commodity. One would expect

¹⁵³JCT, “Tax Incentives for Research, Experimentation and Innovation,” JCX-45-11, at 7 (Sept. 16, 2011) (JCT, “R&D”).

¹⁵⁴See Congressional Budget Office, “Federal Support for Research and Development,” at 10 (2007).

¹⁵⁵See *supra* note 151 for the definition of R&D for section 174 deduction purposes.

¹⁵⁶Reg. section 1.174-2(a)(1). Most expenses identified as research and experimentation for tax purposes, including for the research tax credit, are for compensation for a type of labor that has inelastic supply. JCT, “R&D,” *supra* note 153, at 16; see Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 26.3.2 (3d ed. 2012); Austan Goolsbee, “Does Government R&D Policy Mainly Benefit Scientists and Engineers?” 88 *Am. Econ. Rev.* 298 (1988). Moreover, there is no requirement in section 174 that the R&D be performed in the United States in order to be deductible. Finally, to the extent that spillovers are strongest in geographic proximity to where the R&D is performed, it is unclear why foreign R&D should not be subject to capitalization as appropriate under the facts of a particular case.

¹⁵⁷There is uncertainty regarding the price elasticity of R&D, with estimates ranging above and below 1. JCT, “R&D,” *supra* note 153, at 16-18. If the price of R&D is reduced by \$1, the increase in R&D if the elasticity is 1 also is \$1. If the elasticity were 0.5, a \$1 price reduction would result in a \$0.50 increase in R&D.

¹⁵⁸Treasury, “The Relationship Between U.S. Research and Development and Foreign Income” (May 19, 1995) (the range of uncertainty of the relationship between domestic R&D and foreign income is large).

that researchers would look to favorable overall environments in which to perform their work. Analyses of a country's innovation capacity emphasize the importance of features of an economy, such as education of the workforce, labor mobility, proximity to universities and centers of knowledge, infrastructure, regulatory environment for new products, business practices, and sophistication of capital markets. It is noteworthy that tax benefits for R&D are given little or no weight in leading measures of a country's innovation capacity.¹⁵⁹

The impact of increasing the tax cost of R&D by allocating R&D expense to exempt income and disallowing the allocable portion is an empirical question that is as yet unanswered and should be reviewed in the context of overall U.S. tax subsidies for R&D.¹⁶⁰ Whatever the impact, as with other tax expenditure subsidies, it should be analyzed in relation to the alternative use of funds by the government, including for education and infrastructure.¹⁶¹

IV. Transition

The question of how to treat pre-effective-date deferred earnings implicates several concerns affecting tax system design and revenue that are interrelated. Addressing them requires the balancing of revenue effects, tax design complexity, taxpayer expectations, and government commitment. The complexity issue revolves around whether pre-effective-date earnings remain subject to the prior regime after the effective date of the replacement regime. The practical consequences of the resolution of this issue include whether a taxpayer must track pre-effective-date tax attributes after the ef-

fective date and how pre-effective-date earnings are taken into account after the effective date.

This complexity concern could be addressed by applying the new regime to all pre-effective-date earnings. The revenue consequence of this approach (that is, 95 percent exemption treatment) is taxpayer favorable¹⁶² and, under budget scoring metrics, likely would lose revenue.¹⁶³

Any transition rule that does other than simply follow prior law regarding the recognition of pre-effective-date earnings necessarily would alter the timing of the repatriation of the earnings for tax purposes and, in the case of the Camp proposal, accelerate the repatriation.¹⁶⁴ To the extent that the accelerated distribution accelerates a U.S. tax, it hurts taxpayers and, to the extent it accelerates use of an FTC, it helps taxpayers.

If the question of how to treat pre-effective-date earnings is resolved in any way other than by using prior law to determine the recognition, timing, and tax rate for those earnings, a decision is required regarding the tax rate that should apply to pre-effective-date earnings. The range of alternatives includes applying pre-effective-date tax rates (full taxation), applying the general post-effective-date tax rates if different (in the Camp proposal, the top rate is reduced from 35 percent to 25 percent), or applying some other tax rate specifically created for these earnings.

