

# United States Transnational Income Tax Rules and the Probable Reform in the Sourcing of Corporate Income Earned Abroad

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## **Abstract**

*In today's global economy, tax formalism must be tempered, if not altogether abandoned. Thus, the replacement of Subpart F of the Internal Revenue Code with a régime of greater flexibility in the attribution of corporate income to a U.S. source seems inevitable. This article explores that possibility and tries to anticipate some of the details of the reform in the light of current U.S. fiscal problems.*

**Key words:** *Multinational corporations, corporate tax, corporate residence, tax gap*

## **Introduction**

Experts on United States income tax rules for transnational enterprises and investments have long thought a major overhaul is due. Any such overhaul is sure to include the highly unsatisfactory Subpart F of the Internal Revenue Code (IRC), which treats some, but not all, income of foreign subsidiaries of U.S. resident corporations as income of the parent corporations.

Disregarding the corporate shell of the subsidiaries is a departure from the otherwise unquestioning respect for the corporate shell on which much else in U.S. tax law is based. In a global economy, however, opportunities for tax arbitrage are so numerous that tax formalism must be tempered, if not altogether abandoned.

Subpart F, which dates back to the 1960s, created a limited exception to complete respect for corporate form. Most U.S. trading partners, however, now classify corporations as resident wherever they are controlled or managed. In such an environment, the replacement of Subpart F with a régime of greater flexibility in the attribution of corporate income to a U.S. source seems inevitable.

This Article explores that possibility and tries to anticipate some of the details of the reform in the light of current U.S. fiscal problems. After outlining the general background to Subpart F in part one, the main causes for the tax gaps, a term referring

to the difference between the government's estimates of the total amount legally subject to the income tax and the amount that is actually reported, are explored in part two. Relevant international tax policy goals and their concrete means of achieving greater sensitivity to the sources of corporate income are then analyzed in part three.

## **1. General Background**

Sovereign states impose and collect taxes from citizens and residents on a legal foundation provided by broad principles of sovereignty.<sup>2</sup> This set of ground rules were borrowed from public international law, especially from that part of it that deals with national conflict, cooperation, property rights, and other matters not related in the least to tax administration. Emphasis on the control of sovereign territory and the people and things within that territory has biased national tax systems' handling of transnational enterprise and investment towards all-or-nothing rules like those used in drawing national boundaries and in shielding sovereign acts from other sovereigns' intrusion. The growing superstructure of bilateral tax treaties ameliorates some of the harshness of this tradition. But neither treaties nor the experience of globalization has yet prompted national legislators to correct the inherited awkwardness of sovereignty concepts used in framing income tax rules for the transnational sphere. As the economies of industrial countries blur into each other, received notions of sovereignty and separate jurisdiction jostle

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ever more clumsily with the needs of tax design.

Most states claim full taxing authority over people, property and transactions “within” their territory. If the economic systems of nation states could be kept as distinct as these states’ territories, if economic activity and political jurisdictions were similarly closed to each other, the international aspect of income tax policy would pose few, if any, problems; the very subject matter of international tax might disappear from law schools and university accounting departments. But while physical objects, including human beings, must be located within or outside a country, contract rights, intellectual property and even physical property rights have no physical location, and transactions can obviously “cross borders” without going through customs. Economic systems, unlike sovereign nations, are necessarily ill confined by traditional jurisdictional concepts.

The discussion of international tax policy, under the weight of sovereignty-based tradition, has fallen into two broad areas: one of them concerned with attributing income to source countries, and the other concerned with analyzing enterprises or transactions into parts to which these source rules can apply. Like other tax problems, these have obvious equity and efficiency dimensions, but they also run headlong into potential clashes between competing sovereigns’ interest in protecting their fiscal bases as well as their citizens’ and residents’ economic efforts.

Economists have brought some clarity into the discussion of these problems by focusing attention on the neutrality of tax rules that can affect private economic decisions. Tax neutrality is the general term for a lack of influence by tax laws on the private economic sphere. In the international context, there are potential conflicts among several types of tax neutrality. A tax system that is designed not to influence whether non-resident investors choose to bring capital into the country may have a non-neutral impact on whether enterprises within its borders change the proportions of capital and labor they employ to reach their goals.

