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A Hitchhiker's Guide to Outbound International Tax Reform*

*J. Clifton Fleming, Jr.***

*Robert J. Peroni****

INTRODUCTION

This Article will discuss operating principles for accomplishing international tax reform regarding U.S. persons (i.e., "outbound" international income tax reform). It also will discuss some specific reform proposals that we recommend be included in an international tax reform bill.

I. SOME SUGGESTED OPERATING PRINCIPLES FOR INTERNATIONAL TAX REFORM OF OUTBOUND TRANSACTIONS

A. International Tax Reform Should Be Part of an Integrated Reform Effort

Because the U.S. tax rules for international transactions involving U.S. persons do not operate in a vacuum, fundamental international tax reform needs to be part of a broad-scale reform of the U.S. tax system, rather than an independent project. To be specific, it is not possible to properly design the U.S. international tax rules for outbound transactions without knowing such things as whether fundamental corporate integration reform will be adopted, whether a capital gains preference will be retained and to what extent it will be broadened or narrowed, the general tax rate structure that will be adopted (including the top marginal rates on individuals and corporations, if corporations continue to be treated as separate taxpayers), how foreign persons will be defined and taxed, and

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*** Fondren Foundation Centennial Chair for Faculty Excellence and Professor of Law, The University of Texas School of Law. Professor Peroni dedicates this Article to his loving parents, Betty Peroni and the late Emil Peroni, for their tremendous support and inspiration over the years. Professor Peroni thanks The University of Texas School of Law for its substantial research support.

how the tax system will treat complex financial products and intellectual property transactions (more generally as well as in the international tax rules). Resolution of these and other broadly foundational issues will have an important effect on any re-design of the U.S. international tax rules.

B. The International Tax Part of Tax Reform Should Not Lose Revenue

Given our large (although recently much-reduced) budget deficits, as well as many important and worthy competing direct government programs that need to be funded, the international component of tax reform should not result in a net reduction in tax revenues and probably needs to result in a net revenue increase. So, for example, a move to a territorial tax system that does not have serious anti-tax base erosion provisions (particularly with respect to intellectual property income) should be a non-starter since such a system would result in a net revenue decrease (and a potentially significant one). As another example, so-called simplification measures in the international area that lose significant revenue, such as those relating to the foreign tax credit and the anti-deferral regimes, as applied to large multinational corporations, should be non-starters in this era of budget austerity.

C. International Tax Reform Is Important to Perceived Fairness of the Tax System Overall

It is important that the international tax aspects of tax reform not undermine the actual and perceived fairness of the tax system. Public support for the tax system is indispensable in our self-assessed tax regime, and tax “reform” provisions that appear to substantially reduce, if not eliminate, the U.S. income tax on foreign income of U.S. multinational corporations (“MNCs”) are likely to be perceived by the press and public as “special interest” provisions that result from well-funded lobbying efforts. Thus, although such provisions may involve relatively small amounts of revenue as compared with other features of the income tax system, such as the home mortgage interest deduction or the tax-deferred treatment of various healthcare and retirement savings vehicles, they are likely to undermine public support for the tax system.

D. International Tax Reform Should Not Extend or Enhance Tax Incentives to Shift Business and Investment Activities or Income Abroad

The international tax system should not be restructured in such a way as to create or enhance tax incentives to shift business and investment activities from the United States to low-tax or no-tax foreign countries. Such incentives strip the U.S. tax base of badly needed revenue and may result in loss of domestic jobs (although the economic evidence on this point is inconclusive).¹ Moreover, economic efficiency is undermined if taxpayers choose tax-favored foreign investments producing lower pre-tax returns over domestic investments with higher pre-tax returns that are fully subject to U.S. tax. This is one of our major concerns with territorial systems for taxing international income because those systems do encourage this inefficient behavior.²

E. Competitiveness Claims Have Been Largely Overstated and Unsubstantiated

Commentators who oppose making the current worldwide system into a real worldwide system and instead propose replacing the current U.S. international tax system with a territorial system often have argued that such a change is necessary to enhance the competitiveness of U.S. MNCs.³ The two of us, together with a third co-author (Stephen Shay), have taken the position that this advocacy is in substance an attempt to argue for a competitiveness subsidy provided through the tax

¹ It is clear, however, that in recent years the de facto territorial system of the United States has been correlated with substantial growth in the foreign employment of U.S. MNCs. See Sudeep Reddy, *Domestic-Based Multinationals Hiring Overseas*, WALL ST. J., Apr. 29, 2013, <http://online.wsj.com/news/articles/SB10001424127887324763404578430960988848252>; Martin A. Sullivan, *U.S. Multinationals Cut U.S. Jobs While Expanding Abroad*, 128 TAX NOTES 1102 (2010); Scott Thurm, *U.S. Firms Add Jobs, but Mostly Overseas*, WALL ST. J., Apr. 27, 2012, <http://online.wsj.com/news/articles/SB10001424052702303990604577367881972648906>.

² See, e.g., Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165, 1166 (1996).

³ See, e.g., STAFF OF THE JOINT COMM. ON TAXATION, THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES 5 (2006); R. Glenn Hubbard, *Tax Policy and International Competitiveness*, 82 TAXES 213, 242 (2004); Pamela F. Olson, Peter Merrill, Michael Mundaca, Michael Reilly & Jaime Spellings, *Staking New Ground: Exploring a Potential Territorial System of Taxation*, 90 TAXES 53, 60, 64-66 (2012); Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025, 1040 (2011). For a commentator who supports adoption of an exemption system on the grounds that it would increase worldwide economic efficiency, rather than on competitiveness grounds, see Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835 (2000).

system for the foreign business and investment activities of such U.S. corporations.⁴

In our work, we have pointed out numerous flaws in this competitiveness argument.⁵ Our most basic critique objects to defining competitiveness in terms of improving the after-tax profitability of already successful U.S. MNCs instead of defining it in terms of improving the living standard of American individuals.⁶ In our view, the appropriate focus of international and other tax reforms is on the effect of such reforms on the living standard for U.S. individuals, and the proponents of competitiveness theory/territorial taxation have failed to establish how this living standard will be enhanced by providing U.S. tax subsidies to U.S. MNCs with respect to their foreign business and investment activities.

