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Label contradicts reality for the U.S. international corporate tax system. The U.S. system is typically labeled as a worldwide tax system with a statutory rate of 35%, both uncommon features among our trading partners. Yet these markers of the U.S. tax system do not accurately describe reality, where multinational firms routinely face far lower effective tax rates and little, if any, tax is collected on foreign income. Understanding this discrepancy between label and reality is essential to evaluate recent policy debates surrounding corporate inversions and the competitiveness of the U.S. international tax system. Although there is an essential policy tradeoff between "competitiveness" (an ill-defined term) and corporate tax base protection, there is little evidence that U.S. multinational firms have a competitiveness problem. However, new evidence shows that corporate tax base erosion is a large and increasing problem. There are several options for reform that would address corporate tax base erosion.

I. Introduction

Perhaps fitting within a tradition of American exceptionalism, the U.S. tax system is often described as *sui generis.* Observers repeatedly lament that we are the only major country that employs a worldwide system of taxation, taxing the foreign income of U.S. multinational firms, and that we have one of the highest statutory tax rates in the world. From this observation, it is a quick jump to argue that the United States should adopt a territorial system of taxation that exempts foreign income from taxation, combined with a lower statutory rate.

This Article argues that such a characterization of the nature of the current system as well as the desirability of particular reforms is a misleading representation of reality. In particular, the U.S. tax system, like those of our trading partners, is a hybrid system, with both

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territorial and worldwide components. Further, while the system is in desperate need of reform, the rationale for reform is not what adherents to the exceptionalism view hold. In particular, U.S. multinational firms do not have a competitiveness problem due to the features of our present tax system. However, our system does create both perverse incentives and extensive tax base erosion; these issues need to be addressed in future reforms. Ideal tax reforms would better align the worldwide "label" of the U.S. tax system with the reality on the ground, stemming corporate inversions and tax base erosion and lowering statutory tax rates while raising effective tax rates.

II. THE INTERNATIONAL CONTEXT: IS THE UNITED STATES SUI GENERIS?

Perhaps the best description of the present U.S. international tax system is that we have a "stupid territorial" regime.[1] In particular, U.S. multinational firms pay little tax on foreign income, but engage in inefficient behavior to generate that outcome, and tax base erosion is rampant. Several features of our worldwide tax system generate this "stupid territorial" outcome.

One of the biggest issues is deferral, which allows firms to accumulate foreign income in low-tax countries without paying U.S. tax until that income is repatriated. When income is repatriated, cross-crediting allows excess tax credits from high-tax countries to offset tax that may be due on low-tax country income.[2] Also, under our system, foreign tax credits can offset tax that would normally be due on royalty income, further lowering the tax burden on foreign income. At the same time, U.S. multinational firms have more foreign income than ever before, in part due to shifting of profits out of the U.S. tax base. U.S. multinational firms benefit from rules (such as "check the box") that facilitate the creation of stateless income, and profit shifting out of the U.S. tax base has increased dramatically in recent years.[3]

1. This is the assessment of President Obama's Chief Economic Adviser Jason Furman. *See* Jason Furman, Tax Council Policy Inst., Keynote Speech at Tax Council Policy Institute's Tax Symposium (Feb. 20, 2014) (transcript available at https:// www.whitehouse.gov/sites/default/files/docs/transcript_of_furman_keynote_speech_at_tax_council_policy_institutes_tax_symposium.pdf).

2. Still, as the U.S. statutory tax rate has increased *relative* to declining foreign statutory tax rates, multinational firms have fewer excess tax credits than in years past.

3. *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 717–24 (2011) (detailing elaboration on the generation of stateless income and related policy challenges);

Given the parameters of the U.S. tax system just described, one could easily argue that our system is a hybrid system. Indeed, most major countries of the world have hybrid tax systems with territorial and worldwide components. For example, many purportedly territorial countries tax foreign income more heavily than the United States system does, due in part to base protection laws that tax some foreign income currently. Also, foreign tax credits are not available to shield some types of foreign income, such as royalty income, from domestic taxation.

In order to assess a country's tax system, it is perhaps most useful to think of all tax systems as lying on a spectrum between a pure territorial system and a pure worldwide system. I have argued that several criteria determine where on this spectrum countries are placed, as summarized in Table 1.[4]

Table 1: The Spectrum

	Pure Territorial System	**Hybrid (in between systems)**	**Pure Worldwide System**
1. Share of Foreign Income Taxed	0%	=> Increasing =>	100%
2. Effective Tax Burden on Foreign Income	0%	=> Increasing =>	Domestic Tax Rate
3.Tax Consequences of Repatriation	Not Tax Relevant	=> Increasing tax influence => then dropping to zero again	Not Tax Relevant
4. Relative Incentive to Earn Income in Low-Tax Countries	High	=> Decreasing =>	None

Under a pure territorial system, foreign income is completely exempt from taxation, giving multinational firms a large incentive to earn income in (or shift income to) low-tax destinations. Under a pure

Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 107–09 (2011); *see also* Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L TAX J. (forthcoming Dec. 2016) (estimating profit shifting and its effect on the U.S. tax base).

4. Portions of the text describing features of the table are excerpted from Kimberly Clausing, *Beyond Territorial and Worldwide Systems of Tax*, 15 J. INT'L FIN. & ECON. 43 (2015).

worldwide system, all foreign income is taxed currently at the domestic tax rate, so multinational firms would have no incentive to shift income to low-tax countries and repatriation would be undeterred by tax burdens (since the tax would already be paid). Of course, the United States is quite far away from the pure worldwide end of the spectrum. Less appreciated, perhaps, is the fact that purportedly territorial countries are also far away from the pure territorial end of the spectrum.