Something else complicates income tax policy in the international context. Nations do not recognize impartiality between their own citizens’ interests and those of other nations’ citizens as a basic principle of conduct. Legislators for one country feel bound to advance the interests of their own fellow citizens and perhaps of non-citizens who are residents. National egoism is at least the default rule of national legislation, if it is not inevitably followed in every detail of tax legislation. Yet international trade could not go on at all if nations were not to some extent willing to treat each others’ merchants and investors impartially. A conflict between the perceived need for egoism and the perceived need for a sort of commercial altruism is basic to tax legislation, as to other legislation, aimed at cross-border affairs.

There are also cultural differences among nations, such that the appropriateness of taxing a given transaction may depend on whether the population generally regards the transaction as belonging to a meritorious category. The citizens of a small nation with a highly developed financial sector may consider it perfectly respectable for its banks and financial services to take advantage of other countries’ difficulties in policing their own citizens’ tax compliance. The citizens of a developing nation may consider it desirable and even heroic for its citizens to work at low wages under harsh conditions, whereas those of a prosperous country of consumers may think this competitive edge only deprives their own workforce of reasonable rewards and protections. Finally, the population of an ageing industrial power will consider its governmental choices to be of inherent value, even if they undermine emerging markets and subsidize the country’s own enterprises in their forays abroad. Against the backdrop of such differences in national value sets, it is not surprising that national tax laws often manifest similar discrepancies in their underlying assumptions about how the world would best be run.

Lest it all seem too easy, the legal implementation of national tax regimes, when they reach beyond national boundaries,

becomes in part a matter of diplomacy. While the domestic politics of a taxing authority often dictates somewhat more harsh treatment for foreigners than for its own residents, foreigners can sometimes mobilize tax retaliation by their own (or even other) countries. Tax treaties, often called double-tax treaties because they are designed in large part to prevent double taxation of the same income, grow out of or anticipate the problems of tax evasion and inter-governmental retaliation. They are deliberately more favorable to the citizens and resident corporations of the treaty partners than to others, in order to secure cooperation against tax opportunism. They usually require a great deal of rather technical negotiation because of differences between the party states' tax systems. They are perhaps for that reason hard to amend. They also require standing arbitral arrangements, access to which, by international legal custom, is limited to citizens represented by state sponsors. In view of the difficulty of negotiation and the cumbersomeness of arbitration, it is not surprising that a country's tax treaties are often out of sync with its international tax policy for long periods of time.

## **2. The Tax Gap and its Causes**

The public and most tax professionals in the U.S. have only recently learned of the extent to which U.S. citizens have been concealing their wealth offshore to avoid income tax. Not so long ago, novels like John Grisham's *The Firm*, which presented the possibility that lawyers and accountants might conspire to help well-heeled U.S. citizens hide massive amounts of money at the expense of the fisc, seemed a fantasy to tax experts. The government, however, did have its suspicions, and these turned out to be well founded. Recent revelations confirm that U.S. citizens fraudulently conceal hundreds of billions of dollars offshore, and that major financial institutions actively sell criminal schemes of offshore asset concealment, presumably to all takers but certainly to American tycoons.

All this came to light after the Internal Revenue Service organized a special team of investigators to track down the money. Everyone is now familiar with the story,

released to the press in April 2009, that the U.S. government had reached an agreement with the Swiss bank UBS, in accordance with which the bank would plead guilty to criminal wrongdoing under U.S. laws, pay an \$870 million fine, and release to the U.S. government detailed information on 4,450 accounts belonging to U.S. citizens. The government soon established a partial amnesty program, permitting U.S. citizens to divulge previously secret offshore holdings in exchange for limited tax and penalties. The response has been so overwhelming that the IRS has scarcely been able to deal with the rush of supplicants (*The New York Times*, 2009a).<sup>3</sup> Congress is now contemplating a new law that would give banks outside U.S. jurisdiction certain advantages in exchange for entering into reporting agreements that would reveal certain information about U.S. citizens' accounts in these banks.<sup>4</sup>

The simple fraud committed by individuals of great wealth with the self-satisfied connivance of otherwise respectable foreign bankers and financial advisers is only the tip of a more complex, submerged world of tax subterfuge. Corporations are more prominent than individuals in suspected and partly documented income tax avoidance by means of international financial arrangements. Only a fraction of these arrangements are fraudulent like those uncovered in the UBS scandal.

Before considering the line between fraudulent and non-fraudulent offshore corporate tax avoidance, it is useful to consider how experts have come to understand the problem of the "tax gap."