¹⁶²The most recent public revenue estimate of a territorial system that we are aware of is a statement in the report on tax reform options released by the President's Economic Recovery Advisory Board in August 2010, at 90. ("According to rough estimates from the Treasury, a simplified territorial system without full expense allocation rules would lose \$130 billion over the 10-year budget window.") This estimate presumably was at a 35 percent rate and was not part of the Ways and Means proposal. For a useful description of the intricacies of a revenue estimate of a repatriation holiday, see Edward D. Kleinbard and Patrick Driessen, "A Revenue Estimate Case Study: The Repatriation Holiday Revisited," *Tax Notes*, Sept. 22, 2008, p. 1191. For a recent JCT fiscal 2011-2021 estimate of a repatriation holiday accompanied by an explanation of method, see the letter from Thomas Barthold to Ways and Means Committee member Lloyd Doggett, D-Texas, at 2 (Apr. 15, 2011) (Barthold-Doggett repatriation estimate letter).

¹⁶³One expected behavioral response to a rule that applies post-effective-date law to post-effective-date distributions of pre-effective-date earnings would be for taxpayers to accelerate before the effective date distributions of dividends that carry excess FTCs that could be used to offset U.S. tax on other foreign-source income (that is, general category foreign-source income from royalties and exports). It is routine international tax planning to attempt to separate earnings into high- and low-tax pools to facilitate tax-efficient distributions. See Barthold-Doggett repatriation estimate letter, *supra* note 162, at n.18 (discussing FTC planning for distributions).

¹⁶⁴For this purpose, we use "following prior law" to mean deferring income inclusion of pre-effective-date earnings until they are distributed and taxing those repatriated dividends at then-applicable corporate tax rates subject to a direct and indirect credit for foreign income taxes.

¹⁵⁹The INSEAD-WIPO 2012 Global Innovation Index includes 84 indicators with different weightings, including, on the input side, indicators grouped under institutions, human capital and research, infrastructure, market sophistication, and business sophistication, and, on the output side, indicators grouped under knowledge and technology outputs and creative outputs. Only one output relates to taxes, and that is "ease of paying taxes" under the category of business environment under "institutions." See <http://www.globalinnovationindex.org/gii/index.html>. Similarly, in 2009 the Economist Intelligence Unit developed an innovation index and included a factor for "tax regime," which was given a weight of 1.875 percent in the overall ranking scale. See http://graphics.eiu.com/PDF/Cisco_Innovation_Methodology.pdf.

¹⁶⁰See Graetz and Doud, *supra* note 51, at 18 ("extant studies do not answer the question whether R&D tax incentives drive firms' decisions of where to locate R&D").

¹⁶¹See, e.g., OECD, "Education: Governments Should Expand Tertiary Studies to Boost Jobs and Tax Revenues" (Sept. 7, 2010); Council on Foreign Relations, "Remedial Education: Federal Education Policy," at 1 (June 2013) ("an increase of one year in a country's average schooling level corresponds to an increase in 3 to 4 percent in long-term economic growth") See generally Fleming and Peroni, "Reinvigorating Tax Expenditure Analysis and Its International Dimension," 27 *Va. Tax Rev.* 437 (2008).

The Camp proposal provides that immediately before the effective date of the exemption regime, the subpart F income of each 10-percent-owned CFC or deemed CFC will be increased by the accumulated deferred foreign income (undistributed earnings for all years not attributable to ECI and previously taxed earnings) and included in the income of each U.S. shareholder of the corporation. (The earnings taken into account are not limited to those earned during the period of ownership by the U.S. shareholder.) A corporate U.S. shareholder will be entitled to a deduction equal to 85 percent of the increased subpart F income.