Moreover, even if one were to define competitiveness with reference to its effect on the profitability of U.S. MNCs, the supporters of low or zero U.S. tax on the foreign-source income of those entities have never convincingly established with strong empirical evidence that U.S. MNCs need a tax subsidy to

⁴ For explanations of the subsidy effect of an exemption system, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 528–41, 547–51 (2008) [hereinafter Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1091 (2009) [hereinafter Fleming, Peroni & Shay, *Worldwide vs. Territorial*]. Professor Edward Kleinbard has aptly opined that the competitiveness argument in favor of a territorial system “is indistinguishable from a call for export subsidies, on the grounds that other countries offer export subsidies.” Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 129 (2011). For a leading commentator arguing that a territorial system, as is typically enacted, is a prohibited export subsidy under the General Agreement on Tariffs and Trade, see Reuven S. Avi-Yonah, *Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy*, 21 TAX NOTES INT’L 2841, 2843 (2000).

⁵ See Fleming, Peroni & Shay, *Worldwide vs. Territorial*, *supra* note 4, at 1085–86; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 106–10 (2009) [hereinafter Fleming, Peroni & Shay, *Worse than Exemption*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty*, 13 FLA. TAX REV. 397, 456–59 (2012) [hereinafter Fleming, Peroni & Shay, *Designing a U.S. Exemption System*].

⁶ For example, the World Economic Forum defines competitiveness more broadly as “the set of institutions, policies, and factors that determine the level of productivity of a country.” WORLD ECON. FORUM, THE GLOBAL COMPETITIVENESS REPORT 4 (2013), available at http://www3.weforum.org/docs/WEF_GlobalCompetitiveness_Report_2013-14.pdf. This Report focuses on twelve factors, which it terms “pillars,” in measuring each country’s competitiveness, including its institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, business sophistication, innovation, and market size. Using this approach to measure competitiveness, the Report ranked the United States seventh overall in 2012–2013 and fifth overall in 2013–2014. See *id.* at 15; see also STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME 88 (2011) (noting this alternative approach to defining competitiveness).

compete successfully in the global marketplace.⁷ Indeed, a recent study by a leading public finance economist has concluded that the competitiveness argument “does not seem to have much empirical support.”⁸ This same study found an absence of strong empirical support for the argument that low U.S. tax burdens on U.S. MNCs’ foreign-source income increases U.S. domestic investment,⁹ another claim sometimes made by advocates for territorial taxation. In addition, another prominent public finance economist noted that the competitiveness argument conflicts with standard economic theory, stating: “It can generally be shown that the United States would still be better off, or at least no worse off, if it taxes foreign and domestic investments by its firms at the same rate, even if other countries do not.”¹⁰

Finally, even if one could establish that U.S. MNCs needed a subsidy funded through the U.S. international tax system, this subsidy, like other tax expenditures, should have to undergo a rigorous cost-benefit analysis in which it competes against other meritorious programs for the currently inadequate U.S. revenue stream.¹¹ Such a subsidy should be continued and broadened by Congress only if it survives this scrutiny.

F. Fairness Concerns About International Tax Reform Do Matter

We currently have a hybrid income tax system that is “heavily grounded on a fairness notion—that taxpayers should contribute to the cost of government in relationship to their comparative economic well being or ability-to-pay.”¹² Thus, if we

⁷ See U.S. DEP’T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 56–57, 61 (2000), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf>.

⁸ Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT’L TAX J. 247, 268 (2012).

⁹ *Id.* at 257.

¹⁰ JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 17 (2012) [hereinafter GRAVELLE, OPTIONS AND CHALLENGES], available at www.fas.org/sgp/crs/misc/R42624.pdf; see also ERIC TODER, TAX POLICY CTR., URBAN INST. & BROOKINGS INST., INTERNATIONAL COMPETITIVENESS: WHO COMPETES AGAINST WHOM AND FOR WHAT? 2 (2012), available at www.taxpolicycenter.org/publications/url.cfm?ID=412477.

¹¹ See Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 4, at 439.

¹² J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 350 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; see also AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877-1929, at 8–15

are going to retain this hybrid income tax as a primary source of revenue at the federal government level (instead of, for example, shifting to a cash-flow consumption tax base), we must consider the impact of various international tax reform proposals on the distribution of the tax burden based on ability-to-pay. International tax reform proposals, such as many versions of territorial tax systems, which undermine the fair allocation of the income tax burden by removing most foreign-source active income from the tax base, should be enacted only if their demonstrable efficiency and simplification benefits outweigh their costs in terms of fairness. Although applying ability-to-pay fairness analysis to the international tax area is complicated by the facts that so much of the income is earned through C corporations and that foreign countries have competing claims to tax this income, fairness concerns should play an important role here as they do in other areas of tax reform.¹³ In our view, in the international tax area, fairness concerns have not received the attention they deserve in crafting specific reform proposals or in analyzing the tax policy efficacy of the various proposals.

G. Simplification Concerns Do Matter but May Have to Give Way to Efficiency and Fairness Concerns

The U.S. international tax system has many complex provisions and some (perhaps many) of those provisions could be substantially simplified without undermining their basic purpose. Needlessly complex tax provisions, including those in the international tax area, create a deadweight loss for society by increasing the costs of compliance for both taxpayers and the government, without achieving any offsetting economic benefit. Increased compliance costs can result in higher prices in goods and services for consumers and less capital being available for investment in productive businesses of the taxpayer.¹⁴ Increased administrative costs may lead to a less efficient collection of revenue by the government and fewer resources for worthy direct government programs. Therefore, simplification of the federal income tax, in general, and the international income tax provisions, in particular, is an important goal of any tax reform effort. However, it is important to remember that most foreign-source income is earned by sophisticated corporate taxpayers who have highly competent tax advisors to help them

(2013) (tracing the rise of the ability-to-pay concept as a fundamental principle of taxation in the United States).