The term is now routinely applied to the difference between government estimates of the total amount of U.S. income that is legally subject to the income tax and the significantly smaller amount that is actually reported. By the government's own latest estimate, the income tax is not being paid on roughly \$290 billion in income annually, enough to account for about \$90 billion in income tax revenue.<sup>5</sup> Whose income? The Treasury Department guesses that about half of this untaxed money is earned by small businesses that operate entirely within U.S. territory and that are simply committing

fraud by not reporting it or by claiming undeserved deductions. The other half is individual and corporate income that is held offshore. If the unreported income had all been properly taxed, most of the deficits the government was running before 2008, apart from those for the Iraq War, would have disappeared. No one really believes that *all* the fraud and noncompliance with tax laws could be eliminated, but perhaps a significant part, perhaps half, might be (Slemrod and Bakja, 2009).

Both legal and illegal practices can result in tax avoidance, and this is especially true of corporate income. Let U.S. first consider the most important legal means by which income earned abroad by corporate groups substantially owned by U.S. taxpayers can avoid the U.S. income tax.

From the earliest days of the corporate income tax in America, the common law has treated foreign subsidiaries as separate from their U.S. parents. The offshore income of these “controlled foreign corporations,” or CFCs, is not U.S. income until it is “repatriated” or returned to the parent corporations in the form of dividends from the subsidiaries to the parents, on the liquidation of the subsidiaries, or when the subsidiaries transfer their operations from abroad to within U.S. territory. The non-taxability of CFCs’ offshore income is normally called “deferral” because it is assumed that this income will eventually be repatriated to the parents or become subject to U.S. income tax when the foreign subsidiaries return home. Most other countries do not follow this pattern and do not countenance deferral of foreign income of their resident corporations, no matter what the structure through which the resident corporations “own” that income. Deferral drains the U.S. Treasury’s coffers of a substantial amount of revenue each year. That, however, is not considered part of the tax gap, because the mechanism by which tax is avoided is, to use David Cay Johnston’s phrase, “perfectly legal” (Johnston, 2004).

As we have already seen, the offshore corporate part of the tax gap is money sheltered illegally, not by taking advantage of

the generous policy of deferral but by secretive strategies that are *not* among those contemplated by the legislature. The U.S. has been slowly winning a war over several decades against both corporate and non-corporate tax shelters. In fact, U.S. budget deficits would have been even higher than their current high levels if recent tax collections from the shutdown of bad shelters had not been rolling in rather nicely. But shelters are still big business, and again based on government estimates, it looks as if there is a lot more tax to be collected from this source.

In order to appreciate the current state of presidential and congressional interest in legal offshore corporate tax avoidance, it is useful to review briefly the candidates’ promises in pre-2008 presidential campaign. When the field had been limited to three candidates, each proposed tax relief for the “middle class”. Hilary Clinton and Barack Obama favored no new business tax breaks, and Obama proposed to raise taxes for individual taxpayers with annual net taxable income of more than \$250,000, roughly the top 2% of U.S. taxpayers. The economic downturn has changed the prospects for tax increases, although public opinion is apparently more favorable to tax increases for the rich than it has been at any time in the last decade, perhaps in the last two decades.

McCain’s also included a substantial additional tax break for business: he would have indefinitely extended the “expensing” (that is, immediate deduction instead of gradual write-off) of new purchases of tangible personal property (mobiliens) to be used in business operations. The estimated cost of this extension would have been about \$60 billion a year.<sup>6</sup>

The Obama administration was virtually silent about tax reform until April 2009. Suddenly, on May 5, it launched a public relations campaign. The New York Times ran a front-page story detailing the drop in effective tax rate on overseas income of U.S. corporations, graphically borne out by charts for a select few corporate behemoths – GE, Pfizer, Exxon Mobil, Citigroup, Chevron and Merck (*New York Times*, 2009b). All this was

based on releases from the White House. Strikingly, the “spin” the government gave this information suggested that the use of tax havens was responsible for the declining effective tax rate on U.S. MNCs. In particular, one release – and President Obama repeated this in several speeches – said the average effective rate of tax paid by U.S. MNCs was only 2.3% on offshore income for 2004, the most recent year for which data are available. This was approximately \$16 billion in U.S. income taxes on offshore economic income of about \$700 billion.

