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Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation

Samuel C. Thompson Jr.
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Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation

SAMUEL C. THOMPSON, JR.*

I. INTRODUCTION	339
A. In General	339
B. Deferral System	340
C. Exemption System	341
D. Imputation System	341
E. Focus Here Is on Active Income of Controlled Foreign Corporations	342
F. The Debate	343
G. Guide to the Balance of the Article	343
II. A PERSPECTIVE ON THE DIMENSIONS OF THE ISSUES SURROUNDING THE TAXATION OF FOREIGN-SOURCE INCOME.....	344
III. TRANSFER PRICING AND DEFLECTION OF EXPENSE ABUSE IN THE CONTEXT OF FOREIGN-SOURCE INCOME.....	345
A. Transfer Pricing Abuse	345
B. Deflection of Expense Abuse	347
C. Impact of Imputation System on Transfer Pricing and Deflection of Expense Abuse	348
IV. THE DEFERRAL SYSTEM	348
A. Description of the Deferral System	348

* Professor and Director, Center for the Study of Mergers and Acquisitions, Penn State's Dickinson School of Law, State College, Pennsylvania. I want to thank Steven Jayson and James R. Meizanis, my Research Assistants at Penn State Dickinson School of Law, for their substantial assistance in the preparation of this article. I also thank Becky Sue Thompson, a second year law student at Penn State, and Jacob Mattinson, a first year student at Penn State, for their assistance.

B.	The Benefits of the Deferral System.....	351
1.	Capital Export Neutrality.....	351
2.	Capital Import Neutrality.....	351
C.	The Problems with the Deferral System	351
1.	Time Value of Money.....	351
2.	Incentive for Foreign over U.S. Investment.....	352
3.	Illustration of the “Lockout Effect”	352
4.	Complexity	352
5.	Transfer Pricing and Deflection of Expense Abuse	353
6.	Potential Negative Tax Rate on Foreign Income	353
V.	THE EXEMPTION SYSTEM.....	353
A.	A Description of the Exemption System.....	353
B.	The Benefits of the Exemption System	355
1.	Capital Export Neutrality and Competitiveness.	355
2.	Avoids “Lockout Effect”	355
3.	Potential Reduction in Complexity	355
4.	Capital Ownership Neutrality.....	356
C.	The Problems with the Exemption System.....	356
1.	Continued Complexity	356
2.	Transfer Pricing and Deflection of Expense Abuse	357
VI.	THE IMPUTATION SYSTEM	357
A.	A Description of the Imputation System	357
B.	The Benefits of the Imputation System	359
1.	Capital Export Neutrality.....	359
2.	Economic Efficiency	360
3.	Preserving the Tax Base	360
4.	Horizontal and Vertical Equity	360
5.	Fewer Transfer Pricing and Deflection of Expense Abuses	361
6.	Revenue Savings.....	361
7.	Potential Reduction in the Corporate Tax Rate for All Corporations	362
a.	The Economic Case for a Reduction in the Corporate Tax Rates with the Adoption of an Imputation System	362

b. The Political Case for a Reduction the Corporate Tax Rates with the Adoption of an Imputation System	363
C. The Problems with the Imputation System	364
1. Continued Complexity with the Foreign Tax Credit System.....	364
2. Decrease in Foreign Competitiveness	364
3. Switching Costs	364
4. The New Zealand Experience	365
VII. CONCLUSION.....	365

I. INTRODUCTION

A. In General

President Obama's May 2009 international tax proposals¹ have sparked a heated debate.² Comments have ranged from the pessimistic (Obama's proposals "would . . . reduc[e] U.S. exports as well as business investment and jobs in the United States");³ to the optimistic (Obama's proposals would close the loopholes that multinational corporations have been exploiting for years);⁴ and to the skeptical (Obama's proposals do not go far enough in fighting the unfairness of the deferral system).⁵ Prior to the announcement of these proposals, opposing policy commentators argued vigorously for scrapping the current deferral system all together and adopting either a territorial (*i.e.*, exemption) system⁶ or an imputation taxation system.⁷

1. Press Release, The White House, Office of the Press Secretary, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas* (May 4, 2009), available at http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS [hereinafter White House Outline].

2. See generally William H. Byrnes, *President Obama's International Tax Proposals in a Policy Context*, 2009 EMERGING ISSUES 3843 (2009); Lee A. Sheppard, *News Analysis: A Look at Obama's International Proposals*, 123 TAX NOTES 651 (2009); James Reardon et al., *The Practical Effects of the Obama International Tax Proposals*, 124 TAX NOTES 999 (2009) [hereinafter Reardon, *Practical Effects of the Obama International Tax Proposals*].

3. KEVIN BRADY, JOINT ECON. COMM. REPORT ON OBAMA'S TAX POLICY TO OUTSOURCE INVESTMENT AND JOBS 1 (2009).

4. See Reuven S. Avi-Yonah, *The Obama International Tax Plan: A Major Step Forward*, U. MICH. LAW & ECON., Olin Working Paper No. 09-007, available at <http://ssrn.com/abstract=1400624>; see also Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 2000 WTD 64-15 (2000) (discussing the benefits of the deferral system).

5. See Samuel C. Thompson, Jr., *Obama's International Tax Proposal Is Too Timid*, 54 TAX NOTES INT'L 579 (2009); Clifton J. Fleming et al., *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079 (2009) [hereinafter Fleming, *Perspectives*].

6. See Peter Mullins, *Moving to Territoriality? Implications for the U.S. and the Rest of the World*, 43 TAX NOTES INT'L 839 (2006).

There are three basic approaches a country can take in structuring the taxation of active (as distinguished from passive) foreign income earned by companies owned by residents of such country: (1) a deferral system, which is employed by the U.S.; (2) an exemption system, which is employed by several European countries, Canada, and Australia; and (3) an imputation system, which was employed by New Zealand, until it moved to an exemption system in 2009.⁸

B. Deferral System

In the U.S. deferral system, the active earnings of U.S.-owned foreign corporations (*i.e.*, controlled foreign corporations such as a wholly-owned foreign subsidiary of a U.S. parent corporation) generally are not subject to U.S. taxation until the income is repatriated to the U.S., for example, in the form of dividends.⁹ Also, at the time of repatriation, the U.S. parent corporation may receive a foreign tax credit (*i.e.*, a reduction in its U.S. tax liability) for the foreign taxes paid by the foreign subsidiary on the distributed earnings.¹⁰ This type of system is referred to as a deferral system, because the general principle of worldwide U.S. taxation is deferred (*i.e.*, does not apply) until the income of a controlled foreign corporation is repatriated. The benefit of deferral is generally not available for passive income (*e.g.*, interest and dividends) earned by a controlled foreign corporation.

Since its inception, opponents of the U.S. deferral system have attempted to bring about its demise.¹¹ In the 1960s, Congress succeeded in repealing deferral on passive investment income and, to a limited extent, on certain active income.¹² Opponents of the deferral system argue that it allows multinational corporations to “hide” otherwise taxable income in foreign jurisdictions. By using creative ac-

7. See, *e.g.*, Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 46 TAX NOTES INT'L 63 (2007); Samuel C. Thompson, Jr., *How Should Congress React To Bush's Tax Proposals?*, 114 TAX NOTES 1233 (2007) (see Part VIII, proposing that Congress “tax on a current basis all of the income of foreign corporations controlled by U.S. taxpayers”).