¹³ See Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 12, at 354.

¹⁴ See U.S. DEP'T OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 1 (1993) [hereinafter U.S. DEP'T OF THE TREASURY, INTERIM REPORT].

navigate the complexity of the U.S. international tax rules. In fact, in many cases, these taxpayers voluntarily elect into complexity by structuring intricate transactions primarily to attain significant tax benefits (often in more than one country through tax arbitrage).¹⁵ Moreover, many international transactions are inherently complex; thus, the tax rules that govern them are likely to have a substantial and unavoidable amount of complexity as well. And the important competing considerations of efficiency and fairness may work at cross-purposes with simplicity concerns when constructing international tax reform proposals. Finally, compromise among competing objectives itself breeds complexity;¹⁶ coherent, principled systems are typically less complicated than hybrid systems resulting from compromise, but such coherence is difficult, if not impossible, to achieve in the give and take of the political process as legislation works its way through Congress. Thus, although tax simplification is an important aspect of tax reform, it is not likely to be the major focus of serious international tax reform efforts, particularly with respect to taxation of foreign business activities. Stated differently, whatever international tax rules emerge from the tax reform process are likely to be somewhat complex in nature (i.e., they may be simpler than current law but not simple), and other competing norms, such as economic efficiency and fairness concerns, are likely in many important specific cases to trump simplification concerns.

II. SOME SPECIFIC SUGGESTED INTERNATIONAL TAX REFORMS IN THE BUSINESS/INVESTMENT AREA

A. Making the Current U.S. System a Real Worldwide System (The First-Best Solution)

1. Introduction

The United States purports to have a worldwide system for taxing the income of U.S. persons; i.e., U.S. citizens, resident aliens, and domestic corporations are subject to tax on their worldwide incomes, regardless of source. To mitigate international double taxation, a foreign tax credit is allowed for qualifying foreign income taxes. The foreign tax credit is subject to a number of limitations. The most important of these are in section 904, which limits the total foreign tax credits in a taxable

¹⁵ See Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 394 (2003) [hereinafter Peroni, *A Hitchhiker's Guide*].

¹⁶ See, e.g., U.S. DEP'T OF THE TREASURY, INTERIM REPORT, *supra* note 14, at 1.

year to the pre-credit U.S. tax liability on the foreign-source portion of a taxpayer's worldwide taxable income. Section 904 also prevents a taxpayer from offsetting (i.e., cross-crediting) high foreign taxes on non-passive foreign-source taxable income against the U.S. tax liability on passive foreign-source taxable income.¹⁷ However, the current U.S. international tax system has two important defects that undermine its potential as a true worldwide system—deferral and cross-crediting. Fundamental international tax reform needs to deal with those two defects and make the U.S. system a real worldwide system.

2. End Deferral by Enacting a Pass-Through Regime for U.S. Shareholders of Foreign Corporations or Some Other Full-Inclusion System

The first major defect (deferral) is that under current U.S. tax law, if a U.S. person invests abroad directly or through an unincorporated branch or pass-through entity, the U.S. person pays tax currently on the income earned abroad, subject to a foreign tax credit. By contrast, if the U.S. person earns foreign-source income through a separate foreign corporation, then the U.S. tax on the foreign-source income is generally deferred until it is repatriated to the United States through a distribution or until the U.S. person sells the foreign corporation's stock at a price that reflects the accumulated foreign income.¹⁸ This deferral privilege is subject to two principal exceptions (i.e., anti-deferral regimes), the controlled foreign corporation ("CFC") provisions of Subpart F in the Code (sections 951–965)¹⁹ and the passive foreign investment company ("PFIC") provisions (sections 1291–1298).²⁰ These highly complex anti-deferral regimes provide some restraint on the deferral privilege but are outdated and do not reflect the nature of modern global commerce. They are filled with loopholes and have not been restructured to address contemporary deferral tax-planning strategies. Thus, they do far too little in limiting deferral.

This deferral privilege operates as a tax subsidy accorded to U.S. taxpayers who locate their business and investment activities in low-tax or no-tax foreign countries, a tax subsidy

¹⁷ See I.R.C. § 904(a), (d)(1) (2012).

¹⁸ See, e.g., CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 25, 303, 485–86 (4th ed. 2011).

¹⁹ I.R.C. §§ 951–965. For a detailed discussion of the Subpart F provisions, see 1 JOEL D. KUNTZ & ROBERT J. PERONI, *U.S. INTERNATIONAL TAXATION* ch. B3 (1992 & Supp. 2013).

²⁰ I.R.C. §§ 1291–1298. For a detailed discussion of the passive foreign investment company provisions, see 1 KUNTZ & PERONI, *supra* note 19, at ch. B2.

that would not survive rigorous cost-benefit scrutiny under a tax expenditure analysis.²¹ This deferral privilege also violates the tax policy goal of locational neutrality by encouraging U.S. corporations to shift business and investment activities to low- or zero-tax foreign countries and to engage in aggressive cross-border tax planning strategies that shift income (particularly from highly mobile intangible property) to low-tax foreign countries.²² Moreover, according to the most recent tax expenditure estimates by the Staff of the Joint Committee on Taxation, the deferral privilege results in the loss of about \$273.1 billion of revenue for fiscal years 2013–2017.²³ This foregone revenue could be better used for other purposes, including an across-the-board corporate tax rate reduction.

We have developed a proposed solution to this first defect (the untoward consequences of deferral). In a series of articles, we have recommended that deferral be ended by the United States enacting a pass-through system with respect to U.S. shareholders' shares of income earned by foreign corporations, at least with respect to 10-percent-or-more U.S. shareholders.²⁴ Such shareholders would be able to obtain direct foreign tax credits for any creditable foreign taxes paid with respect to the foreign income that passes through from the corporation. Thus, the indirect credit provisions of sections 902 and 960 would be repealed because they would no longer be necessary. Because deferral would be ended completely with respect to 10-percent-or-more U.S. shareholders of foreign corporations under this proposal, the Subpart F income provisions, with all of their complicated exceptions and operating rules, would be repealed. Previously taxed income rules would be retained to

²¹ See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837, 846 (2000) [hereinafter Fleming, Peroni & Shay, *Consider Ending Deferral*]; 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, 1615 (2001) [hereinafter Peroni, *End It, Don't Mend It*]; Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 4, at 528–41, 547–51.