Now what the releases did *not* mention is that MNCs everywhere are paying lower effective income taxes on their worldwide income (Sullivan, 2008). The reason for this is not at all clearly understood. Part of the explanation may be that much of the money is being earned by operations in low-tax countries – some developing countries, certainly, but also wealthy fast-emerging countries, and countries like Ireland that have deliberately low rates of taxation on inbound investment. This lower effective rate in new countries of MNC operations may reduce the overall effective rate without implying that effective rates are lower on MNC income earned in higher tax jurisdictions or subject to higher tax jurisdictions’ tax laws. In other words, the drop in effective tax rates is common to tax systems everywhere and may not be due to illegal tax avoidance.

On the other hand, every industrial country is aware that deliberate abuse of transfer pricing, which probably does not rise to the level of tax fraud in most instances, can also account for declining effective tax rates on MNCs. Corporate units of an MNC need only contract with each other to sell services or property at rates that put profits in low-tax countries and losses in high-tax countries. Since these units are not competitors, they do not negotiate self-interestedly, and the contracts they make are not “at arm’s length.”

The universally accepted standard, imposed by many countries through their own national tax systems, is to disregard such transfer pricing if the terms are not equivalent to those

of arm’s-length contracts, i.e., equivalent to terms that would be found in contracts between unrelated parties. This “would be” or contrary-to-fact hypothetical standard is difficult to apply, chiefly because the information necessary to enforce it is elusive or beyond the reach of auditors altogether. As a consequence, transfer pricing could account for some, or all, of the phenomenon of falling effective corporate tax rates on MNCs.

The Obama administration initially expressed an interest in taxing offshore corporate income, and the chair of the House Ways and Means Committee, Charles Rangel, was a strong advocate of broadening the corporate tax base. It seemed at first that the government would try to tax this MNC income more heavily, probably by weakening the traditional U.S. tax rule that treats a corporation’s distinctness from another corporation as absolute, a rule that makes it possible for a single group of corporations to be taxed on only part of its worldwide income. As has been mentioned, the income of foreign subsidiaries of U.S. parent corporations is not attributed to the parents, whether the foreign subsidiaries have permanent establishments abroad or not.<sup>7</sup>

At the moment, the prospect of such a weakening of the traditional U.S. doctrine of corporate separation has faded, though the pressure for a change in tax principles along these lines remains as strong as ever (Calmes, 2010). At the same time, and this may have distracted the political elite from the technical intricacy of international tax reform, popular pressure for deficit reduction is at fever pitch among many voters and their representatives in both parties. Some aspects of international tax reform would help reduce the deficit. Current proposals from the White House suggest that the administration may now attempt to raise revenues by imposing a number of new taxes on politically unpopular targets, such as the profits of financial firms and “Cadillac” health care plans of union and governmental employees (Greenhouse, 2010; Calmes, 2010). The political vulnerability of these is not so different from that of multi-national

corporations, whose roots in the country are weakened by their reputation for sending jobs abroad.

It seems more likely that Congress and the White House have only shelved plans for international tax reform to concentrate on more pressing business. There will continue, however, to be underlying policy pressure for them to return to this legislative agenda item. The following discussion explains why.

### 3. International Tax Policy Goals and Concrete Means of Achieving Greater Sensitivity to the Sources of Corporate Income

Economists and others have identified several broad goals of international tax design, including capital import and export neutrality, national neutrality, and sometimes capital owner equity (Musgrave, 1969). For decades now, experts and some legislative leaders have tentatively discussed how best to revise the U.S. tax laws in the light of these goals. For temporal perspective, it may be worthwhile to mention that these goals are now frequently discussed, while only a few years ago they surfaced infrequently even in dedicated tax policy analyses.

As I have suggested above, some combination of new rules governing the residence of corporations for U.S. tax purposes and revision - if not outright repeal - of the long standing policy of “deferral” would improve the capital export neutrality of U.S. tax law. It might also raise the effective rate of the corporate tax overall. A case can of course be made that it is not wise to tamper with basic international commercial tax burdens during a financial crisis. But the effective U.S. corporate tax rate could be held at current levels or even reduced if corporate tax preferences – deductions, credits and sheer exemptions, and deferral itself – (see Table 1 below) were curtailed. Change of this sort would just make the corporate tax fairer without driving away investors.