8. New Zealand Revamps Tax Regime for Controlled Foreign Companies, 198 Daily Tax Rep. (BNA) 1-1 (Oct. 16, 2009).

9. See I.R.C. § 951 et seq.; SAMUEL C. THOMPSON, JR., U.S. INTERNATIONAL TAX PLANNING AND POLICY: INCLUDING CROSS-BORDER MERGERS AND ACQUISITIONS 393-454 (2007) [hereinafter THOMPSON, INTERNATIONAL TAX PLANNING] (discussing CFC rules).

10. See I.R.C. § 902 (2006). See generally THOMPSON, INTERNATIONAL TAX PLANNING, *supra* note 9, at 227-304.

11. Reardon, *Practical Effects of the Obama International Tax Proposals*, *supra* note 2.

12. *Id.*

counting methods and transfer pricing, U.S. corporations are able to use their foreign subsidiaries to lessen their tax burden in the U.S.¹³

C. Exemption System

In an exemption system, the active income of a controlled foreign corporation is not subject to taxation in the home country of the parent corporation at the time the income is earned or at the time the income is repatriated. Thus, foreign active income is exempt from home-country taxation. Exemption systems are sometimes referred to as territorial systems, meaning that foreign active income is only subject to taxation in the country where it is earned. As with the U.S. deferral system, most exemption systems do not grant the benefit of the exemption to passive income.

An exemption system is consistent with what economists call the Capital Import Neutrality principle:

Capital import neutrality refers to a system of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor. Some commentators refer to the principle of capital import neutrality as promoting “competitiveness.” Under capital import neutrality, capital income from all businesses operating in any one locality is subject to uniform taxation. The nationality of investors in a particular locality will not affect the rate of tax.¹⁴

D. Imputation System

In an imputation system, all earnings of a foreign subsidiary, whether active or passive, are imputed to the parent corporation at the time the earnings are realized, and the parent is given a foreign tax credit for any foreign taxes paid with respect to such income. Thus, the income of the foreign subsidiary passes through to the parent corporation much like the income of a partnership passes through to the partners. In a pure imputation system, both the foreign jurisdiction

13. GOV'T ACCOUNTABILITY OFFICE, TESTIMONY BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, TAX COMPLIANCE, OFFSHORE FINANCIAL ACTIVITY CREATES ENFORCEMENT ISSUES FOR IRS, GAO-09-478T, 4 (Mar. 17, 2009) (finding that “creation of offshore entities and structures can be relatively easy and inexpensive [E]stablishing a Cayman Islands exempted company can be accomplished for less than \$600 . . . and the company is not required to maintain its register of shareholders in the Cayman Islands or hold an annual shareholders meeting.”).

14. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT-LAW RULES AND REGULATIONS AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION, 4 (Comm. Print 1999) [hereinafter JCT, ECONOMIC ISSUES IN INTERNATIONAL TAXATION].

and the home country tax the income of the foreign corporation as such income is earned.

An imputation system is consistent with what economists refer to as the Capital Export Neutrality principle:

Capital export neutrality refers to a system where an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax. Under capital export neutrality, decisions on the location of investment are not distorted by taxes. Capital export neutrality is a principle describing how investors pay tax, not to whom they pay. Capital export neutrality primarily is a framework for discussing the efficiency and incentives faced by private investors, and not the distribution of the revenues and benefits of international investment.¹⁵

E. Focus Here Is on Active Income of Controlled Foreign Corporations

In both the U.S. deferral system and generally in exemption systems, foreign passive income is taxed on a current or imputation basis. This means that passive income is imputed to the parent corporation at the time the income is earned, thereby imposing an immediate home country tax on the passive income. However, the home country tax may be reduced by a foreign tax credit for foreign taxes paid on the passive income. This is an accepted norm and no policy commentator that I am aware of has argued for deferral or exemption of foreign passive income.

The general distinction between active and passive income is that active income is income earned by a company's primary business activities while passive income is income earned by a company through means other than its primary business activities.¹⁶ A Government Accountability Office (GAO) report on exemption systems identifies some of the many challenges presented when attempting to tax active foreign-source income, including "ensuring tax law compliance, minimizing tax induced distortions of [business] decisions about where to locate investment, avoiding the double taxation of income earned in

15. *Id.*

16. See GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMM. ON FINANCE, U.S. SENATE, INT'L TAXATION, STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCE INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES GAO-09-934, at 6 (Sept. 2009) [hereinafter GAO, REPORT ON EXEMPTION SYSTEMS]. For a good illustration of different types of foreign-source income, see Table 1. *Id.*

one country by companies located in another country, and minimizing unnecessary taxpayer compliance burden, such as recordkeeping.”¹⁷

Notwithstanding the challenges that can be presented in distinguishing active from passive income, the discussion here focuses only on the treatment of active trade or business income of foreign subsidiaries, and to simplify matters further, the discussion assumes that the foreign subsidiary is wholly-owned by a U.S. (or home country) parent corporation. In the U.S., such corporations are referred to as “controlled foreign corporations,” or CFCs.¹⁸

F. The Debate

The crux of an ongoing debate in international tax focuses on whether to tax active foreign-source income earned by foreign-subsidaries of multinational corporations, and, if so, the most effective and efficient way to tax such income. The outcome of this debate has a wide ranging effect on (1) the U.S., (2) multinational corporations, and (3) other countries around the world as a result of the global influence of multinational corporations based in the U.S. No country has a pure exemption or pure imputation system, and most countries have adopted a hybrid of the two systems.¹⁹

G. Guide to the Balance of the Article

This article first gives a perspective on the dimensions of the issues surrounding the taxation of foreign source income (Part II) and then discusses transfer pricing and related issues (Part III). The article then discusses the pros and cons of (1) the current deferral system (Part IV), (2) an exemption system (Part V), and (3) an imputation system (Part VI). As discussed in Part VI.B.6, significant revenues would be realized by moving from the current deferral system to an imputation system, and Part VI.B.7 proposes that at least a part of the enhanced revenues be used to reduce the corporate tax rate for all

17. *Id.* at 1.

18. The anti-deferral rules in the U.S. currently apply to a “controlled foreign corporation” (CFC), which is a foreign corporation where U.S. persons holding at least 10 percent of the stock of such corporation own in the aggregate more than 50% of the stock of the corporation. THOMPSON, INTERNATIONAL TAX PLANNING, *supra* note 9, at 393, 399.

19. GAO, REPORT ON EXEMPTION SYSTEMS, *supra* note 16, at 2. (The GAO report finds that “large developed countries do not use a pure worldwide [imputation] or pure territorial [exemption] approach when taxing foreign-source corporate income.” The report does not discuss tax systems used by medium-sized developed or under developed countries).

corporations. Part VII concludes that the U.S. should adopt an imputation system.