²² See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 18, at 486, 488–89; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 85–86, 96–97.

²³ See STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 30 (Comm. Print 2013) [hereinafter STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF TAX EXPENDITURES].

²⁴ See Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 986–94 (1997) [hereinafter Peroni, *Back to the Future*]; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 507–19 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]; Fleming, Peroni & Shay, *Consider Ending Deferral*, *supra* note 21; Peroni, *End It, Don't Mend It*, *supra* note 21; Robert J. Peroni, *The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1579 (2001).

ensure that income when distributed by the corporation to the shareholders is not taxed again at time of distribution. Transition rules would need to be carefully crafted to ensure that untaxed earnings deferred under prior law are subject to U.S. tax. A number of approaches to taxing such deferred earnings would need to be considered.

As a less drastic reform, but one that would still substantially improve the anti-deferral rules of current law, a new category of Subpart F income could be created for low-taxed foreign income.²⁵ The new category would not have exceptions for same-country income or for manufacturing income.²⁶

3. Substantially Restrict Foreign Tax Credit Cross-Crediting by Enacting a Per-Country Limit or Expanding the Number of Basket Limitations

The second major defect of the U.S. international income tax system (cross-crediting) is that under current U.S. tax rules, a U.S. taxpayer has substantial opportunities to essentially eliminate the residual U.S. tax (i.e., the U.S. tax remaining after allowance of the foreign tax credit) on foreign-source income that is subject to low or no foreign taxes by cross-crediting high foreign taxes on some types of active business income against the residual U.S. tax on other types of business income earned in low-tax or zero-tax jurisdictions, including many types of intellectual property income that are highly mobile and often lightly taxed. This means that the foreign tax credit is going beyond its primary function of preventing double taxation from discouraging efficiency-enhancing cross-border transactions. Instead, the foreign tax credit is being used by U.S. taxpayers to ensure that certain foreign income is not taxed anywhere.

The foreign tax credit limitations in section 904²⁷ have been substantially weakened by recent legislative developments, particularly the 2004 American Jobs Creation Act.²⁸ The 2004 legislation essentially gutted the foreign tax credit limitations by reducing the number of limitation categories in section 904 to two: the passive category income limitation and the general

²⁵ See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. (forthcoming 2014) [hereinafter Fleming, Peroni & Shay, *Putting Lipstick on a Pig*].

²⁶ See *id.*

²⁷ I.R.C. § 904 (2012). For a detailed discussion of the foreign tax credit limitation provisions in Section 904, see 1 KUNTZ & PERONI, *supra* note 19, at ch. B4.

²⁸ For our critique of the 2004 Jobs Act provisions, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax—What's ETI Repeal Got To Do With It?*, 104 TAX NOTES 1393 (2004).

category income limitation.²⁹ In addition, the look-through rules in section 904(d)(3) that apply to royalties and other deductible payments from a controlled foreign corporation to its U.S. shareholders essentially place such payments in the same limitation basket as high-taxed foreign business income, where the U.S. residual tax on such payments is eliminated through foreign tax cross-crediting even though these payments are usually deductible and therefore untaxed in the jurisdiction in which the foreign corporation is organized.³⁰ Loose limitations on foreign tax cross-crediting provide a strong incentive for U.S. taxpayers with profitable, active businesses in high-tax foreign countries to locate other business and investment activities in low-tax or zero-tax foreign countries to exploit cross-crediting opportunities that reduce the U.S. residual tax on the lightly taxed foreign income.³¹ This is a violation of well-established economic efficiency norms.

We have also developed a proposed solution to this defect. In a number of articles, we have argued that our current international tax system needs to be made into a true worldwide system by enacting more serious limitations on cross-crediting.³² Our preference would be for Congress to enact a per-country foreign tax credit limit, with separate single-country basket limitations for both passive income and all other income arising within each individual country.³³ No other categories or baskets based on type of business income should be necessary under a per-country limit. The per-country limit does a better job of restricting cross-crediting than even the multi-basket foreign tax credit limitation enacted as part of the Tax Reform Act of 1986 and thus helps ensure that the foreign tax credit provisions accomplish their core purpose of ameliorating international double taxation, instead of creating untaxed foreign income. We believe that criticisms of the per-country limitation as being too

²⁹ See I.R.C. § 904(d)(1) (2004) (after enactment of the 2004 Jobs Act).

³⁰ See, e.g., Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 142–44.

³¹ See, e.g., Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393.

³² See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003) [hereinafter Peroni, Fleming & Shay, *Reform of the U.S. Foreign Tax Credit Rules*]; Peroni, *Back to the Future*, *supra* note 24, at 994–1000; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 394–95; Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture "What's Source Got to Do With It?": Source and U.S. International Taxation*, 56 TAX L. REV. 81 (2002) [hereinafter Shay, Fleming & Peroni, *Source and U.S. International Taxation*]; Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

³³ See Peroni, Fleming & Shay, *Reform of the U.S. Foreign Tax Credit Rules*, *supra* note 32, at 121–23; Peroni, *Back to the Future*, *supra* note 24, at 995–96; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 394–95; see also Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 153.

complex and unadministrable³⁴ are overstated and that it is possible to construct an administratively practicable per-country limitation.

As an alternative, we would recommend that the foreign tax credit baskets for certain types of lightly taxed and highly mobile business income be reinstated, e.g., the separate basket limitations for shipping income and financial services income. Even better, thought should be given to creating a separate basket limitation for low-taxed business income.³⁵

4. Other Reforms: Changes to the Source Rules

Source rules serve different purposes in international tax law. In the inbound foreign tax area governing the U.S. taxation of foreign persons, the source rules serve to help define the extent and limits of the U.S. income taxation of such persons. In the outbound context, they mainly serve to help define the amount of the foreign tax credit limitation. Yet the Internal Revenue Code often uses the same source rules for both functions.