First, consider the share of foreign income that is taxed. Many territorial countries have controlled foreign corporation (CFC) laws that seek to limit abusive tax avoidance by currently taxing foreign income. The Joint Committee on Taxation provides detail on other countries' CFC laws.[5] Some countries (e.g., France, Germany, Italy, and Japan) have very broad CFC laws that go beyond currently taxing passive foreign income; active foreign income is also currently taxed, when such income is insufficiently taxed in the source country.[6] The French benchmark for insufficient taxation is less than half the French rate; the Japanese benchmark is less than twenty percent.[7] Beyond CFC laws, many territorial countries have other provisions aimed at countering corporate tax base erosion that may affect the taxation of foreign income, including thin capitalization (earnings stripping) rules, which are widely used.[8] Indeed, many territorial countries tax some foreign income.

The United States exempts much foreign income from tax, since foreign income that is reinvested abroad can escape home taxation indefinitely. Cross-crediting can also reduce the domestic taxation of foreign income, and tax credits from dividends can offset tax that would otherwise be due on other sources of foreign income, such as royalty income. Thus, it is quite possible that a move to a territorial system could *raise* rather than lower the share of foreign income that is taxed. Further, U.S. multinational firms have become particularly adept at generating stateless income, income that goes untaxed in any jurisdiction.

5. STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 14-45 (Comm. Print 2011).

6. *Id*. at 22–30.

7. *Id*. at 29.

8. *Id*. at 14–15, 19, 28, 32, 36, 43.

Second, consider the effective tax rates paid on foreign income. In studies of multinational firm effective tax rates, there is no pattern that distinguishes purportedly territorial countries from purportedly worldwide countries.[9] Studies differ on where the United States fits relative to peer countries. Avi-Yonah and Lahav find that U.S. multinational corporations (MNCs) have effective tax rates that are lower than MNCs based in the European Union.[10] Markle and Shackelford find that the United States has relatively high effective tax rates.[11] It is important to note that these calculations are more complicated than they might seem, and effective tax rates vary a great deal depending on methodological issues and individual firm circumstances.[12] Indeed, many U.S. multinational firms have achieved single digit tax rates, including Pfizer, *prior* to their planned inversion.[13]

9. *See, e.g.*, Kevin S. Markle & Douglas A Shackelford, *Cross-Country Comparisons of the Effects of Leverage, Intangible Assets, and Tax Havens on Corporate Income Taxes*, 65 TAX L. REV. 415, 416 (2012) (performing a regression analysis of the determinants of effective tax rates for over 11,000 public corporations from 82 countries during the period 1988–2009 and finding that firms resident in countries with a worldwide tax system have lower effective tax rates than firms resident in countries with a territorial tax system, controlling for other factors); *see also* Giorgia Maffini, *Territoriality, Worldwide Principle, and Competitiveness of Multinationals: A Firm-Level Analysis of Tax Burdens* (Oxford CBT Working Paper No. 12/10, 2012) (analyzing ORBIS firm-level data for over 3000 companies in 15 OECD countries over the period 2003 to 2007 and concluding that although worldwide countries do tend to have higher statutory rates than territorial countries in this sample, controlling for statutory tax rates in the home country, there is no difference in the effective tax rates of firms operating under a worldwide versus territorial tax system).

10. Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX L. REV. 375, 383 (2012).

11. *See* Markle & Shackelford, *supra* note 9, at 421.

12. For example, the General Accounting Office found that "[f]or tax year 2010 (the most recent year with information available), profitable U.S. corporations that filed a Schedule M-3 paid U.S. federal income taxes amounting to about 13 percent of the pretax worldwide income that they reported in their financial statements." GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS: EFFECT TAX RATES CAN DIFFER SIGNIFICANTLY FROM THE STATUTORY RATE 1 (2013). The rate is higher if foreign and state and local income taxes are included, at 17%. *Id.* If firms with losses are included, that raises the effective tax rate averages further, to about 16% at the federal level, and about 22% inclusive of other taxes. *Id.*

13. Pfizer has a 7.5% effective tax rate. AMERICANS FOR TAX FAIRNESS, PFIZER'S TAX DODGING RX: STASH PROFITS OFFSHORE (2015), http://www.americanfortaxfairness.org/pfizers-tax-dodging-rx-stash-profits-offshore/. Many other companies have achieved comparably low rates. *See, e.g.*, Christopher Helman, *What The Top U.S. Companies Pay In Taxes*, FORBES (Apr. 1, 2010), http://www.forbes.com/2010/04/01/ge-exxon-walmart-business-washington-corporate-taxes.html.

One clear point is that the United States raises very little additional revenue by taxing the foreign income of its resident firms. In part, this is due to the fact that: (1) foreign income is rarely repatriated in a manner that generates foreign tax payments, and (2) tax credits from dividends shield other foreign income from taxation.[14] Data from other countries is less complete, but the U.K. Treasury estimated a very low cost of moving to territorial taxation—less than one percent of the corporate tax liability—due to the fact that very little revenue was collected on repatriated dividends under their prior worldwide system.[15]

Third, consider repatriation incentives. Here, differences in tax systems are larger. In theory, there should be no tax incentive affecting repatriation decisions in either a pure territorial system or a pure worldwide system. However, since *actual* worldwide systems typically allow domestic tax on foreign income to be deferred until repatriation, this creates a "lock out" effect whereby firms will be reluctant to repatriate dividends from low-tax countries due to the tax cost associated with bringing the money home. Absent deferral, this is not an issue.