II. A PERSPECTIVE ON THE DIMENSIONS OF THE ISSUES SURROUNDING THE TAXATION OF FOREIGN-SOURCE INCOME

A December 2008 report by the GAO²⁰ presents a good picture of the challenges facing the U.S. in addressing the issues involving the taxation of foreign income. The GAO report detailed the 100 largest U.S. companies and federal contractors, as well as the number of subsidiaries each company has located in a tax haven²¹ or financial privacy jurisdiction.²² The report found that “[83] of the 100 largest publicly traded U.S. corporations in terms of 2007 revenue reported having subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions and 74 of the 83 had federal contracts in the fiscal year 2007.”²³

The GAO report also noted that of the 83 companies with foreign subsidiaries, “[12] corporations had more than 50 percent of their foreign subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions.”²⁴ Appendix II of the GAO’s report includes figures showing the number of foreign subsidiaries and the number of those subsidiaries in tax havens or financial privacy jurisdictions. For example, as of December 2008, Citigroup had 1,240 foreign subsidiaries; 427 of those foreign subsidiaries were located in tax havens or

20. GOV’T ACCOUNTABILITY OFFICE, REPORT TO CONG. REQUESTERS, INT’L TAXATION, LARGE U.S. CORP. & FED. CONTRACTORS WITH SUBSIDIARIES IN JURISDICTIONS LISTED AS TAX HAVENS OR FIN. PRIVACY JURISDICTIONS, GAO-09-157 (Dec. 2008) [hereinafter GAO, TAX HAVEN REPORT]. While the report focuses on the location of foreign subsidiaries, it did not seek to determine whether foreign subsidiaries in tax havens or offshore financial centers were used for the purpose of reducing a company’s tax burden.

21. The report did not seek to define the term “tax haven” or compile a list of countries considered to be tax havens. The report simply noted characteristics that define and identify tax havens to be “no taxes or nominal taxes; lack of effective exchange of tax information with foreign tax authorities; lack of transparency in the operation of legislative, legal, or administrative provisions; no requirement for a substantive local presence; or self-promotion as an offshore financial center.” *Id.* at 2 n.6.

22. The report also did not seek to define the term “offshore financial center” or “financial privacy jurisdiction.” The report simply noted again the characteristics that a few sources have used to describe offshore financial centers as jurisdictions that have a high level of nonresident financial activity and that may have low or no taxes, light and flexible regulation, and a high level of client confidentiality. The report noted also that a characteristic that has been used to describe financial privacy centers is a jurisdiction that has strict bank secrecy laws that persons can use to shield their wealth from taxation in their home countries. *Id.* at 2 n.7.

23. *Id.* at 4 (citation omitted).

24. *Id.*

financial privacy jurisdictions.²⁵ Specifically, 90 foreign subsidiaries were located in the Cayman Islands (a known tax haven) and 40 foreign subsidiaries were located in Hong Kong (also a tax haven).²⁶ Marathon Oil had 115 foreign subsidiaries; 76 of those foreign subsidiaries were located in tax havens or financial privacy jurisdictions, with 65 of these foreign subsidiaries located in the Cayman Islands.²⁷ Morgan Stanley had 568 foreign subsidiaries; 273 of those foreign subsidiaries were located in tax havens or financial privacy jurisdictions, with 158 located in the Cayman Islands and 29 located in Luxembourg (also a tax haven).²⁸

These data show that the IRS has its hands quite full in determining whether the income earned by these foreign subsidiaries is properly reported. If the U.S. were to adopt a pure imputation system as proposed below, much of the incentive for companies to establish multiple foreign subsidiaries in tax havens would be eliminated because the U.S. parent would be required to report all of the income earned by each of the subsidiaries.

III. TRANSFER PRICING AND DEFLECTION OF EXPENSE ABUSE IN THE CONTEXT OF FOREIGN-SOURCE INCOME

A. Transfer Pricing Abuse

Transfer pricing is “the allocation of profits for tax and other purposes between parts of a multinational corporate group.”²⁹ John Neighbour gives the following example:

Consider a profitable UK computer group that buys micro-chips from its own subsidiary in Korea: how much the UK parent pays it—the transfer price—will determine how much profit the Korean unit reports and how much local tax it pays. If the parent pays below normal local market prices, the Korean unit may appear to be in financial difficulty, even if the group as a whole shows a decent profit margin when the completed computer is sold. UK tax administrators might not grumble as the profit will be reported at their

25. *Id.*

26. GAO, TAX HAVEN REPORT, *supra* note 20, at 25.

27. *Id.* at 32.

28. *Id.* at 34.

29. John Neighbour, *Transfer pricing: Keeping It at Arm's Length*, OECD OBSERVER, July 3, 2008, http://oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html. See also THOMPSON, INTERNATIONAL TAX PLANNING, *supra* note 9, at 349.

end, but their Korean counterparts will be disappointed not to have much profit to tax on their side of the operation.³⁰

Although Section 482 of the Internal Revenue Code requires that sales and other transfers between related parties be at an “arm’s length” price, a 2007 report by the Department of the Treasury found that some U.S. corporations use transfer pricing as a way to avoid paying U.S. taxes by transferring income from the U.S. to a subsidiary located in a foreign jurisdiction.³¹

According to the GAO’s September 2009 report to the U.S. Senate’s Committee on Finance, many tax agency officials in countries with exemption systems, whom the drafters of the report consulted, consider transfer pricing to be the single greatest compliance risk related to the taxation of foreign-source income.³² The possible magnitude of the compliance risk related to transfer pricing is shown in the GAO’s report, which states:

Trade in services in the United States, while not a measure of overall U.S. trade provides an example. According to the U.S. Bureau of Economic Analysis, trade in services between CFCs [i.e., foreign subsidiaries] and related parties increased (in nominal dollars) from approximately \$38.4 billion in 1999 to approximately \$178.7 billion in 2006.³³

Along the same lines, a 1999 report by the Staff of the Joint Committee on Taxation provided the following analysis of the magnitude of intra-firm sales between U.S. parents and their controlled foreign subsidiaries: “[I]n 1994[,] intra-firm trade accounted for at least 40 percent of U.S. merchandise exports [i.e., sales by U.S. persons to foreign persons] and 44 percent of U.S. merchandise imports [i.e., sales by foreign persons to U.S. persons].”³⁴ It would appear that the level of intra-firm sales has increased from the 1994 levels. In any event, this high level of intra-firm transfers puts a significant amount of pressure on Section 482 and the ability of the IRS to properly administer it. Furthermore, the importance of transfer pricing is illustrated by the 2006 settlement between the IRS and Glaxo-SmithKline, where

30. *Id.*

31. DEP’T OF THE TREASURY, REPORT TO THE CONG. ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TREATIES (Nov. 2007) [hereinafter TREASURY, TRANSFER PRICING REPORT].

32. GAO, REPORT ON EXEMPTION SYSTEMS, *supra* note 16, at 19.

33. *Id.* (citing U.S. Bureau of Econ. Analysis, *U.S. Int’l Serv. Cross-Border Trade 1986–2007 and Serv. Supplied Through Affiliates, 1986–2006*).

34. JCT, ECONOMIC ISSUES IN INTERNATIONAL TAXATION, *supra* note 14, at 14.

the pharmaceutical company agreed to pay \$3.4 billion for tax deficiencies in transfer pricing over a 12 year period.³⁵ Glaxo-SmithKline is not alone when it comes to recent transfer pricing disputes: Merck & Co. also had tax claims of approximately \$5.6 billion asserted against it regarding its transfer pricing practices.³⁶ The IRS also has several other cases regarding transfer pricing issues either pending before the U.S. Tax Court or recently settled.³⁷

One of the ways that countries currently attempt to address issues with transfer pricing is by developing advanced pricing agreement (APA) programs, which bring the taxpayer and the taxing authority together to agree on transfer pricing issues before the actual tax return is filed.³⁸ Arguably, the use of APA programs is a more efficient way to eliminate or alleviate the issues associated with transfer pricing, but the GAO reports that many tax experts cast doubt on the effectiveness of such programs.³⁹ These programs can be time consuming and require an abundance of documentation and correspondence that, as a result, has caused some taxpayers to seek such agreements for only large value transactions. On small value transactions, taxpayers will generally avoid entering into such APA programs and will only address such pricing issues if questioned by the respective taxing authority.⁴⁰ In any event, APAs can only address a small fraction of the transactions raising significant transfer pricing issues.