In other words, the Camp proposal seeks to simplify treatment of pre-effective-date earnings in future years by accelerating their distribution for U.S. tax purposes to the effective date. Taken alone, this would be a burden for some taxpayers that would pay more tax sooner. Taxpayers with excess FTCs may not view the acceleration as detrimental, but other taxpayers will be disadvantaged. The Camp proposal addresses this issue by allowing an 85 percent dividends received deduction for pre-effective-date foreign earnings deemed distributed on the effective date. This creates an effective U.S. tax rate of 5.25 percent (35 percent \times 15 percent = 5.25 percent)¹⁶⁵ and an FTC is allowed for the taxable portion of the deemed distribution. The tax on the increased subpart F income may be paid in two to eight annual installments.

The Enzi proposal does not attempt to achieve systemic simplification benefits from dealing with old earnings. Instead, it would allow each corporate U.S. shareholder of a CFC to separately make a one-time election for accumulated deferred foreign earnings of a CFC to be included in the income of the electing U.S. shareholder subject to a 70 percent (instead of 85 percent) dividends received deduction. Thus, the effective rate before FTCs would be 10.5 percent (35 percent \times 30 percent = 10.5 percent). As with the Camp proposal, FTCs would be allowed, and payment of the incremental tax could be extended. Post-effective-date distributions are treated as coming first from pre-effective-date earnings, however, and then from post-effective date earnings eligible for exemption. Qualifying U.S. corporate shareholders would be allowed section 902 credits for foreign taxes on pre-effective-date earnings.

As with any taxpayer election, the Enzi proposal's elective inclusion will be used by a corporate U.S. shareholder of a CFC when it is beneficial, and the election would therefore raise less revenue than a comparable mandatory rule. Although the election only offers a 70 percent deduction, it allows a direct and

indirect FTC for foreign taxes on distributed post-effective-date earnings. If this approach is enacted, taxpayers would be expected to organize their structures to maximize their benefits from the election. This approach would foster planning to isolate any unrepatriated pre-effective-date earnings, so that distributions of post-effective-date earnings will be eligible for 95 percent exemption.

Some simplification is achieved by the Camp proposal's mandatory inclusion of pre-effective-date earnings. Since section 902 is repealed prospectively, taxpayers would no longer need to track historic pools of earnings and FTCs. As discussed above, under the Camp proposal, the protection from a second income inclusion for previously taxed earnings is inexplicably repealed for post-effective-date years, so the earnings would be taxed again when distributed.

We expect that eight installments were chosen as the maximum that could be allowed without a risk of some of the revenue falling outside the budget window once tax years are taken into account. Under both proposals, interest would be payable under section 6601 on the deferred liability at the rate specified by section 6621. Generally, the section 6621 underpayment rate is the federal short-term rate plus 3 percentage points (5 percentage points for a large corporate underpayment). The short-term rate is inappropriate if the deferral is extended beyond a year. Moreover, the financing is favorable by definition since taxpayers that can obtain lower costs of financing without adverse effects would do so.

Under the Camp proposal, the mandatory current inclusion and 85 percent deduction also applies to non-corporate U.S. shareholders. Depending on the facts, this could be beneficial.¹⁶⁶ If a taxpayer, such as a private equity fund, is going to sell a 10 percent interest in a CFC at a substantial gain but has not completed the sale before the effective date, the transition rule allows the taxpayer to obtain a basis step-up in CFC stock at a maximum cost of 5.25 percent of the inclusion, instead of the 15 percent or 39.6 percent rate that might otherwise apply. There are no rules that restrict jumping into or out of U.S. shareholder or CFC status (such as the five-year lookback rule for CFC status under section 1248) to benefit from the transition rule.

The effect of the Camp transition rule for pre-effective-date earnings is to force a deemed repatriation of deferred earnings, but at a substantially reduced effective tax rate. While the acceleration is inconsistent

¹⁶⁵Kleinbard and Driessen indicate that the JCT staff's estimate of the effective tax rate after FTCs on earnings repatriated in the 2004 holiday was 3.65 percent. Kleinbard and Driessen, *supra* note 162, at 1200.