Still, even with deferral, there should not be a tax disincentive on repatriation for mature firms. If the ultimate U.S. taxation of income earned in low-tax countries is inevitable, then repatriation taxes should not affect the decisions of mature firms regarding whether to reinvest

14. As Altshuler and Grubert report, using 2006 data, only $32 billion is collected on *all* foreign source income, amounting to less than 4% of foreign income. Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671, 695 (2013).

> "But the amount raised from dividends represents only a very small portion of this revenue. Indeed, if dividends are removed from taxable foreign income total U.S. tax revenue increases by about one billion. The dividends taxable on the margin after credits are more than offset by the credits originating with dividends that currently spill over to other income." *Id.*

Gravelle makes a similar point using 2007 and 2008 data. Effective tax rates on *all* foreign income were 7% in 2007 and 5% in 2008, but royalties were shielded from tax by excess credits. Without this effect, tax revenues would have been higher. JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 10–11 (2012).

15. Li Liu, International Taxation and MNE Investment: Evidence from the UK Change to Territoriality 6–7 (June 10, 2015) (unpublished manuscript), http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/symposia/2015/liu-paper4.pdf.

funds abroad or repatriate.[16] The decision between reinvestment and repatriation depends on the relative returns of the two investment options; the tax cost of repatriating funds is incurred irrespective of whether one reinvests the funds or repatriates them.[17] Yet in the case of *temporary* changes in the tax cost of repatriation, this result no longer holds. For example, if there is a temporary holiday for dividend repatriation, one would expect increased repatriations during the holiday and reduced repatriations in the surrounding periods. Further, the mere *expectation* of holidays or changes in tax treatment can make investors tax sensitive in their repatriation decisions.

Substantial evidence confirms that firms respond to these temporary changes in tax costs.[18] Many argue that the current buildup of un-repatriated foreign income by U.S. multinational firms is due to anticipation of future holidays or, perhaps, U.S. adoption of a territorial system. Under a territorial system, there should be no tax disincentive affecting dividend repatriation. Yet there are caveats in practice. As the Joint Committee on Taxation notes, many other conditions might still distort repatriation decisions even if the United States adopted a territorial system.[19]

Finally, consider the incentive to earn income in low-tax countries. While in theory, MNCs residing in territorial countries should face greater incentives to earn income in low-tax countries (compared to MNCs residing in worldwide countries), in practice, empirical work

16. David G. Hartman, *Tax Policy and Foreign Direct Investment*, 26 J. PUB. ECON. 107, 115–18 (1985).

17. Kimberly A. Clausing, *Tax Holidays (and Other Escapes) in the American Jobs Creation Act*, 58 NAT'L TAX J. 331, 333–35 (2005) (referring to result discussed in Hartman, *supra* note 16), provides a more detailed development of this point. Also note that the Hartman result only applies to mature firms. Immature firms may have an incentive to underinvest in order to take full advantage of deferral.

18. *See generally* DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (2011).

19. STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 84. Under a territorial system, tax distortions to repatriation would occur under several possible conditions: if dividends were not wholly exempt, if not all levels of foreign ownership generated exemption, or if foreign earnings were required to have been subject to tax in order to qualify for exemption. In part for these reasons, the predicted effects on repatriation from adoption of a territorial system are typically small. Gravelle notes that the effects of the recent adoptions of territorial systems in Japan and the U.K. were modest. GRAVELLE, *supra* note 14, at 14. Given the perceived permanence of these changes, this could be due to the Hartman result; taxpayers are most responsive to temporary changes that affect the relative cost of repatriating dividends at a particular time. *See* Hartman, *supra* note 16 and related text.

on this question has been difficult due to the problem of distinguishing country tax systems when many countries have hybrid systems. The evidence on this question is therefore mixed, although meta-analyses by De Mooij and Ederveen confirmed a higher tax elasticity for studies based on territorial tax systems.[20] In the 2003 meta-analysis, they conclude that studies using data from territorial countries exhibit more tax responsiveness than studies using data from worldwide countries, although this outcome does not persist if one eliminates extreme findings.[21] The 2008 meta-analysis also finds that studies based on territorial countries (162 of the semi-elasticities) have higher elasticities than those based on worldwide countries (118 semi-elasticities).[22] The point estimate of the semi-elasticity difference between the two groups of studies is about 1.0.

There are far fewer studies that consider how tax systems affect income-shifting behavior. One exception is Markle; using data from ORBIS over the period 2004–2008. Markle finds that multinationals based in territorial countries shift more income than those in worldwide countries.[23] The difference is limited to the subset of firms that are financially constrained; there is no difference in income shifting behavior for the subsample of firms that are not financially constrained. Similarly, Dyreng and Markle find that financially constrained multinational firms would increase outbound income shifting if the United States were to adopt a territorial system.[24]

III. AMERICAN EXCEPTIONALISM AND CORPORATE INVERSIONS

As Part II demonstrates, most countries have a hybrid system of international taxation where some types of foreign income are taxed under some circumstances. The most important difference between purportedly territorial and purportedly worldwide systems of taxation

20. Ruud A. de Mooij & Sjef Ederveen, *Taxation and Foreign Direct Investment: A Synthesis of Empirical Research*, 10 INT'L TAX & FIN. 673, 687 (2003).

21. *Id.*

22. Ruud A. de Mooji & Sjef Ederveen, *Corporate Tax Elasticities: A Reader's Guide to Empirical Findings*, 24 OXFORD REV. ECON. POL'Y 680, 692 (2008).

23. Kevin Markle, A Comparison of the Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries 28 (Sept. 2014) (unpublished manuscript), http://ssrn.com/abstract=1764031.

24. Scott D. Dyreng & Kevin Markle, The Effect of Financial Constraints on Tax-Motivated Income Shifting by U.S. Multinationals 31 (May 14, 2015) (unpublished manuscript), http://ssrn.com/abstract=2336997.

concerns repatriation incentives and the related problem of profit shifting incentives.