Our view is that the source rules in the Code should be revised to reflect the purpose for which they are being used. So, in the foreign tax credit area, the source rules should be revised to generally treat income as foreign-source income for foreign tax credit limitation purposes “only if it is subject to a substantial tax by a foreign country that is consistent with international norms for asserting source-based taxing jurisdiction.”³⁶ Thus, using this proposed approach, various types of income of U.S. residents that are typically not subject to taxation in a foreign country, such as space and ocean income, or international communications income, should be treated as U.S.-source income for foreign tax credit limitation purposes. Similarly, income that is exempt from U.S. tax by reason of a tax treaty between the United States and the country in which the income arises should be treated as U.S.-source income for foreign tax credit limitation purposes.³⁷ Finally, the inventory export source rule in sections 861(a)(6) and

³⁴ See, e.g., AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 323–26, 328 (1987).

³⁵ See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25. For discussion of earlier proposals to separate the general income limitation into a high-tax limitation basket and a low-tax limitation basket, see Michael J. McIntyre, *Separate Basket Limitations in Theory and in Practice*, 70 TAX NOTES 1393, 1398 (1996); Peroni, *Back to the Future*, *supra* note 24, at 999–1000.

³⁶ Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396; see Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 149–51.

³⁷ See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396. Alternatively, such treaty-protected income could be placed in its own foreign tax credit limitation basket to prevent cross-crediting. See Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1775 (1995).

862(a)(6) results in export sales income being treated as foreign-source income by reason of the seller of inventory goods passing title to them abroad even though this income is usually not subject to foreign tax by reason of the foreign tax law itself or under a U.S. income tax treaty. This means that the U.S. seller/exporter can eliminate the U.S. residual tax on such export sales income through cross-crediting with foreign taxes on other highly-taxed foreign business income. This source rule makes little policy sense. Thus, under revamped source rules, income from inventory sales should be treated as U.S.-source income, unless the taxpayer has a foreign office or fixed place of business to which the inventory sale is attributable and which results in the taxpayer incurring a significant foreign income tax on such income.³⁸

5. Other Reforms: Expand and Revamp Earnings Stripping Rules in Section 163(j)

The earnings stripping rules in section 163(j) are designed to protect the U.S. tax base by disallowing interest deductions for U.S. tax purposes in situations where the recipient of the interest is exempt from U.S. income tax by reason of a tax treaty or otherwise. However, the provision is triggered only if a specified debt-equity ratio is exceeded and other rules substantially narrow its scope and reduce its effectiveness. Our view is that these rules should be broadened to cover other deductible payments such as royalties and service payments and that the trigger and other rules for calculating the limitation need to be substantially revised to broaden the impact of these limitations. We are currently working on another article in which we develop this thesis.

6. Other Reforms: Formulary Apportionment is No Panacea

U.S. MNCs might be expected to regard the present U.S. international income tax system as perfectly satisfactory³⁹ because, as discussed above, it creates ample opportunities to achieve a zero U.S. tax, and even a negative U.S. tax in certain cases.⁴⁰ However, the system relies on the highly complex

³⁸ See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396; see also Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 151.

³⁹ Indeed, a major association of U.S. MNCs has expressed a preference for maintaining the current U.S. system while enlarging its loopholes. See Nat'l Foreign Trade Council, Inc., *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L 687 (2002).

⁴⁰ See generally Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5.

arm's-length method⁴¹ to allocate income between domestic parent corporations and their foreign subsidiaries, it is very complex in additional ways,⁴² it raises little revenue, it causes taxpayers to incur high tax-planning and transaction costs in order to create favorable results, and it imposes large administrative costs on the Internal Revenue Service ("IRS").

A U.S. exemption or territorial system would limit the United States to taxing only business income earned within its borders and foreign-source business income would be exempt from U.S. income taxation. Such a system would be simpler and would involve lower costs than the present U.S. system with regard to tax planning and enforcement. The current U.S. international income tax system indirectly creates virtually the same end result as an exemption system (no U.S. tax on foreign business income) through deferral and cross-crediting. Consequently there has been considerable interest in replacing the current system with an explicit territorial or exemption system that would directly, and more simply, impose a zero U.S. tax on foreign-source business income.

There are two types of explicit exemption systems: traditional territoriality and formulary apportionment. Traditional territoriality uses source rules and the above-mentioned arm's-length approach to distinguish between domestic-source business income that is subject to tax and exempt foreign-source income. This arm's-length approach⁴³ is widely criticized because it is highly complex, readily manipulable, very expensive for taxpayers to comply with and for the IRS to administer, theoretically incoherent,⁴⁴ and quite ineffective in dealing with the shifting of intangible property income to low-tax foreign countries.

The second type of territoriality is formulary apportionment. Instead of using the arm's-length method, it distinguishes between taxable domestic income and exempt foreign income by combining the worldwide incomes of a U.S. MNC and its foreign

⁴¹ The arm's-length method seeks to ascertain the prices that would be charged in transactions between related parties if they were independent entities dealing at arm's length and then to determine tax consequences as if those arm's-length prices had been used by the related parties. See I.R.C. § 482 (2012); Treas. Reg. §§ 1.482-1–1.482-9 (1994). For a detailed discussion of the arm's-length method and the provisions of section 482 and the regulations issued thereunder, see 1 KUNTZ & PERONI, *supra* note 19, at ch. A3.

⁴² For example, computation of the credit allowed by the United States for foreign taxes can be very complicated, as are the anti-deferral rules of Subpart F, as discussed above.

⁴³ See *supra* note 41 and accompanying text.