B. Deflection of Expense Abuse

In addition to transfer pricing issues arising in the sale of goods and the provision of services, similar issues can arise with the allocation of expenses and interest. For example, it may be beneficial for a

35. Kleinbard, *supra* note 7, at 552 (citing I.R.S. News Release IR-2006-142 (Sept. 11, 2006)).

36. *Id.*

37. TREASURY, TRANSFER PRICING REPORT, *supra* note 31, at 46. In this report, the Treasury notes the following transfer pricing cases: *H Group Holding, Inc. v. Commissioner*, T.C. Memo. 1999-334; *Adaptec, Inc. v. Commissioner*, Docket Nos. 10077-00, 3480-01; *BIB USA, Inc. v. Commissioner*, Docket No. 4434-03; *BMC Software v. Commissioner*, Docket No. 2671-00; *Compaq Computer Corp. v. Commissioner*, T.C. Memo 1999-220; *Dart Container Corp. v. Commissioner*, Docket No. 10526-01; . . . *Mark Kay Corp. v. Commissioner*, Docket No. 18150-02; *Schneider Electric Holdings, Inc. v. Commissioner*, Docket No. 12225-02; *United Parcel Service of America, Inc. v. Commissioner*, T.C. Memo. 1999-268, *rev'd and remanded*, 254 F.3d 1014 (11th Cir. 2001), *dismissed per stipulation*, order entered Jan. 22, 2003; *Veritas Software Corp. v. Commissioner*, Docket No. 12075-06; *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005), *appeals docketed*, Nos. 06-74246 and 06-74269 (9th Cir. Sept. 29, 2006).

38. GAO, REPORT ON EXEMPTION SYSTEMS, *supra* note 16, at 22.

39. *Id.*

40. *Id.*

company to treat interest and other expenses that are properly allocable to foreign income as allocated to domestic income. This could result in the deduction of such interest or other expense in the computation of high-taxed U.S. income rather than in the computation of low-taxed foreign income. The Obama Administration's May 2009 International Tax Proposals address the deflection of expense issue: "[C]ompanies [will not] receive deductions on their U.S. tax returns supporting their offshore investments until they pay taxes on their offshore profits."⁴¹

C. Impact of Imputation System on Transfer Pricing and Deflection of Expense Abuse

As will be seen below, both deferral and exemption systems are vulnerable to transfer pricing and deflection of expense abuse as taxpayers attempt to divert as much active income (and as little expense) as possible to low tax jurisdictions. On the other hand, a pure imputation system takes away most, if not all, of the incentive to engage in transfer price and expense manipulation in transactions between a U.S. parent corporation and its foreign subsidiary. Thus, adoption of the exemption system, as discussed below, would have the secondary benefit of significantly reducing transfer pricing and deflection of expense abuse.

IV. THE DEFERRAL SYSTEM

A. Description of the Deferral System

The deferral system is a hybrid system. For active foreign source income earned by a foreign subsidiary of a U.S. parent, the deferral system turns off (*i.e.*, defers) (1) the U.S. principle requiring that the worldwide income of the U.S. parent be subject to U.S. taxation, with an appropriate foreign tax credit for foreign taxes paid, until (2) such active income is repatriated to the U.S. The repatriation can be shareholder income in the form of dividends or liquidating distributions from the foreign subsidiary⁴² or from the sale by the U.S. parent corporation of the stock of the foreign subsidiary.⁴³

Under the controlled foreign corporation (CFC) rules of Sections 951 through 964, passive income and certain other types of "subpart

41. See White House Outline, *supra* note 1.

42. I.R.C. § 951(a) (2006).

43. I.R.C. § 1248 (2006).

F" income (*i.e.*, tax haven type income) of a CFC is subject to taxation under an imputation system, meaning that the subpart F income is imputed to the controlling U.S. parent at the time the income is earned with a foreign tax credit, subject to limitation, for any foreign taxes paid on the tax haven type income.⁴⁴

The deferral system is not available for foreign income earned by a foreign branch or division of a U.S. corporation; under the U.S.'s worldwide approach, such branch or division income is subject to U.S. taxation at the time it is earned, with an appropriate foreign tax credit for foreign taxes paid on such income.⁴⁵ Because branch income does not get the benefit of deferral, most foreign business activity of U.S. corporations is conducted through foreign subsidiaries.

The following example illustrates the effect the deferral system can have on the investment decisions of U.S. corporations.⁴⁶ Assume that State Oil Corp. is engaged in the oil exploration business and is headquartered in State College, PA. It is faced with the following investment decision:

- (1) invest \$50 million in oil exploration and refining in State College, which is expected to produce \$10 million in annual taxable income; or
- (2) set up a subsidiary in China, China Oil Sub., and have it invest \$50 million in oil exploration and refining in China, which is also expected to produce \$10 million in annual taxable income.

Thus, the pretax return of both investments is \$10 million. However, State Oil Corp. is faced with a 35% effective corporate tax rate in the U.S., and China Oil Sub. would be faced with a 15% effective corporate tax rate in China.⁴⁷ Other things being equal, under our deferral system which investment decision would State Oil Corp. make?

The answer is clear: State Oil Corp. would invest in China because the after-tax return on the China investment is \$8.5 million (\$10 million minus the \$1.5 million China tax), while the after-tax return for the State College investment is only \$6.5 million (\$10 million minus the \$3.5 million U.S. tax).

44. For a discussion of the CFC rules, see THOMPSON, *INTERNATIONAL TAX PLANNING*, *supra* note 9, at 393-454.

45. *Id.* at 227-304.

46. This example is based on an example in *Obama's International Tax Proposal Is Too Timid*, *supra* note 5.

47. Assume for the purpose of this discussion that the effective corporate tax rates are the same as the maximum statutory rates.

This is the case even though under the U.S. deferral system, State Oil Corp. would be subject to U.S. tax when China Oil Sub. repatriates its after-tax income to State Oil Corp. in the form of dividends. As a result of the foreign tax credit provisions, at that time of repatriation, State Oil Corp. would have to pay an additional \$2 million in tax, so that the combined China tax (\$1.5 million) and U.S. tax (\$2 million) on the repatriated income would be 35%. Thus, the U.S. tax on the income of China Oil Sub. is "deferred" until the income is repatriated.

Through the use of creative schemes pursuant to which the deferred foreign income is reinvested in foreign businesses, the deferral can be indefinite or even permanent. In other words, if all of the foreign business earnings are reinvested in foreign businesses, the U.S. tax is never imposed on any of such earnings. This is referred to as the "lockout effect;" that is, the deferral system has the effect of locking foreign earnings out of the U.S., thereby distorting the investment decisions of U.S. firms by making foreign investment more beneficial than domestic investment.

The example of State Oil understates the effect of the deferral system on investment decisions of U.S. firms. In the above example, the pre-tax returns of the investments in the U.S. and China are the same, that is, \$10 million. However, even if the pre-tax return of the investment in China is lower than the pre-tax return in the U.S., it may still be beneficial for State Oil to make the investment in China. For example, if the pre-tax return on an investment in China were \$8 million instead of \$10 million, it still would be more beneficial for State Oil to invest in China rather than in the U.S. as long as the China earnings could be deferred for a significant period. This principle can be illustrated as follows. Assume that State Oil has an \$8 million pre-tax return in China. In such case, the China tax is \$1.2 million (15% of \$8 million), and the after-tax earnings are \$6.8 million (\$8 million-\$1.2 million), which is more than the \$6.5 million after tax return with an investment in the U.S. at the higher \$10 million pre-tax return.