Estimates indicate that about two trillion dollars are held by U.S. corporations abroad (as permanently reinvested earnings),[25] about half of which is in cash.[26] These profits have accumulated over time due to booking income in low-tax countries. Un-repatriated earnings are often held in U.S. financial institutions, and are thus available to U.S. capital markets, but U.S. MNCs are constrained in their use of these funds. These funds are assets of the firm that increase the firm's creditworthiness; however, firms cannot return the cash to shareholders as dividends or share repurchases without incurring U.S. corporate tax liabilities upon repatriation.

In the past, the multinational community succeded in lobbying for a repatriation holiday as part of the American Jobs Creation Act of 2004. Yet there is consensus among economists that, despite the hopeful title of the legislation, the holiday did not increase jobs or investment in the United States, but instead fueled dividends and share repurchases.[27] This has made it difficult to argue for a repeat performance of the holiday. Instead corporations have argued that the United States should follow other countries and adopt a territorial system of taxation, removing the repatriation tax and exempting future foreign income from taxation.

If the United States were to move to a pure territorial system, it would avoid the repatriation lock-out problem. However, this approach would increase the already large incentive to shift profit toward low-tax countries, since there would no longer be any constraint on profit shifting due to anticipated tax burdens upon repatriation. Indeed, the repatriation tax acts as a natural limit to the amount of profit shifting multinational corporations may do, since they fear accumulating large amounts of income abroad that cannot be used for dividends or share repurchases without triggering U.S. tax. Thus, eliminating the U.S. tax upon repatriation also eliminates the

25. Maxwell Murphy, *Indefinitely Reinvested Foreign Earnings on the Rise*, WALL ST. J.: CFO J. (May 7, 2013), http://blogs.wsj.com/cfo/2013/05/07/indefinitely-reinvested-foreign-earnings-on-the-rise/.

26. Edward D. Kleinbard, *Tax Inversions Must Be Stopped Now*, WALL ST. J., July 21, 2014.

27. MARPLES & GRAVELLE, *supra* note 18, at 3; PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, 112TH CONG., REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTINATIONALS (2011).

remaining constraint on profit shifting behavior, turbocharging incentives to shift profits abroad.

Note that there are other steps, beyond territoriality, that would diminish the lock-out problem. As Hartman shows, a repatriation tax that is presumed to be permanent would create much smaller lock-out effects;[28] it is the prospect of more favorable tax treatment in the future that makes firms reluctant to incur the tax costs of repatriation. Policy uncertainty is a key part of the problem.

Of course, another way to handle repatriation lock-out would be to simply tax foreign income currently by ending deferral. Since this change would raise the tax burden on foreign income, a plausible compromise might be to tax foreign income currently, but at a lower rate, or through a system of minimum taxes.

Still, many multinational business interests favor a territorial system of taxation, and if such a system is not forthcoming, some have threatened to pursue corporate inversions, effectively "self-helping" to the tax reform outcome they desire. For example, Carl Icahn, the billionaire investor who recently pledged $150 million to launch a super PAC aimed at such tax reforms,[29] claims that there will soon be a flood of corporate inversions, unless Congress creates a more "competitive" corporate tax code.[30]

Indeed, the recent spate of corporate inversions had a clear motive. Multinational firms want easier access to the $2 trillion in foreign earnings held abroad. But equally important, corporate inversions ease future profit shifting through earnings stripping. Earnings stripping occurs when corporations use loans between the new foreign parent and the U.S. affiliate to shift income out of the United States. This happens by leveraging the U.S. company, through internal loans within the multinational corporation, up to the limits set by the rules of earnings stripping provisions in section 163(j) of the Internal Revenue Code.[31] Inverted corporations will be able to shift income

28. *See* Hartman, *supra* note 16 and accompanying text.

29. Rebecca Ballhaus, *Carl Icahn to Invest $150 Million in Super PAC*, WALL ST. J. (Oct. 21, 2015), http://www.wsj.com/articles/carl-icahn-to-invest-150-million-in-super-pac-1445441825.

30. Carl C. Icahn, *How to Stop Turning U.S. Corporations Into Tax Exiles*, N.Y. TIMES (Dec. 14, 2015), http://www.nytimes.com/2015/12/14/opinion/how-to-stop-turning-us-corporations-into-tax-exiles.html.

31. I.R.C. § 163(j) (2012).

out of the United States without running afoul of these provisions.[32] For example, with these sorts of strategies, estimates suggest a planned inversion transaction could have saved Walgreens over $780 million in taxes in one year alone.[33]

Yet corporate inversions do not reveal anything about the tax competitiveness of the U.S. multinational corporations that undertake them, since these incentives to undertake corporate inversions are not resulting from higher effective tax rates for U.S. based multinational firms, nor from the fact that more foreign income is taxed. Instead, inversions result from perverse features of the U.S. tax system—in particular, the combination of deferral and limited earnings stripping rules.

Systematic corporate tax reforms could address the problems of repatriation lock-out and corporate inversions, among other key reform objectives. Yet as we wait for systematic reforms, there are still many policy tools that are capable of addressing inversions.[34] For example, recent treasury regulations have made inversions more difficult by addressing "hopscotch" loans and reducing some types of earnings stripping. But more could be done, including increasing the legal standard for a foreign affiliate to become a parent to fifty percent ownership of the newly merged company. In addition, U.S. corporations could be disallowed from moving abroad for tax purposes if they remain managed and controlled in the United States or if the corporation does not do significant business in the country it claims as its new home.