¹⁶⁶We assume that the earnings inclusion will result in previously taxed earnings relief if the earnings are distributed during the last pre-effective-date year. Alternatively, we assume that if the earnings included as part of the transition earnings inclusion are not distributed before the effective date, the taxpayer still would have a basis step-up for the shares of stock under section 961 (but no previously-taxed-income relief if the earnings are not distributed before the effective date).

with prior-law deferral and will be viewed by some as a change in government commitment (in contrast to the elective lower rate repatriation holiday adopted in 2004), the lower rate and extended time to pay mitigate the force of this objection. As noted by professor Susan C. Morse, to the extent that a tax on pre-effective-date earnings exceeds the tax that otherwise would be paid, which as noted above will vary from taxpayer to taxpayer, it could be considered to offset windfall gains to prior equity owners.¹⁶⁷ In the Camp proposal case, however, the effective tax rate is quite favorable. Moreover, if the reform is revenue neutral, in the aggregate there should be no windfall to old equity. While there will be winners and losers, it seems unlikely that the tax aligns to only tax the winners under a reform.

In principle, revenue from taxation of pre-effective-date earnings should not be taken into account in evaluating whether a territorial system is revenue neutral over an indefinite period, as opposed to within a limited budget period. It is a separate question whether pre-effective-date earnings are appropriately a potential source of revenue (for deficit reduction or otherwise). Some will claim that taxing old earnings is the most favored way to raise revenue because it will have the least distortive effect on future behavior under a territorial system. The choice to tax those earnings, and pre-announcement of the intended policy, will trigger pre- and post-enactment behavioral responses (and likely has already done so). These responses will restrict revenue gains and may adversely affect future tax policy credibility.¹⁶⁸

V. Preliminary Observations

A. The Camp Proposal

The Camp proposal is a serious attempt to move U.S. corporate taxation of business income toward a source-based tax. By treating branches the same as subsidiaries, it importantly addresses a discontinuity of current law. The proposal's flaws, however, are material:

- *Scope of exemption.* The scope of exemption is not tied to avoidance of double taxation. The low-taxed-income anti-base-erosion option does not

address this concern because it has material loopholes that open the door to earning substantial amounts of low- or zero-taxed foreign income. Thus, there is a substantial incentive to forgo taxable domestic income in favor of earning low-taxed foreign income that is 95 percent exempt from U.S. income taxation.

- *Scope of anti-base-erosion rules.*
 - The excess intangibles income anti-base-erosion option seeks to address income shifting from intangibles, but this does not address the full range of base erosion concerns that would arise under the Camp proposal. Moreover, the same-country exception creates a material loophole that undermines the effectiveness of the proposal.
 - The intangibles income proposal is a misguided effort to provide a benefit to U.S. companies exporting products and services using intellectual property. It also does not address the potential exposure of the U.S. tax base under the Camp proposal's 95 percent exemption.
 - The low-taxed-income proposal will be largely ineffective in reducing the incentive to shift income and investment abroad, but that could be cured if the exceptions to low-taxed-income inclusion were eliminated. Doing so would narrow the income-shifting area down to the disparity between the U.S. (federal and state) tax rates and the proposal's 13.5 percent benchmark.
 - None of the anti-base-erosion proposals would as drafted reduce materially the income shifting through transfer pricing abuse and affiliated group structures that is eroding the U.S. corporate tax base. If the damaging exceptions to the low-taxed-income proposal were eliminated, this proposal could reduce income shifting to tax havens and countries that nominally impose tax but give away their tax base (such as Ireland, Luxembourg, Mauritius, Singapore, and Switzerland).
- *Expenses allocable to exempt income.* The 95 percent ceiling on the exemption is an inefficient and incomplete substitute for disallowing expenses properly allocated to exempt income. The 5 percent haircut substantially understates the expenses that would be allocated to foreign-source income under current law for many taxpayers and overstates the expenses that would be allocated to foreign-source income for other taxpayers. It advantages companies that have substantial U.S. interest, general and administrative expense, and R&D expense properly allocable to foreign income but not charged to foreign affiliates, and penalizes those that do not.