Also, because the foreign tax credit is not computed on a business by business or a country by country basis, through proper repatriation planning, the repatriation of low-taxed foreign business income (*i.e.*, foreign income taxed at a rate lower than the U.S. rate) can be implemented at the same time as the repatriation of high-taxed foreign business income (*i.e.*, foreign income taxed at a rate higher than the U.S. rate). By using this device, the excess foreign tax credits on the high-

taxed foreign business income (foreign taxes in excess of the 35% U.S. rate) can be used to shelter from U.S. tax, low-taxed foreign income. This is referred to as cross crediting; that is, using excess foreign tax credits imposed on high-taxed income to prevent U.S. tax on low-taxed foreign income.

B. The Benefits of the Deferral System

1. Capital Export Neutrality

The deferral system is a balance between capital export neutrality and capital import neutrality. The deferral system attains the goal of capital export neutrality by deferring the U.S. tax on active foreign income of foreign subsidiaries, thereby initially subjecting those subsidiaries to the same tax rate that applies to other businesses competing against the foreign subsidiary in the particular country. This gives foreign subsidiaries the ability to compete in the countries they are located in by allowing them to retain more working capital. This is referred to as the competitiveness principle; that is, the deferral principle arguably enhances the competitiveness of U.S. companies that invest abroad. As will be seen below, an exemption system adheres completely to the competitiveness principle, and an imputation system is inconsistent with the principle.

2. Capital Import Neutrality

The deferral system is also consistent with the capital import neutrality principle because it imposes a U.S. tax at the time the deferred income is repatriated to the U.S., thereby recapturing the lost U.S. tax revenue upon repatriation. However, because of the potential for infinite or permanent deferral and cross crediting at the time of repatriation, the deferral system is more consistent with the capital export neutrality principle than the capital import neutrality principle.

C. The Problems with the Deferral System

1. Time Value of Money

The deferral system gives a “time value of money” advantage to foreign investment over domestic investment.⁴⁸ The time value of money concept holds that a dollar today is worth more than a dollar

48. THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 103 (2005) available at http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_5-7.pdf.

tomorrow. Therefore, a corporation would prefer to pay tax at a later time rather than when the income is earned. Due to the postponement of paying of tax, the deferral system allows foreign-source income to be taxed at a lower effective rate than if it were earned domestically.⁴⁹ According to the U.S. President's Advisory Panel on Federal Tax Reform the deferral system "creates an incentive for the foreign subsidiary to retain the earnings as long as possible and distorts other business and investment decisions."⁵⁰

2. Incentive for Foreign over U.S. Investment

The deferral system addresses, at least in part, the foreign competitiveness principle by not subjecting the active earnings of foreign subsidiaries to immediate U.S. taxation. However, deferral produces another competitiveness issue: the creation of an unlevel playing field between business conducted in the U.S.—in State College, for example—and business conducted in China. Thus, in purportedly addressing the foreign competitiveness issue, the deferral system creates a U.S. competitiveness issue.

3. Illustration of the "Lockout Effect"

One of the strongest pieces of evidence for the argument that the current deferral system is inadequate was the repatriation of foreign-source income after the passage of the American Jobs Creation Act of 2004.⁵¹ As a result of the passage of this Act, there was a one-year reduction in the tax rate on repatriated dividends and the amount of dividends from foreign companies that occurred during this time was staggering. Mullins reports that data show "an almost fivefold increase in dividends from foreign companies since the measure was introduced (US \$244 billion in 2005 compared with US \$50 billion in 2004). That outcome is consistent with research that has found there is a negative relationship between dividend repatriation taxes and dividend payout rates."⁵²

4. Complexity

Another problem with the current U.S. deferral system is the complex nature of the rules and regulations governing foreign-source

49. *Id.*

50. *Id.*

51. Mullins, *supra* note 6, at 839 n.18.

52. *Id.* at 839, nn.19-20.

income. As one editorial in the *Wall Street Journal* said, the deferral system is “a tax code so riddled with complexity that it is both expensive to administer and inefficient at collecting revenue.”⁵³ This idea of complexity is also addressed by Professor Peroni in his article, *Deferral of U.S. Tax on International Income: End It, Don’t Mend It—Why Should We Be Stuck in the Middle with Subpart F?*,⁵⁴ where he claims that Subpart F, the part of the Internal Revenue Code addressing foreign-source income, is already too complex.⁵⁵

5. Transfer Pricing and Deflection of Expense Abuse

The deferral system also presents opportunities for abuses with transfer pricing and deflection of expenses as taxpayers attempt to divert as much active income (and as little expense) as possible to foreign subsidiaries located in low-tax jurisdictions.⁵⁶

6. Potential Negative Tax Rate on Foreign Income

As demonstrated by Fleming, Peroni, and Shay, the current deferral system with all of its complexity can be manipulated to produce a result that is even more favorable than an exemption system.⁵⁷

V. THE EXEMPTION SYSTEM

A. A Description of the Exemption System

Unlike the deferral system discussed in Section IV, where both the foreign state and the home state tax the foreign subsidiary, the exemption system only permits the foreign state to tax the foreign subsidiary. In a pure exemption system, when the income earned from a foreign subsidiary is repatriated back into the parent company’s country, there is no tax on the repatriation. That is, the dividend is exempt from tax in the home country.

53. Editorial, *Obama’s Global Tax Raid*, WALL ST. J., May 6, 2009, at A13.

54. Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don’t Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609 (2001).

55. *Id.* at 1610.

56. TREASURY, TRANSFER PRICING REPORT, *supra* note 31, at 47. See also Samuel C. Thompson, Jr., *The Case for Tax Sparing Along with Expanding and Limiting the Subpart F Regime*, 35 GEO. WASH. INT’L L. REV. 303, 310 (2003) (finding that the transfer pricing rules established in Section 482 of the Internal Revenue Code are both “complex and difficult to administer”).

57. Clifton J. Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009).

Several countries implement an exemption system in some form, including Australia, Canada, France, Germany, and the Netherlands.⁵⁸ The exemption systems in these countries were the subject of a GAO report.⁵⁹ The report found that countries can “[v]ary in the [t]ypes of [f]oreign-[s]ource [i]ncome [e]xempted from [d]omestic [t]ax.”⁶⁰ These “study countries generally exempt, but to varying extents, income of domestic corporations received as foreign-source dividends from foreign subsidiaries, sales by foreign branches, and the gains from the sale of shares in foreign subsidiaries.”⁶¹

An exemption system can be illustrated by a modification of the above example involving State Oil, which is engaged in the oil exploration business and is headquartered in State College, Pa. Again, assume that State Oil is faced with the following investment decision:

- (1) invest \$50 million in oil exploration and refining in State College, which is expected to produce \$10 million in annual taxable income, or
- (2) set up a subsidiary in China, China Oil Sub., and have it invest \$50 million in oil exploration and refining in China, which is also expected to produce \$10 million in annual taxable income.

Thus, the pretax return of both investments is \$ 10 million. However, State Oil Corp. is faced with a 35% effective corporate tax rate in the U.S., and China Oil Sub. would be faced with a 15% effective corporate tax rate in China.⁶² Other things being equal, under an exemption system, which investment decision would State Oil Corp. make?