**Table 1** - Corporate Tax Preferences and Projected Revenue Costs, FY2008-2017

Preference	Revenue Cost (\$ Billions)
Expensing and accelerated depreciation	410
Deduction for U.S. production activities	210
Exclusion of interest on state and local debt	135
Research and experimentation (R&E) credit	132
Deferral of income of controlled foreign corporations	120
Low income housing credit	55
Exclusion of interest on life insurance savings	30
Inventory property sales source rule	29
Deductibility of charitable contributions	28
Special Employee Stock Ownership Plan (ESOP) rules	23
Exemption of credit union income	19
New technology credit	8
Special Blue Cross/Blue Shield Deduction	8
Excess of percentage over cost depletion	7
Other corporate preferences	27

**Source:** Treasury Report, reprinted in CRS, Corporate Tax Reform: Issues for Congress, Oct. 31. 2007.

Altered residence rules for corporations are most easily recommended against a backdrop of timeless international tax design goals. Three of these are: *capital export neutrality* (tax-neutral treatment of invested capital of a country’s own residents, independently the place of investment), *capital import neutrality* (tax non-discrimination between resident and nonresident investors), and *national neutrality* (equal return on total national capital invested).

*Residence-based* taxation, which taxes the country’s own residents without regard to where they earn their income, and *source-based* taxation, which taxes only the income arising within the countries borders, regardless of the residence of the persons who earn it, contribute differently to these goals, in some instances clashing with each other.

*Capital export neutrality* is achieved when

the same tax rate applies to firms' investments in or out of the taxing country. A residence-based income tax system would easily accomplish this by subjecting all residents' income to the same level of tax, no matter what its territorial source. *Capital import neutrality*, as the phrase suggests, is achieved when tax burdens on firms of different national residence that invest in the same country are taxed the same, and a source-based or territorial tax straightforwardly accomplishes neutrality in this respect. *National neutrality* requires that the nation's total return on investment, the sum of national tax revenue and domestic firms' profits, should be the same wherever it is earned, in the country or abroad. This form of neutrality is obtained by taxing foreign-source income and allowing a deduction for foreign taxes.

Other concerns may be peculiar to the economic predicament of advanced industrial nations. When capital is plentiful within a national economy, to discourage in-bound investment may promote national welfare, by encouraging the use of domestic labor instead of foreign capital.<sup>8</sup> Fending off foreign capital, if this reasoning is sound, hurts foreign labor, by leaving more capital to be invested in the foreign country itself. A policy that serves to balance the use of capital and labor within a country, sometimes called national neutrality, is at odds with capital import neutrality.<sup>9</sup>

These broad goals obviously compete to some extent with each other. How does this apply, if at all, to the definition of residence itself? Can residence reform disturb any of the types of neutrality? Changing the U.S. residence rules may improve the capital export neutrality of the U.S. tax system, by causing more investment abroad to face the same rate of tax investment at home faces. It should have no effect on capital import neutrality, because corporations that might have been classified under more formalistic rules as nonresident could benefit from that status only by avoiding activity in the U.S.. A broader definition of residence might increase the national neutrality of the current system by increasing the national return on investment, in this instance of course by collecting that return in the form of taxes;

taxing U.S.-owned foreign corporations could, on the other hand, worsen national neutrality by giving the U.S. too large a return on its total governmental and private capital. In brief, two out of three goals might be better served, and the other would not be affected.

The U.S. approach today is a hybrid of residence and source-based approaches. The U.S. does exempt nonresident corporate income from U.S. income tax, even if a U.S. parent has ownership-related control of the nonresident corporation. Although this serves the goal of capital export neutrality, the U.S. simultaneously does something to further national neutrality by crediting foreign taxes paid, if foreign subsidiaries send their earnings back to their U.S. parents. U.S.-source income of non-residents faces selective income taxation. A portfolio-interest exemption and the exemption of capital gains of nonresidents partly accords with capital import neutrality. On the whole, however, the U.S. is extremely non-neutral vis-à-vis inbound passive investment.

From this highly general perspective, ending deferral entirely or selectively (as Subpart F, without teeth, purported to do) could impair capital export neutrality, which in turn might lead to capital export retaliation by our trading partners and others. Most sensitively, it would threaten *de jure* discrimination in the treatment of developed and developing countries, because our treaties would still prevent the U.S. from taking permanent establishments in treaty-partner countries. Needless to say, the world is no longer a safe place for economic unilateralism, and so this aspect of residence rule reform is fraught with difficulty.