Another area that could be revised in response to inversions is the earnings striping rules under section 163(j). Since one of the key drivers behind inversions is facilitating the subsequent shifting of income out of the U.S. tax base, tightening these rules would reduce the lure of inversion. Sullivan has cataloged many previous proposals

32. The same logic holds for foreign-headquartered firms more generally. *See* Stephen E. Shay, *Mr. Secretary, Take the Tax Juice out of Corporate Expatriations*, 144 TAX NOTES 473 (July 28, 2014).

33. Walgreens explored the possibility of a corporate inversion but decided against expatriation. Seida and Wempe find evidence that firms' effective tax rates decline following inversion because of income shifting through changes in intercompany debt (*see* Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 NAT'L TAX J. 805 (2004)).

34. These are discussed in more detail in, KIMBERLY A. CLAUSING, TAX POLICY CENTER, CORPORATE INVERSIONS (2014). This borrows from that discussion.

to tighten these rules.[35] Such changes to earnings stripping provisions would also help address the profit shifting problem more generally, including in cases in which multinational firms have not inverted.

Finally, an exit tax would be a key anti-inversion policy tool. The tax would be levied on repatriating companies, based on the U.S. tax due on outstanding stocks of income that have not been repatriated.[36]

These anti-inversion measures are likely to be effective, and they could also be enacted retroactively.[37] Of course, systematic corporate tax reform could also address the tax incentives behind corporate inversions, in addition to other even more important desiderata, such as reducing the economic distortions under the present system and protecting the corporate tax base. Part V evaluates options for reform in detail.

IV. COMPETITIVENESS AND CORPORATE TAX BASE EROSION

"Competitiveness" is a vague and ill-defined concept. In corporate tax debates, the term is used to capture only a very narrow aspect of competitiveness, the corporate tax facet of the overall ability of a multinational firm to compete. Of course, there are many other variables that affect a firm's ability to compete, including, but not limited to, the exchange rate, the firm's financial constraints, and the unique organization and internalization advantages of the particular firm. In addition, the attractiveness of a particular country as a location for production depends on much more than its corporate tax environment: its market size, infrastructure, government services, legal institutions, regulation, labor productivity, labor costs, geography, and other factors. Indeed, these other aspects of a

35. *See* Martin Sullivan, *Economic Analysis: The Many Ways to Limit Earnings Stripping*, 144 TAX NOTES 377 (July 28, 2014).

36. For elaboration, see Daniel Shaviro, *Understanding and responding to corporate inversions*, DANSHAVIRO.BLOGSPOT.COM, (July 28, 2014), http://danshaviro.blogspot.com/2014/07/understanding-and-responding-to.html. Shareholders still pay capital gains taxes under typical inversion deals since the merger creates a realization event, but exit taxes would affect tax at the corporate level. Of course, many capital gains are not taxed at the individual level if the shareholder is tax-exempt (e.g., nonprofits, pensions, and annuities).

37. There are good arguments for retroactivity. For example, the prospect of retroactivity would deter current plans for new inversions, thus avoiding situations in which firms rush to complete inversions before legislation is enacted. Retroactivity would also reduce the "tilt" of the playing field in favor of firms that had already successfully completed inversions before the legislation.

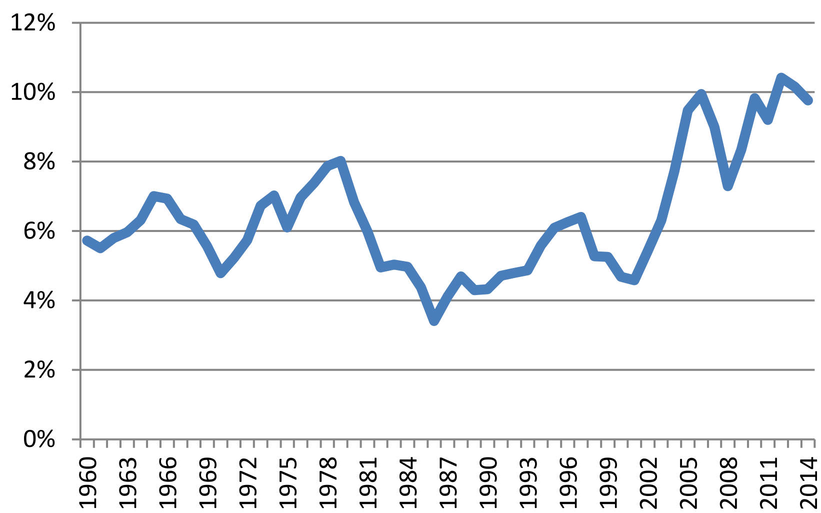
country's (or a firm's) competitiveness may be far more important for national welfare than the tax facet of multinational firm competition.

Turning to the question of tax competitiveness, it is far from clear that U.S. multinational firms are disadvantaged. Much foreign income goes untaxed, and effective tax rates are on par with those in many trading partner countries. Our multinational firms are also world leaders in tax avoidance, and, as a result, they often achieve single-digit effective tax rates, making them the envy of the world in terms of tax planning competitiveness.[38]

By other conventional measure of competitiveness, U.S. multinational corporations are healthy and thriving. As Figure 1 shows, corporate profits as a share of GDP in recent years are higher than at any point in the last fifty years.

38. Edward D. Kleinbard, '*Competitiveness' Has Nothing to Do With It*, 144 TAX NOTES 1055, 1057 (2014) (describing this phenomenon in detail).