Unlike the deferral system, where China and then the U.S. would tax State Oil Corp. for a cumulative tax rate of 35%, under the exemption system, State Oil Corp. is taxed only in China at the local tax rate of 15%. Therefore, under this scenario, State Oil Corp. would only pay \$1.5 million in taxes, meaning its after-tax income on its investment would be \$8.5 million. This is the same after-tax income with a deferral system, provided there is no repatriation of the income. Even if State Oil Corp. were to repatriate its earnings as a dividend, there would be no tax on the dividend because the dividend would be exempt from home country tax.

58. GAO, REPORT ON EXEMPTION SYSTEMS, *supra* note 16, at 9.

59. *Id.*

60. *Id.*

61. *Id.*

62. Assume for the purpose of this discussion that the effective corporate tax rates are the same as the maximum statutory rates.

B. The Benefits of the Exemption System

1. Capital Export Neutrality and Competitiveness

An exemption system is consistent with the capital import neutrality principle and thereby promotes foreign competitiveness by putting foreign subsidiaries on a level playing field with (1) businesses in the host foreign country, and (2) foreign subsidiaries owned by parent corporations located in other countries with exemption systems where the foreign subsidiaries are doing business in the host foreign country. Thus, a foreign subsidiary of a U.S. parent company, operating in a U.S. exemption system would be on a level playing field with a competing foreign subsidiary of a foreign parent company operating in foreign jurisdictions, which also employ an exemption system. Arguably, moving to an exemption system would have the effect of strengthening a U.S. company's competitive advantage in the world.

However, the ability to compete has many aspects, including the cost of labor and the state of a country's infrastructure, that are likely to be more important to the ability to compete than the income tax rate. Also, the following is an analogy to this competitiveness argument in the context of domestic taxation. Since S corporations are subject to only one level of taxation, in making investments and operating, they should have an advantage over C corporations, which are subject to two levels of taxation. Although this argument is theoretically sound, there seems to be no evidence that, as a practical matter, S corporations have such an advantage over C corporations.

2. Avoids "Lockout Effect"

An exemption system also avoids the "lockout effect" present with the deferral system. Since with an exemption system, there is no tax on the repatriation of earnings, there is no artificial barrier to moving earnings out of a foreign subsidiary and into the U.S.

3. Potential Reduction in Complexity

An exemption system would likely ease some of the complexity of the U.S. income tax system.⁶³ If the U.S. were to adopt a pure exemption system the foreign tax credits and the basket system present in the deferral system would be much less important. Also, com-

63. J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005).

panies would no longer need to use cross-crediting to offset higher corporate tax rates paid in a foreign country with respect to active income.

4. Capital Ownership Neutrality

The capital ownership neutrality (CON) principle, which purportedly provides a more concrete theoretical basis for an exemption system than the capital import neutrality principle, is beyond the scope of this article. However, I agree with the conclusion of Fleming, Peroni, and Shay that the purported benefits of an exemption system identified by CON are “unlikely to occur.”⁶⁴

C. The Problems with the Exemption System

1. Continued Complexity

While some claim that the exemption system is easy to understand and easy to use, there are those that argue that the exemption system is more complex than people think.⁶⁵ The following is a list of several reasons an exemption system is likely to be full of complexity:

First, [exemption] systems have to define the income that is exempt. In practice, [exemption] systems tend to apply only to active business income. Even within that category, the [exemption] system may only exempt active business income: (a) if it faces taxes above a certain threshold level in the host country, (b) from a certain type of business (for example, e-commerce), and/or (c) from certain countries. Second, the treatment of non-exempt income must be specified. Third, the allocation of income and expenses across jurisdictions takes on heightened importance in [an exemption] system. For all of these reasons, [exemption] systems end up with complex rules regarding foreign tax credits, antideferral mechanisms, and allocation of income and expenses.⁶⁶

While theoretically an exemption system may seem like an easy system (*i.e.*, only pay tax in the country where the business is located), no country has adopted a pure form of the exemption system. Conse-

64. Fleming, *Perspectives*, *supra* note 5, at n.137.

65. See, e.g., William G. Gale, *Notes on Corporate Inversions, Export Subsidies, and the Taxation of Foreign Source Income*, 27 TAX NOTES INT'L 1495 (Sept. 23, 2002); see also STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., JCT REPORTS ON U.S. INTERNATIONAL TAX RULES (Comm. Print 2003); J. Clifton Fleming, Jr. & Robert J. Peroni, *supra* note 63; and Edward D. Kleinbard, *supra* note 7.

66. Gale, *supra* note 65.

quently, carve-outs and exceptions are needed with any exemption system and these carve-outs and exceptions create complexity.

2. Transfer Pricing and Deflection of Expense Abuse

Also, an exemption system is a magnet for transfer pricing abuse because companies have an incentive (that is even stronger than the incentive in a deferral system) to divert active income into subsidiaries operating in low-taxed jurisdictions. For example, if a parent company can divert active income earned by the parent to a foreign subsidiary operating in a low-tax jurisdiction, the parent can then repatriate the income back to the home country without any home country tax because of the exemption for dividends. This type of immediate round trip sanitization of business profits is not possible in a deferral system, because the repatriation is subject to tax, assuming no benefit from the cross-crediting of foreign tax credits.

An exemption system is also a magnet for deflection of expense abuse, as companies attempt to allocate expenses properly attributable to foreign income to the home country so that the expenses are taken against taxable, rather than tax-free, income.

VI. THE IMPUTATION SYSTEM

A. A Description of the Imputation System

In the imputation system, the home country taxes foreign-source income of foreign subsidiaries when the income is earned and without regard to where the income is earned. Thus, an imputation system, in essence, treats a foreign subsidiary of a U.S. parent corporation the same as a foreign branch of such U.S. parent. To address the issue of a foreign subsidiary being subject to a double tax (*i.e.*, taxed on the same income by both the foreign jurisdiction and the U.S.), this system would provide the U.S. parent a foreign tax credit, subject to limitation, on the imputed income of the foreign subsidiary. With an imputation system a foreign subsidiary is treated similarly to a partnership or subchapter S corporation, which are flow-through entities; the entity is not subject to tax, but the entity's income is imputed up to the owners who pay tax on the income.

In 1961, President Kennedy proposed to significantly curtail deferral,⁶⁷ but the proposal was largely rejected. Instead, Congress

67. President Kennedy's Proposal to Congress for, *inter alia*, a significant curtailment in deferral (Apr. 20, 1961), available at <http://www.nationalcenter.org/JFKTaxes1961.html>. President Kennedy proposed:

III. TAX TREATMENT OF FOREIGN INCOME.

Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system of other countries, consistently favor United States private investment abroad compared with investment in our own economy.

1. Elimination of tax deferral privileges in developed countries and "tax haven" deferral privileges in all countries. Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to United States tax only when they are returned to the parent company in the form of dividends. In some cases, this tax deferral has made possible indefinite postponement of the United States tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary [p. 295] companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States . . . To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the postwar reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries. If we are seeking to curb tax havens, if we recognize that the stimulus of tax deferral is no longer needed for investment in the developed countries, and if we are to emphasize investment in this country in order to stimulate our economy and our plant modernization, as well as ease our balance of payments deficit, we can no longer afford existing tax treatment of foreign income. I therefore recommend that legislation be adopted which would, after a two-step transitional period, tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations organized in economically advanced countries. This current taxation would also apply to individual shareholders of closely-held corporations in those countries. Since income taxes paid abroad are properly a credit against the United States income tax, this would subject the income from such business activities to essentially the same tax rates as business activities conducted in the United States . . . While the rate of expansion of some American [p. 296] business operations abroad may be reduced through the withdrawal of tax deferral such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country. At the same time, I recommend that tax deferral be continued for income from investment in the developing economies. The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued income tax deferral for these areas will be helpful in this respect. In addition, the proposed elimination of income tax deferral on United States earnings in industrialized countries should enhance the relative attraction of investment in the less developed countries. On the other hand, I recommend elimination of the "tax haven" device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.