International corporate tax revenues are, however, a small part of the corporate tax as a whole. "Despite increasing globalization of the U.S. economy, foreign direct investment remains a small share of the U.S.-owned capital stock" (Brumbaugh and Gravelle, 2007). Taxing CFCs more heavily would increase the worldwide effective rate of the corporate tax, if we regard all the relevant foreign subsidiaries as properly comparable to corporations that are exclusively active in the U.S. Other tax policy

goals, however, are not particularly concerned with international tax neutrality. Critics of the corporate income tax have long argued that it burdens domestic investment, by lowering the effective rate of return on invested capital. Increasing the effective rate of tax on multinational corporations is not desirable insofar as it will only increase the effective rate of tax on U.S. corporations generally. Several economists have therefore argued that instead of increasing the tax at the corporate level, dividends should be taxed more heavily (Ibid.). By increasing the dividend tax rate, the overall design might buy a lower rate of tax on corporate income as such.<sup>10</sup>

The expert view that corporate tax inevitably distorts investment incentives emphasizes that taxation affects the return on investment in the corporate sector as a whole.<sup>11</sup> Yet corporate executives are often more concerned to preserve their competitive positions, based to some extent on their tax strategies within the existing régime, even at the cost of allowing corporate income to be depressed. In other words, they may be content to “game the system,” either by defending sectoral tax discrimination (faster cost recovery for tangible than for intangible business property) or by exploiting arbitrary but tax-sensitive differences within a single industry (e.g., through different depreciation rules for trucking and railroad freight transportation). The last time a U.S. administration forthrightly experimented with the possibility of repealing the corporate tax and replacing it with a more neutral business tax, the private sector plainly yawned and ignored the gesture.<sup>12</sup>

It therefore seems that the double corporate tax, beloved of corporate tax reform advocates, is a doubly bad thing. Not only does it distort investment incentives for investors in the corporate sector as a whole, it also distorts business practices of U.S. corporations, inspiring them to shape their business decisions to achieve tax advantages over their rivals.

If this is a correct diagnosis of the problem as a whole, the Obama administration should *both* eliminate tax deferral and broaden the corporate tax base. Unfortunately, the principal

corporate tax preferences seem to be the very ones, apart from the tax benefit of deferral, that are always boosted in an economic downturn: enhanced write-offs for depreciable property and R&D. Some of the others have been mentioned by Treasury Secretary Geithner as among the administration’s tax reform measures: elimination of LIFO inventory accounting (an easy thing to do in deflationary times) and the exclusion of corporate owned life insurance (COLI) benefits.

The correspondence between the tax reform measures theorists have identified and those for which the Obama administration has released trial balloons is impressive. This suggests that the current government is at least looking for objectively reasonable reform strategies, not just serving as a mouthpiece for lobbyists. But is theory right?

Perhaps the most important proposal so far is the Obama administration’s demand for better tax enforcement. This means requiring that a wider range of intermediaries disclose the income of U.S. taxpayers and related information, as well as giving the IRS more money for enforcing the tax law. At present the percentage of U.S. tax returns that are audited is less than 2%. It would be easy to audit more if intermediaries gave the IRS more information – computers could then match the disclosed information with tax returns, as they already do for most taxpayers who are employees.

Better tax enforcement is not a new theme for presidents, but it is possible that the less friendly attitude of the public towards financial institutions and big corporations may result in a major increase in tax revenue. Some types of enforcement do not require congressional approval. For example: In April 2009 the IRS offered “qualified intermediaries” – primarily foreign banks and other financial institutions – a choice of voluntarily disclosing more information or facing closer scrutiny from the IRS. This choice takes the form of “allowing” foreign institutions to apply for the benefits – less stringent reporting of their own proprietary information – in exchange for greater disclosure of their U.S. clients’ tax-sensitive information to the IRS.



## Conclusion

Given the forces that now shape U.S. fiscal policy, a broad change in the attribution of corporate income earned by U.S. corporations abroad or by their subsidiaries is necessary and, on the basis of recent presidential and congressional signals, more likely than at any time in several decades. The precise content that U.S. international tax rules will take, when revision occurs, can be anticipated with some confidence in the light of the obvious shortcomings of current residence and income attribution rules. But a departure from the traditional formalism of U.S. income tax law regarding the separateness of corporations will require either a new approach to corporate residence, a more intrusive approach to international income reporting, or both. The foregoing analysis points to rule changes that may be central elements in U.S. international tax reform.