⁴⁴ The arm's-length method is theoretically incoherent in that it does not take into account the economic efficiencies of related-party business integration and probably cannot do so.

subsidiaries and then allocating this income to the United States (taxable income) and to foreign countries (exempt income) in proportion to the amounts of certain factors of production of the U.S. MNC and its subsidiaries that are located in the United States and in foreign countries. For example, if 75% of the relevant production factors of a U.S. MNC and its subsidiaries were located in foreign countries, 75% of the combined worldwide income would be exempt foreign-source income and the remainder would be domestic-source income taxable by the United States.

Both forms of territoriality are a poor second-best to real worldwide taxation because both forms require the revenue-constrained United States to give up a residual tax on business income earned in low-tax foreign countries, and both encourage U.S. MNCs to locate real business activity and the related employment in low-tax foreign countries where the resulting income is excluded from the U.S. tax base. The United States would do much better to follow our recommendations above, and adopt real worldwide taxation.⁴⁵

Territoriality advocates, however, push back against that recommendation and argue in favor of formulary apportionment as the way to achieve territoriality without the problems of the arm's-length method. The most often-discussed production factors that would be used by a formulary system in place of the arm's-length method to distinguish exempt foreign income from taxable domestic income are assets, payroll, and sales. Assets are a substantial proxy for business operations and payroll is an indisputable proxy for jobs. Thus, formulary apportionment clearly creates an incentive for U.S. MNCs to move their business operations and jobs, as well as their sales, to low-tax foreign countries because to the extent they do so, they shift their combined worldwide income into the exempt foreign category. The negative effect on the U.S. tax base and U.S. employment is clear.

Some formulary advocates have argued that sales are significantly immobile and cannot be shifted into a low-tax country. Thus, these advocates maintain that a formulary apportionment system that allocates the income of a U.S. MNC between the United States and foreign countries exclusively in proportion to U.S. sales and foreign sales will not result in the U.S. tax base migrating to low-tax foreign countries.⁴⁶

⁴⁵ See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

⁴⁶ See Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

The validity of this argument depends on how the location of a sale is identified. If the longstanding U.S. title-passage rule is used in a formulary system with respect to sales of goods,⁴⁷ it will be easy to locate all sales of goods in low-tax countries, outside the U.S. tax base, by arranging sale terms so that title passes in low-tax locations.

Consequently, some have suggested locating sales of goods where the first sale to an independent buyer occurs.⁴⁸ If that test is used, then MNCs will move their sales out of the United States by selling their products to independent foreign distributors who sell into the United States. By imposing contractual performance and conduct standards on the foreign distributors, the U.S. MNCs can preserve most of the vertical integration advantages of doing their own distributing. And if sales of services are located where the work is done, the work can be performed in low-tax countries with delivery being made over the Internet.⁴⁹

The sales location approach to formulary appointment does have the salutary effect of ending the game of locating foreign intangibles in low-tax foreign countries and then creating low-tax foreign income by paying deductible royalties from subsidiaries in high-tax countries to intangible licensing subsidiaries in low-tax countries. This is because intra-group payments are irrelevant under a formulary system with combined reporting. MNCs can, however, approximate the result of this game by locating product sales in low-tax countries when product prices reflect high value intangibles.⁵⁰

The current U.S. system is badly in need of replacement. If a real worldwide system is not politically possible as a replacement choice, then in our view, either form of territorial system is preferable to the present bollixed U.S. international income tax system, and the issue is which of the two types of territorial system should be chosen.

Regarding whether a multilateral decision is possible, a few commentators believe that it is plausible to expect that the United States and the world's major economic powers can agree on a universal allocation formula that will uniformly apportion international income among them in a way that avoids double taxation and that they all accept as a reasonable accommodation of their tax claims. We see no evidence that this kumbaya hope is

⁴⁷ See Treas. Reg. § 1.861-7(c) (1960) (providing that the location of a sale of goods is generally where the seller's rights, title, and interest pass to the buyer).

⁴⁸ See Avi-Yonah, Clausing & Durst, *supra* note 46, at 509, 513.

⁴⁹ See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

⁵⁰ *Id.*

plausible. If the United States is to adopt formulary apportionment, it will have to do so unilaterally.

In that context, the problem must be seen as a choice between (1) traditional territoriality that perpetuates the costly arm's-length transfer pricing method that has been very feeble in restraining the shifting of income from intangibles but does exercise a modicum of restraint on the shifting of income from sales of tangible property and (2) formulary apportionment that eliminates the arm's-length system but that creates virtually unrestrained income shifting opportunities. What a choice!

B. Properly Designed Exemption or Territorial System (A Second-Best Solution)

Thus, we strongly prefer avoiding the above-described dilemma by reforming the U.S. international tax system into a real worldwide system. However, if Congress instead decides to reform the system by adopting an exemption or territorial system, we believe that such a system, whether of the traditional or formulary variety, should be structured in such a way as to have measures that protect against tax base erosion and minimize the distortive economic effects of an exemption system. In addition, if a territorial system is properly designed, its adoption will actually raise revenue (rather than lose revenue) as compared with the current U.S. international tax regime. As we have more fully explained in a prior article,⁵¹ such a properly designed territorial system should not be based on unsupported competitiveness assertions and should have the following design characteristics:

1. Only active foreign business income that meets a subject-to-tax requirement should be eligible for exemption treatment. In other words, exemption treatment should not apply to dividends from a foreign corporation unless either a meaningful foreign tax has been paid with respect to the active business earnings from which the dividends are distributed or the dividend payor is a resident of a country that has a bilateral tax treaty with the United States that reciprocally waives this subject-to-tax requirement;⁵²

2. Passive income should not be eligible for exemption even in the rare cases where it has been subject to a meaningful

⁵¹ See Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5. For our earlier analysis of exemption proposals, see J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005).