2. Taxation of Foreign Investment Companies. For some years now we have witnessed substantial outflows of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces. I recommend that these tax benefits be removed and that income derived through such foreign investment companies be treated in substantially the same way as income from domestic investment companies . . .

continued the deferral system for active income and enacted the CFC provisions, which provide for imputation of tax haven type income. An imputation system has been recently proposed by, among others, Stephen E. Shay, Treasury International Tax Counsel during the administration of the first President Bush. Currently, he is the Deputy Assistant Treasury Secretary (International Tax Affairs) in the administration of President Obama.⁶⁸

An imputation system can be illustrated by reference to the example above with State Oil Corp. Under such a system, State Oil Corp. would be taxed currently on the income earned by China Oil Sub. In other words, the income of China Oil Sub. would be imputed to State Oil Corp., as it is earned. Also, State Oil Corp. would, within limits, receive a foreign tax credit for the China tax paid by China Oil Sub. There would be no additional tax on the payment by China Oil Sub. to State Oil Corp. of the imputed profits as dividends.

Thus, under an imputation system, State Oil Corp. would be taxed in the U.S. on the \$10 million of income earned by China Oil Sub., which would produce a tentative U.S. tax of \$3.5 million. However, State Oil Corp. would receive a credit of \$1.5 million against that tax for the China taxes paid by China Oil Sub., producing a final U.S. tax liability of \$2 million. Thus, the total of the U.S. and China's taxes would be \$3.5 million. Under this system, the after-tax return from investing in the U.S. and China would be the same. Therefore, the investment playing field would be level.

B. The Benefits of the Imputation System

1. Capital Export Neutrality

Contrary to the premise of the exemption system, which relies on the concept of capital import neutrality, an imputation system relies on the concept of capital export neutrality, which holds that a taxpayer should pay the same amount of tax on income earned both inside and outside of the resident country.

68. See, e.g., Fleming, *Perspectives*, *supra* note 5; Robert Peroni, Clifton Fleming, & Stephen Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign-Source Income*, 52 SMU L. REV. 455 (1999); see also Fleming & Peroni, *supra* note 63 (analyzing the territorial proposal of the tax reform panel report and a similar proposal by the JCT and concluding that the U.S. should move to an imputation system).

2. Economic Efficiency

The main benefit of the imputation system is that it promotes economic efficiency.⁶⁹ An imputation system achieves economic efficiency because it does not distort investment decisions; it does not permit home country income taxes to be a consideration in where investment is located. Therefore, an imputation system would lessen the impact of tax havens or financial privacy jurisdictions. An imputation system will allow companies to make decisions based on economics and business principles rather than on possible tax implications.

3. Preserving the Tax Base

Preserving the U.S. tax base is another benefit that can be achieved by adopting the imputation system. Under an exemption system, income earned abroad is lost forever from the U.S. tax base while under the imputation system all income earned abroad is reflected in the tax base.

4. Horizontal and Vertical Equity

Adopting an imputation system will also promote horizontal and vertical equity.⁷⁰ Horizontal equity is achieved when taxpayers who are similarly situated, or are earning similar levels of income, are taxed at the same effective rate. Horizontal equity within the corporate sector can be achieved by taxing corporations at the same effective corporate tax rate regardless of where the income is earned.⁷¹ An imputation system would not give benefit to a foreign subsidiary located in the Cayman Islands over a domestic subsidiary located in Pennsylvania.

Vertical equity is the concept that taxpayers who are earning higher levels of income should shoulder more of the overall tax burden in the resident country because taxpayers earning higher levels of income have a greater ability to pay taxes. Vertical equity will be promoted under an imputation system because foreign-source income will be included in income and subjected to progressive rates.⁷² For

69. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., JCT. REPORTS ON U.S. INTERNATIONAL TAX RULES 4 (Comm. Print 2003).

70. *Id.* See also Fleming, *Perspectives*, *supra* note 5 (discussing "Fairness Considerations" and the "Ability to Pay").

71. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., JCT. REPORTS ON U.S. INTERNATIONAL TAX RULES 3 (Comm. Print 2003).

72. *Id.*

example, if a U.S. individual owned all of the stock of a foreign corporation, under an imputation system, all of the income earned by the foreign corporation would be included in the shareholder's gross income and would thereby be subject to the U.S. progressive rate system applicable to individuals under Section 1 of the Internal Revenue Code. Consequently, there would be little, if any, tax incentive under an imputation system for the wealthy taxpayers to earn income abroad. A progressive rate system also applies to corporations under Section 11 of the Internal Revenue Code.

5. Fewer Transfer Pricing and Deflection of Expense Abuses

An imputation system improves economic efficiency because it allows the taxing authority to expend fewer resources in monitoring foreign-source income. In looking at the problems associated with transfer pricing, an imputation system would resolve the problem as it exists with outbound and inbound sales and services transactions between a U.S. parent corporation and a foreign subsidiary. The imputation system achieves this result because income earned in source states would be subject to a total tax at the home country rate. Therefore, profits will be taxed at the same rate no matter where they are earned. Transfer pricing issues would still arise with respect to transactions between a foreign parent corporation and its U.S. subsidiary. An imputation system would also largely eliminate any incentive for deflection of expense abuse between U.S. parent corporations and their foreign subsidiaries.

6. Revenue Savings

Another benefit of an imputation system is the additional revenue it would generate. The Joint Committee on Taxation's October 2008 Tax Expenditure Report shows that only the allowance for accelerated depreciation for equipment produces a larger corporate tax expenditure (*i.e.*, reduction in tax liability) than the deferral provision.⁷³ Thus, of the nearly 150 corporate tax expenditures covered in the report, only one produces a greater revenue loss than the deferral provision.⁷⁴ This means that any meaningful amendment to the corporate tax would have to consider the deferral tax expenditure, which the

73. STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, Tbl. 4 (Comm. Print 2008).

74. *Id.*

Joint Committee estimated will result in the loss of \$62.9 billion in tax revenues over the period 2008-2012.

It is not clear if this estimate takes into account all of the detriments associated with transfer pricing and expense deflection abuse under the current deferral system. If such abuses are not included in this revenue estimate, then the tax revenue gain from moving to an imputation system would be even greater.

7. Potential Reduction in the Corporate Tax Rate for All Corporations

a. The Economic Case for a Reduction in the Corporate Tax Rates with the Adoption of an Imputation System

The repeal of the deferral system could, on a revenue neutral basis, provide the revenue needed to significantly reduce the current 35% maximum corporate tax rate. Professor Clemons has reported that the revenue gained from the “repeal of the deferral provision [could be used on such a revenue neutral basis to] decrease the top corporate tax rate for all U.S. corporations from 35 percent to 28 percent.”⁷⁵ Thus, the trade-off with this type of revenue neutral policy would be (1) increasing the tax rate on companies investing abroad, and (2) reducing the maximum tax rate from 35% to 28% on all companies, both those investing abroad and those investing domestically.