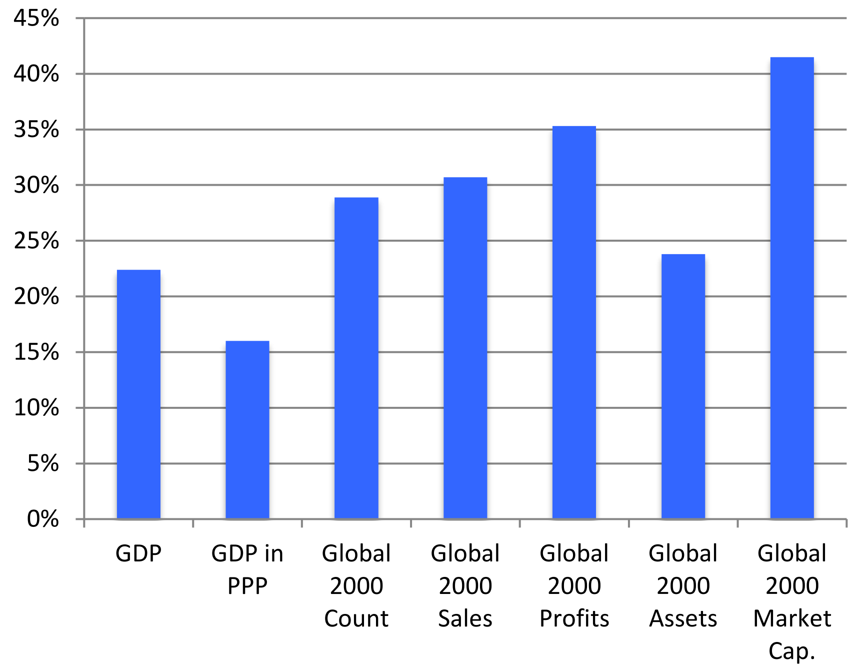
Figure 1: Corporate Profits as a Share of GDP, 1960–2014[39]



The United States is also home to a disproportionate share of the Forbes Global 2000 list of the world's most important corporations. As Figure 2 shows, the U.S. share of world GDP in 2014 (in dollar terms) is 22%, and the U.S. share of GDP in PPP terms (which accounts for different prices levels in different countries) is 16%. Yet the U.S. share of the world's biggest firms is far higher: 29% by count, 31% by sales, 35% by profits (consolidated worldwide), 24% by assets, and 42% by market capitalization.

39. U.S. Bureau of Economic Analysis, *Corporate Profits After Tax (without IVA and CCAdj)/Gross Domestic Product*, FED. RESERVE BANK ST. LOUIS, https://fred.stlouisfed.org/graph/?g=cSh.

Figure 2: 2014 Data on U.S. Share of Forbes Global 2000 Firms (and world GDP)



Still, competitiveness concerns are often voiced as the key impetus for moving the U.S. tax system toward a pure territorial system, or absent that policy change, the necessity of "self-help" tax reform by corporate inversion.[40] Those in the multinational community that argue for a more "competitive" tax system are explicitly arguing for a lighter tax burden to enable U.S. multinational firms to "compete" with those based in other countries. Thus, when advocating for a territorial system of taxation, business interests are certainly in favor of moving toward the territorial end of the tax policy spectrum. But they are unlikely to suggest a "tough" territorial system such as those used by some of our trading partners since such a system would, on net, increase the taxation of foreign income. Robinson notes that a well-designed territorial system has potential to be as burdensome, if not more so, on a U.S. multinational firm than the current poorly-

40. *See* Icahn, *supra* note 30.

designed worldwide system.[41] Adopting the label of territoriality could still move the U.S. system toward the *worldwide* end of the spectrum.

Systematic tax reforms will face a tradeoff between two essential desiderata: corporate "competitiveness" and tax base protection. The narrow version of competitiveness used in corporate tax policy debates leads business interests to push for moves toward the territorial end of the spectrum. Yet moves in this direction can exacerbate concerns about efficient capital allocation and tax base protection. Such concerns would favor moves toward the worldwide end of the spectrum.[42]

Indeed, a more "competitive" U.S. tax system will likely make the already large corporate tax base erosion problem larger by increasing the incentive to book income in low-tax countries due to the (even) lighter tax burden that would be placed on those earnings. Yet the evidence indicates a very substantial tax base erosion problem at present. For example, my recent research suggests that, by 2012, profit shifting will generate an *annual* revenue cost to the U.S. government of between $77 and $111 billion.[43] Extrapolating to 2015 at a 5% growth rate, this implies losses that are likely in excess of $100 billion per year.[44] Figure 3 shows how this cost has increased dramatically in recent years. This increase is due to the increasing foreign profits of U.S. multinational firms as well as the increased discrepancy between U.S. tax rates and foreign tax rates, due to steadily diminishing foreign tax rates.[45]

41. *See The U.S. Tax Code: Love It, Leave It, or Reform It: Hearing before the S. Comm. On Finance,* 113th Cong. 13 (2014) (statement of Leslie Robinson). Grubert and Mutti, for example, design a territorial system that would result in an overall higher tax burden on income generated in low-tax countries. HARRY GRUBERT & JOHN MUTTI, TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM 3–4 (2001). See STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 86 for a discussion of this point.