## Notes

<sup>2</sup>The British government has already relieved dividends from CFCs from all income taxation and is in the process of revising other aspects of the taxation of CFCs themselves, with the goal of preventing the further erosion of the British company tax base. See HM Treasury, Proposals for controlled foreign companies (CFC) reform: discussion document (January 2010).

<sup>3</sup>Department of Justice, News Release: Justice Department & IRS Announce Results of UBS Settlement & Unprecedented Response in Voluntary Tax Disclosure Program, November 17, 2009; Lynnley Browning, 14,700 Disclosed Offshore Accounts, N.Y. Times, November 17, 2009, p C1.

<sup>4</sup>This legislative scheme would extend an existing administrative one that has similar features but requires less of foreign banks and puts less pressure on foreign banks to participate. Rev. Proc. 2003-64, Appendix 3, I.R.B. 2003-32.

<sup>5</sup>"In 2005, the IRS estimated this gross tax gap to be approximately \$345 billion. After subtracting revenue obtained through enforcement actions and other late payments, the IRS estimated the net tax gap to be approximately \$290 billion. These estimates, which remain the most recent estimates available, were conducted using data collected in tax year 2001 and before." U.S. Dept. of Treasury, Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance (July 8, 2009), page 2. According to a Cato Institute

Report, the US tax gap is actually small in comparison to that of other advanced industrial countries. Daniel Mitchell, *The Tax Gap Mirage*, 44 Cato Institute Tax & Budget Bulletin, March 2007, page 1. International comparisons, however, are unreliable in some respects, because different countries maintain tax statistics. OECD efforts to compile comparative statistics are not yet fully developed. Daniel Mitchell, *The Tax Gap Mirage*, 44 Cato Institute Tax & Budget Bulletin, March 2007, page 1. See A Progress Report on the Jurisdictions Surveyed by The OECD Global Forum in Implementing the Internationally Agreed Tax Standard (September 9, 2009), at [http://www.oecd.org/document/21/0,3343,en\\_2649\\_33745\\_42344853\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/21/0,3343,en_2649_33745_42344853_1_1_1_37427,00.html).

<sup>6</sup>McCain's would also have reduced middle and upper-middle class income taxes by repealing the Alternative Minimum Tax (AMT), which is really a disguised reduction of the personal deductions available to these taxpayers. This would have cost an estimated \$60 billion a year as well. The total of his proposals would have increased the then anticipated annual budget deficit by about 1/3, although the stimulative effect of these proposals might have reduced the deficit. The net effect was impossible to predict, especially with the real estate bubble and rising fuel prices that were signs of economic instability ahead.

<sup>7</sup>German tax law, I believe, does not tax any income from a foreign Betriebsstätte. By contrast, a corporate group that has its central management in the U.S. is treated as having a non-U.S. parent, if the parent was not formed and is not now recognized under the law of the U.S. or one of its member states. Corporate residence has always been analyzed in a purely formal way for U.S. income tax purposes. Under German law, if Germany is the situs, in this sense, of a corporation or the place where its Geschäftsleitung is located, the corporation is liable for German income tax on its worldwide income, with a credit for taxes paid abroad, and with certain exceptions, such as that for income from permanent establishments abroad. Most countries approach the corporate income measurement in this or a similar way; the U.S. is alone, as far as I can tell, in adherence to the formal understanding of corporate residence.

<sup>8</sup>All this assumes that capital and labor are in relevant measure interchangeable within the economy as a whole.

<sup>9</sup>See David L. Brumbaugh, International Taxation and Competitiveness, Congressional Research Service Report, May 19, 2006, page 5.

<sup>10</sup>*Id.* at pages 21-23.

<sup>11</sup>For a thorough, brief summary of expert opinion on the matter, see Martin A. Sullivan, A Hitchhiker's Guide to

Corporate Tax Reform, Tax Notes, December 7, 2009, page 1043.

<sup>12</sup>In 1991, on leaving office, George Bush Sr. had his Treasury Department publish a report calling for elimination of the double corporate tax, and the National Association of Manufacturers, the biggest corporate trade association, openly said it had little interest in that goal.

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