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

To summarize, the trade off is between (1) keeping the current deferral system, which gives a select group of U.S. corporations a lower tax rate on foreign earnings, and (2) adopting an imputation system, which gives all U.S. corporations and all foreign corporations doing business in the U.S. the benefit of a lower corporate tax rate.

75. Roy Clemons, *U.S. International Tax Policy: Is Significant Reform on the Way?*, 55 TAX NOTES INT'L 965, (2009).

There is a general consensus among economists that there are many economic benefits from lowering corporate tax rates.⁷⁶ For example, Martin A. Sullivan⁷⁷ claims that “with rate cuts, a government can directly reduce corporations’ incentives to move profits to low-tax countries by paying their affiliates interest, royalties, and artificially high prices.”⁷⁸ Sullivan relies on a Congressional Budget Office report from November 2005, which shows that reducing the corporate tax rate would substantially lessen a corporation’s desire to shift profits overseas.⁷⁹ An imputation system is the only system that can successfully address the challenge of income shifting.

b. The Political Case for a Reduction the Corporate Tax Rates with the Adoption of an Imputation System

By adopting an imputation system, Congress can decide to use the revenue gained from the elimination of deferral for some other purpose. However, it would be politically prudent for Congress to devote a significant portion of the revenue pick-up to fund a meaningful reduction in the corporate tax rate.

When President Kennedy proposed in 1961 that Congress significantly curtail deferral,⁸⁰ many in the business world lobbied in opposition to the proposal, and it can be anticipated that many businesses will lobby against the adoption of an imputation system. However, if the end of deferral is accompanied by a reduction in the corporate tax rate, political support for such a move should come from companies that do not have significant offshore business operations, thereby gaining active business support to balance against the large companies that will be actively opposing such a change.

The political attractiveness of this approach is illustrated by the proposal in February 2010 by Senators Ron Wyden (D–Ore.) and Judd Gregg (R–N.H.) for the adoption of *The Bipartisan Tax Fairness and Simplification Act of 2010*.⁸¹ The explanation of the proposal, which encompasses many reforms to both the individual and corporate income taxes, explains that the proposal would (1) “eliminate[]

76. Fleming, *Perspectives*, *supra* note 5 at n.141.

77. Martin A. Sullivan, *Economic Analysis: A New Era in Corporate Taxation*, 41 TAX NOTES INT’L 415, (2006).

78. *Id.*

79. *Id.*

80. *See supra* note 67.

81. The Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018, 111th Cong. (2010) (sponsored by U.S. Senators Ron Wyden (D–Ore.) and Judd Gregg (R–N.H.)).

incentives for companies to export jobs and keep their foreign earnings overseas by repealing the rule that allows U.S. companies to defer taxes on their foreign income,” and (2) “reduc[e] the top corporate tax rate and replac[e] the existing six corporate rates and eight brackets with a single flat rate of 24 percent.”

C. The Problems with the Imputation System

1. Continued Complexity with the Foreign Tax Credit System

While there are those that champion the imputation system, it is not without its critics. One of its problems is that companies would still have to deal with the complexity embedded in the foreign tax credit rules. In using foreign tax credits, multinational corporations would still be able to cross-credit. Therefore, the benefit of easing the economic efficiency could be eroded by efforts that both multinational corporations and the IRS will have to expend in complying with the foreign tax credit provisions.

2. Decrease in Foreign Competitiveness

By not allowing foreign subsidiaries to defer payments or exempting foreign subsidiaries from paying any tax to the resident state, money that could be used to spur foreign re-investment is lost. A U.S. parent's foreign subsidiary operating in a low-tax jurisdiction would not be on an equal level playing field with regard to taxes on its operations when compared to (1) a locally owned competitor, and (2) a competitor owned by foreign parent company located in a country with an exemption system. By implementing an imputation system, multinational corporations may be deterred from investing in foreign countries because the tax incentives are no longer present. On the other hand, there would be greater incentives for investing in the U.S. and a lower corporate tax rate applicable to the foreign income earned by U.S. controlled foreign subsidiaries.

3. Switching Costs

Another problem with adopting an imputation system is the administrative costs associated with switching from the current U.S. deferral system. For example, if the imputation system were adopted, a decision would have to be made on the treatment of income that has been previously deferred. Would that income become subject to immediate U.S. taxation? I would suggest that the previously deferred

income become subject to tax on a ratable basis over a three or four year period. This is similar to the rules that applied as a result of the enactment of the Tax Reform Act of 1986 (TRA 1986), which forced certain tax-exempt Keogh plans onto a calendar year basis, thus eliminating the benefit of deferral for the owners of such plans.⁸² The income resulting from the elimination of this deferral by the TRA 1986 was included in the income of the owner ratably over a four-year period.⁸³

Further, the issue of foreign tax credits would need to be addressed. Under an imputation system the U.S. would have to decide whether it would still allow foreign corporations the ability to cross-credit.

4. The New Zealand Experience

On October 9, 2009, New Zealand switched its system for taxing foreign-source income from an imputation system to an exemption system. The reasons behind this switch from one tax system to another were to “‘put New Zealand businesses on a better footing internationally by freeing them from a tax cost that the controlled foreign companies of other countries do not face.’”⁸⁴ New Zealand also expressed that its “goal is to design a system that is both simple for New Zealand businesses to work with and preserves the integrity of New Zealand income.”⁸⁵

VII. CONCLUSION

While there are no easy solutions to the complexities presented in international taxation, the imputation system offers many benefits over the current deferral system or an exemption system. One of the major benefits of an imputation system is the elimination of bias in favor of foreign investments over U.S. investments. Another benefit is that an imputation system would preserve the U.S. tax base. As indicated in the discussion above on the tax expenditures associated

82. Staff of the Joint Committee on Taxation, *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986* (May 4, 1987), G. Taxable Years of Partnerships, S Corporations, and Personal Service Corporations (§ 806 of the Act and §§ 706, 1378, 441, & 267 of the Code) 533.

83. *Id.* at 538.

84. Mary Swire, *New Zealand Forges Ahead with International Tax Reform*, Oct. 23, 2007, http://www.tax-news.com/archive/story/New_Zealand_Forges_Ahead_With_International_Tax_Reform_xxxx28766.html (quoting finance minister Michael Cullen and revenue minister Peter Dunne).

85. *Id.*

with the current deferral system, the U.S. loses billions of dollars in tax revenue in its current deferral system and this would also be true with an exemption system. With more tax revenue coming in every year under an imputation system, the U.S. would be able to significantly lower their corporate tax rate for all its corporations. A reduction in the corporate tax rate would lead to an increase in both U.S. and foreign investment inside the U.S., which would then increase the U.S. tax base.

By enacting an imputation system, U.S. multinational corporations would no longer have an incentive to abuse the transfer pricing rules by deflecting income to foreign subsidiaries or to enter into abusive transactions to deflect expenses to U.S. parents. Such abuses are significant in the current deferral system and would be even greater in an exemption system.

Finally, although New Zealand has abandoned its imputation system in favor of an exemption system similar to that in Australia, the U.S. should not let the tax policies of other countries drive its decisions regarding the most appropriate U.S. tax policy. The U.S. should be a leader in addressing this issue and lead our major trading partners in the adoption of an imputation system. It is my belief that such a move would likely influence other countries to abandon their exemption systems in favor of imputation systems, thereby following the U.S. in eliminating the bias in such systems in favor of foreign investment over home country investment.