⁵² Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 413–26.

foreign tax. Such income is highly mobile and subject to locational choice largely based on tax considerations;⁵³

3. Royalties, interest, services payments, and other foreign-source items paid by a foreign corporation to a U.S. person that do not bear a significant foreign tax should not qualify for exemption treatment, even if they relate to an active foreign business;⁵⁴

4. The current tax exemption for 50% of the income from U.S. export sales, which is accomplished through cross-crediting and the inappropriate source rules in sections 861(a)(6), 862(a)(6), 863(b), and 865(b), and the regulations issued under those provisions, should be eliminated;⁵⁵

5. Qualifying income earned by a U.S. corporation through an unincorporated branch should be eligible for exemption, notwithstanding the various significant problems that need to be worked out in order to extend exemption treatment to branch income;⁵⁶

6. The allocation of domestic expenses to foreign-source exempt income must be accomplished in a more realistic and appropriate way than the inadequate 5-percent “haircut” that is part of some congressional territorial proposals⁵⁷ (i.e., under those proposals, 5% of the dividends received from a foreign corporation would not be eligible for exemption treatment as a substitute for applying actual allocation-and-apportionment rules to the U.S. corporate shareholder’s expenses). We believe that either factually based allocation-and-apportionment rules (i.e., a reformed and modified version of the allocation-and-apportionment rules under current law) should apply to expenses incurred by a U.S. corporation or, alternatively, a more significant “haircut” (i.e., greater than 5%) should be used, and serious consideration should be given to having the percentage vary based on the industry in which the U.S. corporation’s business income is earned (these varying percentages could be established by the Treasury Department through administrative guidance pursuant to specific statutory authorization);⁵⁸ and

⁵³ *Id.* at 426–28.

⁵⁴ *Id.* at 431–35.

⁵⁵ *Id.* at 435–38, 446–48.

⁵⁶ *Id.* at 441–45.

⁵⁷ *See, e.g.*, Tax Reform Act of 2014, H.R., 113th Cong. § 245A(a) (2014) (the 95-percent participation exemption deduction in the second Camp proposal).

⁵⁸ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 448–52.

7. The exemption system should prohibit the deduction against U.S. taxable income of foreign losses arising from foreign business activities producing income eligible for exemption treatment. Allowing the deduction of such losses is inconsistent with fundamental income tax theory (i.e., a taxpayer should not be allowed the double tax benefit of exempting foreign-source business income from tax and deducting for U.S. tax purposes expenses that relate to such income) and would in some cases result in a negative effective tax rate on exempt foreign-source income.⁵⁹

As our earlier article explained, a territorial system lacking these features would go beyond the United States's international law obligation to alleviate international double taxation, and to that extent, the United States would simply be engaging in a relinquishment of badly needed tax revenue in favor of the U.S. multinational corporate community.⁶⁰ As we noted in that article, advocates of a U.S. territorial system for taxing foreign income would likely find the above-described design features that would raise revenue as *ipso facto* objectionable because, in their view, they would undermine the competitiveness effects of a U.S. exemption system.⁶¹ This response is often augmented by an argument that the United States must enact an exemption system lacking the design features described above, notwithstanding that it goes beyond the requirements of international law, represents bad tax policy, and loses badly needed revenue, because our trading partners have done so.⁶² Thus, in the view of these territoriality advocates, the United States must follow those other countries and vigorously join this race to the bottom, so that U.S. multinationals can compete on a level playing field with their foreign rivals.⁶³ This use of these

⁵⁹ *Id.* at 452–56; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 116–17.

⁶⁰ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 458–59.

⁶¹ *Id.* at 459 (citing Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, *The U.S. International Tax System at a Crossroads*, 127 TAX NOTES 45, 59 (2010) (generally objecting to a subject-to-tax requirement)); Olson, Merrill, Mundaca, Reilly & Spellings, *supra* note 3, at 65 (same and also generally objecting to a territorial regime that raises revenue); Martin A. Sullivan, *Let's Promote the Competitiveness of All American Businesses*, 133 TAX NOTES 1175, 1179 (2011) [hereinafter Sullivan, *Promote Competitiveness of All*] (“U.S. multinationals are not interested in territorial systems . . . [that effect] an overall tax increase. Nor do U.S. multinationals want a territorial system that is revenue neutral relative to current law. They want a territorial system that reduces their taxes.”).

⁶² Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 459.

⁶³ *Id.* *But see* GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 10, at 17 (“[M]oving to a territorial system because other countries have generally done so does not mean such a system is desirable either for them or for the United States.”).

competitiveness arguments suffers from the same flaws as its application to the general question of whether the United States should adopt a territorial system as a replacement for the current U.S. international tax system.⁶⁴

In 2011 and early 2014, Representative David Camp released two draft proposals of a participation dividend exemption system for taxing foreign income.⁶⁵ Both drafts contain only some of the recommended features above and seem to be based on the unsubstantiated competitiveness claims by territorial proponents. Thus, we do not recommend that Congress adopt either version of the Camp proposal in their current forms. In order to mold Representative Camp's proposed territorial system into a principled regime that does not undermine the U.S. tax base, more work needs to be done with respect to anti-base erosion features and to excluding from territorial treatment income that has not been subject to meaningful income taxation in any country.

III. INTERNATIONAL TAX REFORM IN THE INDIVIDUAL TAXPAYER AREA

A. Repeal the Foreign Earned Income Exclusion in Section 911

Under section 911 of current law, a U.S. citizen or resident alien who meets either a bona fide residence test or physical presence test can exclude up to \$99,200 (as indexed for inflation for the 2014 year)⁶⁶ of foreign earned income⁶⁷ and a housing cost amount. Proponents of section 911 argue that it is necessary to make U.S. businesses that employ U.S. workers abroad competitive in the global marketplace by not requiring them to absorb the higher costs of their U.S. expatriate employees living and working abroad through higher pay to those workers that would have to be passed on to their customers in the form of

⁶⁴ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 459.

⁶⁵ See HOUSE COMM. ON WAYS & MEANS, TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME (2011); STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS & MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE IV—PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME (2014). For our critique of Representative Camp's first discussion draft of this proposed exemption system, see Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173 (2013).

⁶⁶ See Rev. Proc. 2013-35, 2013-47 I.R.B. 537, 543 (containing the inflation adjustments for 2014).