¹⁶⁷Susan C. Morse, "A Corporate Offshore Profits Transition Tax," 91 *N.C.L. Rev.* 549 (2013).

¹⁶⁸This is similar to the claim made by proponents of a consumption tax that the taxation of consumption from pre-effective-date wealth rather than future capital income is efficient because the tax is lump sum and will not distort future savings-consumption choices. Peter Diamond and Emmanuel Saez observe that such a policy "strains the relevance of the assumption that the government is committed to a policy that this taxation of wealth will not be repeated" and suggest that it could affect future savings decisions and have efficiency effects. Diamond and Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations," 25 *J. Econ. Perspectives* 165, 179 (2011).

- *Ninety-five percent exemption of stock sale gain of a CFC.* The 95 percent exemption of gain on the sale of CFC stock and denial of losses would exempt gain that would not be taxed by the other country or indeed anywhere. It would in many cases permit corporate expatriations of foreign subsidiary groups without a full U.S. tax on the gain as of the effective date. A stock gain exemption should be limited to gain up to realized earnings that would qualify for dividend exemption after applying a robust low-taxed-income limitation.
- *Foreign tax credit and its limitation.* Because of the scope of potential income taxed currently under subpart F, it is necessary to retain the FTC. However, the Camp proposal would allow unlimited cross-crediting and thereby invite a return to allowing FTCs for foreign-source income that is not taxed. Cross-crediting should be restricted by (1) revising the source rules to prevent income not taxed by another country from being treated as foreign-source income; (2) limiting the amount of high-taxed subpart F income available for cross-crediting by making the section 954(c)(4) high-tax exception from subpart F mandatory; (3) retaining and expanding the section 909 rules limiting separation of foreign taxes and income; and (4) expanding the scope of separate limitations to prevent cross-credit planning.
- *Transition for pre-effective-date earnings.* The taxation of pre-effective-date earnings is warranted and will allow less carryover of the complexities of applying the indirect FTC in relation to prior-year earnings. The reduced rate of tax on pre-effective-date earnings is unnecessary from a normative perspective. Instead, the determination of a tax rate on those earnings is principally a political and revenue issue.

Other aspects of the Camp proposal, particularly the treatment of non-C corporate shareholders, should be assessed after the taxation of business entities and qualified dividends has been determined.

B. Enzi Proposal

The Enzi proposal has none of the structural virtues and most of the failings of the Camp proposal. It leaves foreign branches subject to current taxation, thereby perpetuating the disparity in treatment of a foreign branch and a foreign subsidiary. The Enzi proposal would leave open the possibility of retaining deferral for pre-effective-date earnings. Its low-taxed-income subpart F proposal is designed to allow it to be broadly avoided, except for foreign intangible income of a CFC, and its special tax relief for intangible income of a U.S. corporation would materially reduce the U.S. tax base and be difficult to police. The Enzi proposal, however, does treat export sales income as U.S.-source income and preserve FTC limitations.

VI. Conclusions

It would be possible to modify the Camp and Enzi proposals to address their weaknesses in ways consistent with a principled exemption system. We recognize that those changes would make them unattractive to many in the multinational corporate community; however, that likely is true of any exemption system that would be a material improvement over current law.

In our view, unless a shift to an exemption system would constitute a material improvement over current law, the likely revenue loss from and transition costs of such a change would outweigh the benefits. If it is not possible to make progress on a comprehensive tax reform proposal, anti-base-erosion elements of the Camp and Enzi proposals that would improve aspects of current law, or that if modified would improve current law, could be pursued independently as part of less fundamental international tax reform. ◆