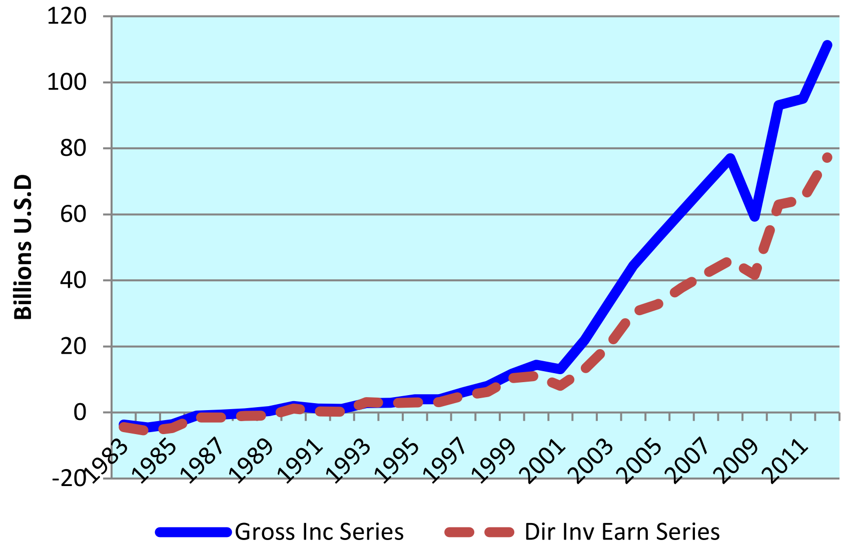
42. These concepts go back to Musgrave's conceptions of capital export neutrality and capital import neutrality. PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS 108–38 (1969).

43. Clausing, supra note 3, at 2.

44. Kimberly Clausing, *Profit Shifting and U.S. Corporate Tax Policy Reform*, WASHINGTON CENTER FOR EQUITABLE GROWTH, May 2016, at 13 & n.12, http://cdn.equitablegrowth.org/wp-content/uploads/2016/05/05115111/051016-clausing-profit-shifting.pdf.

45. The increase is *not* due to the increased tax sensitivity of foreign profits (since that elasticity is held constant in this analysis).

Figure 3: Estimates of Revenue Loss due to Income Shifting, billions U.S.D (estimates using U.S. BEA gross income series and direct investment earnings series)



These estimates are explained in detail in another study by the author.[46] That analysis uses survey data on U.S. multinational firms' operations to estimate the size of the U.S. tax base absent profit shifting. It does this by first estimating the tax sensitivity of U.S. multinational firms' taxable income to tax differences across countries, controlling for other features of countries that may generate different levels of corporate profits. It then calculates how much "excess" (or deficit) profits are earned in low-tax (or high-tax) countries relative to what profits would be without such profit shifting incentives. Profits by affiliates of U.S. multinational firms in low-tax countries are shown to be much higher than would be expected absent the incentive to shift income to low-tax destinations.[47] Table 2 shows the countries where the greatest profit shifting is occurring.

46. Clausing, *supra* note 3.
47. *Id.*

Table 2: Key Locations of Profit Shifting, 2012[48]

Country	Gross Income Reported, $ billions	Estimate of Gross Income without Shifting, $ billion	% of Total Excess Income in Location
Netherlands	172.3	33.0	23.0%
Ireland	122.3	23.6	16.3%
Luxembourg	96.1	15.0	13.4%
Bermuda	79.7	9.9	11.5%
Switzerland	57.9	14.6	7.2%
Singapore	42.4	10.5	5.3%
UK (Caymans)	40.9	8.7	5.3%
All Others Under 15%	188.6	89.8	16.3%
Total Under 15%	800	205	98.4%
All Others with Data[49]	267	257	1.6%

Then, a fraction (39% in 2012)[50] of this "excess" income in tax havens and other low-tax countries is attributed to the United States tax base, where it is assumed to be taxed at 30%. (This assumption allows for some degree of base narrowing relative to the statutory tax rate.) These estimates also take into account profit shifting by foreign multinational firms. The estimates use the best publicly available data, careful methodology, and conservative assumptions.[51] The estimates are supported by similar findings by researchers at the Organisation for Economic Cooperation and Development (OECD), International

48. *Id.*

49. Note that the total of gross income in 2012 ($1,219 billion) is larger than the income that is reported in particular countries analyzed here ($1,067 billion); some income is earned in "other" countries that are not designated.

50. This is based on the share of foreign affiliate transactions that occur with the United States compared to other foreign countries.

51. See Clausing, *supra* note 3, for a detailed discussion of the assumptions used in the analysis, as well as alternative calculations that account for the range of estimates.

Monetary Fund (IMF), Joint Committee on Taxation (JCT), and elsewhere.[52]

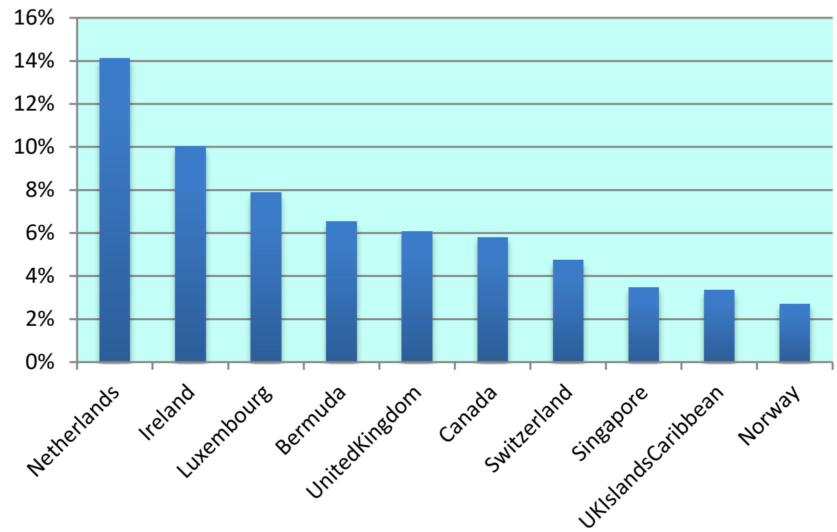
Indeed, even a look at the raw data is sufficient to illustrate the large magnitude of the profit shifting problem. U.S. affiliate firm profits were 645% of Bermuda's GDP and 547% of the Cayman Islands GDP in 2004.[53] As absurd as these numbers are, they increased to 1,614% for Bermuda and 2,065% for the Caymans by 2010. Figure 4 shows the top ten locations of U.S. multinational firm affiliate gross profits in 2012 (gross profits are net income with foreign income tax payments added).[54]