⁶⁷ See I.R.C. § 911(a), (b)(2)(D)(i) (2012).

higher prices.⁶⁸ However, it seems questionable for the U.S. tax system to provide a “subsidy to U.S. businesses that results in an understatement of the true costs of operating abroad, thereby providing a [tax] incentive” for those businesses to shift operations to foreign countries.⁶⁹ Moreover, this exclusion distorts individuals’ behavior by providing a tax incentive for U.S. workers to accept employment abroad rather than in the United States in situations where they would not have done so without the tax incentive.⁷⁰ In addition, the section 911 exclusion is not limited to U.S. individuals who work for U.S. employers abroad but also applies to U.S. individuals working for foreign employers, thus strangely providing a tax subsidy for such foreign employers to invest in business operations abroad with U.S. workers rather than in operations in the United States.⁷¹ This exclusion also violates the traditional tax policy criteria of horizontal and vertical equity and, thus, is inconsistent with the ability-to-pay concept that underlies an income tax base.⁷² Section 911 also adds complexity to the tax system with a provision that has many requirements that are the subject of detailed regulations⁷³ and many judicial and administrative interpretations.⁷⁴ Finally, according to the most recent tax expenditure estimates by the Staff of the Joint Committee on Taxation, section 911 results in the loss of about \$30.3 billion of revenue for fiscal years 2013–2017 from the foreign earned income exclusion and about \$6.1 billion of revenue for fiscal years 2013–2017 from the housing exclusion.⁷⁵ This foregone revenue (while not huge in relation to total U.S. budget expenditures) is badly needed for other purposes and section 911, if subjected to a rigorous cost-benefit, tax expenditure analysis, would surely fail

⁶⁸ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455.

⁶⁹ *Id.*; see also Peroni, *Back to the Future*, *supra* note 24, at 1008.

⁷⁰ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455; Peroni, *Back to the Future*, *supra* note 24, at 1008. In other cases, a U.S. taxpayer who would have worked abroad anyway is nonetheless receiving a windfall in the form of the U.S. tax avoided on the exclusion amount. See Renée Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 157–58 (1985).

⁷¹ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455; see also Peroni, *Back to the Future*, *supra* note 24, at 1008.

⁷² See Peroni, *Back to the Future*, *supra* note 24, at 1008–09; see also Sobel, *supra* note 70, at 156–57 (criticizing the regressive nature of the section 911 exclusion). U.S. persons who work in the United States have to pay full U.S. tax on their earned income while those who choose to work abroad and earn the same amount of earned income can exclude it up to the limits in section 911. *Id.*

⁷³ See Treas. Reg. §§ 1.911-1–1.911-8 (2014).

⁷⁴ See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 18, at 453–75 (detailed casebook discussion of section 911 judicial and administrative authorities); 1 KUNTZ & PERONI, *supra* note 19, ¶ B1.04 (detailed treatise discussion of the section 911 judicial and administrative authorities).

⁷⁵ See STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF TAX EXPENDITURES, *supra* note 23, at 30.

such scrutiny. Thus, fundamental reform of the U.S. international tax rules should include repeal of this poorly designed and inequitable tax subsidy provision.⁷⁶

B. Expand the De Minimis Rule in Section 904(j) and Make It Mandatory

Section 904(j) of current law contains a de minimis rule that exempts certain individual taxpayers from the foreign tax credit limitations in section 904. The de minimis rule applies if an individual taxpayer's only foreign-source income for the taxable year is "qualified passive income" (i.e., passive income reported on the requisite payee tax information statement),⁷⁷ the creditable foreign taxes paid during the year do not exceed \$300 (\$600, for married taxpayers filing a joint return), and the taxpayer elects to apply the rule. This de minimis rule does help to simplify the tax law and seems to have worked well so far as it goes. It makes little sense to require individuals with limited amounts of foreign taxes and foreign income to navigate the complexities of the section 904 limitations. However, we believe that the de minimis rule is too narrow in scope and should cover a larger amount of foreign taxes (e.g., \$10,000 for single taxpayers and \$20,000 for married taxpayers filing a joint return).⁷⁸ We also would not require that the taxpayer's foreign-source gross income be limited to passive income and, instead, would apply the de minimis rule to taxpayers with foreign-source business income, provided that the amount of the creditable taxes does not exceed the dollar limitations (as expanded under this proposal) and the taxpayer's total foreign-source gross income on which the foreign taxes were imposed is not less than the amount of the foreign taxes to be credited.⁷⁹ The taxpayer, of course, would be required to identify and report as taxable income such income on his or her tax return for the taxable year for which the foreign tax credits were sought to be taken. Finally, there is no reason that this de minimis rule should be subject to election and, thus, we would have it apply whenever its requirements are met. However, we would continue to limit the availability of this de minimis rule to

⁷⁶ See Joseph M. Dodge, *Some income Tax Simplification Proposals*, 41 FLA. ST. U. L. REV. 71, 134–35 (2013) (advocated repeal of section 911). Note that the section 911 exclusion is not necessary to mitigate international double taxation because a U.S. citizen or resident alien who pays foreign income tax on his or her foreign earned income receives a U.S. credit for those foreign taxes (subject to the limitations in Section 904).

⁷⁷ See I.R.C. § 904(j)(3)(A) (2012).

⁷⁸ See Peroni, *Back to the Future*, *supra* note 24, at 1001; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393–94; see also Dodge, *supra* note 76, at 135–36; David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POLY 187, 233–34 (1990).

⁷⁹ See Dodge, *supra* note 76, at 136.

2014] *Outbound International Tax Reform* 155

individual taxpayers; the de minimis rule should not apply to corporate taxpayers.⁸⁰

CONCLUSION

International tax reform will not be easy and there is a great danger that Congress could make things worse by adopting a defective exemption system in place of our current less-than-ideal worldwide system. We have suggested a number of operating considerations that we hope are kept in mind in designing the international tax reform provisions. We have also suggested a number of specific international tax reforms that we hope will be adopted.

⁸⁰ Allowing corporate taxpayers to use this de minimis rule would undermine its simplification benefits and would create opportunities for individuals to abuse the rule by conducting integrated business operations in multiple corporate entities. See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393 n.8.