52. *See* Organization for Economic Cooperation and Development [OECD], *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report* (2015), http://dx.doi.org/10.1787/9789264241343-en (last visited Oct. 27, 2016); Ernesto Crivelli, Ruud de Mooij & Michael Keen, *Base Erosion, Profit Shifting and Developing Countries* (International Monetary Fund, Working Paper 15/118, 2015), https://www.imf.org/external/pubs/ft/wp/2015/wp15118.pdf; Mark P. Keightley & Jeffrey M. Stupak, CONG. RESEARCH SERV., R44013, CORPORATE TAX BASE EROSION AND PROFIT SHARING (BEPS): AN EXAMINATION OF THE DATA, (Apr. 30, 2015), https://www.fas.org/sgp/crs/misc/R44013.pdf; Tim Dowd, Paul Landefeld & Anne Moore, *Profit Shifting of U.S. Multinationals* (Jan. 6, 2016) (forthcoming) http://ssrn.com/abstract=2711968; Gabriel Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. ECON. PERSPECTIVES 4, 121–48 (2014); GABRIEL ZUCMAN, THE HIDDEN WEALTH OF NATIONS: THE SCOURGE OF TAX HAVENS, (Teresa Lavender Fagan trans., Univ. of Chicago Press 2015); and many earlier studies reviewed in de Mooij & Ederveen, *supra* note 22.

53. Jane G. Gravelle, CONG. RESEARCH SERV., R40523, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 18, (Jan. 15, 2015), https://www.fas.org/sgp/crs/misc/R40623.pdf. Similar stylized facts regarding the scale of the problem are reported by many sources, including Mark P. Keightley, CONG. RESEARCH SERV., AN ANALYSIS OF WHERE AMERICAN COMPANIES REPORT PROFITS: INDICATIONS OF PROFIT SHARING (Jan. 18, 2013), http://digitalcommons.ilr.cornell.edu/key_workplace/1006/ and Robert S. McIntyre, Richard Phillips & Pineas Baxandall, *Offshore Shell Games: The Use of Offshore Tax Havens by Fortune 500 Companies*, OSPIRG (Oct. 2015), http://ctj.org/pdf/offshoreshell2015.pdf.

54. There is a lag in data availability, so at the time of analysis, 2012 was the most recent year. Other recent years display similar patterns.

Figure 4: Top Gross Income Countries, Affiliates of U.S. Multinational Firms, 2012 (as share of Total Income)[55]



Of the top ten locations, seven of them are tax havens with effective tax rates less than 5%: Netherlands, Ireland, Luxembourg, Bermuda, Switzerland, Singapore, and the UK Caribbean Islands (including the Caymans). Effective tax rates are calculated as foreign income taxes paid by all affiliates in a given country relative to their income (net income plus foreign tax payments). These countries alone account for 50% of all foreign income earned by affiliates of U.S. multinational firms, but they only account for 5% of all foreign employment of such firms. Further, the economic size of these countries is quite small relative to this disproportionate profit; their combined population is less than that of either Spain or California.[56]

55. Clausing, *supra* note 3.

56. The data includes "income from equity investments", some of which are counted more than once if there are tiers of ownership within the same country. Unfortunately, with existing data, it is not possible to account for this double-counting accurately. Still, one can use an alternative data series, also from the Bureau of Economic Analysis, on direct investment earnings. This series eliminates the possibility of double counting, but it is also incomplete, since income from investments is excluded. Still, if one uses that series instead, the same seven countries with low effective tax rates are in the top ten countries: Netherlands, Ireland, Bermuda, Luxembourg, Singapore, the Cayman Islands, and Switzerland. Together, they account for 52% of all foreign direct investment earnings.

As noted above, estimates indicate that U.S. multinational firms have accumulated over $2 trillion in permanently reinvested earnings in low-tax locations, about half of which is held in cash. Due to the large amounts of income booked in low-tax countries and havens, the estimated costs of deferral have been increasing in recent years, and the JCT now estimates this tax expenditure at $83.4 billion for 2014. OMB estimates are somewhat lower, at $61.7 billion in 2014.[57]

The United States is not the only country with a corporate tax base erosion problem.[58] Table 3 shows that other countries are also likely to face important corporate tax base erosion problems:

Table 3: Estimates of Corporate Tax Base Erosion for Selected Countries, 2012[59]

	Estimated Profits in 17 low-tax Countries, $ billion	**Effective Tax Rate (Combined Statutory Rate - 5%)**	**Excess Income Booked in Low-tax Countries, $ billion**	**Revenue Loss (effective tax rate * share of group GDP * $1,076b), $ billion**	**Share of *all* Corporate Revenue, including subfederal**
Australia	67.7	25%	36.3	7.4	9%
Brazil	71.1	29%	46.4	13.5	17%
China	204.5	20%	79.7	32.7	11%
Czech R.	1.9	14%	0.4	0.6	8%
Denmark	7.2	20%	2.8	1.3	13%
Finland	5.3	20%	2.0	1.0	18%
France	90.5	29%	60.2	15.3	23%
Germany	80.4	25%	43.5	17.2	28%
Greece	2.2	15%	0.5	0.7	26%
India	55.0	27%	33.3	9.7	14%

57. This represents the estimated revenue cost associated with allowing deferral of the U.S. tax on foreign income until it is repatriated. *See* JOINT COMMITTEE ON TAXATION, *Estimates of Federal Tax Expenditures for Fiscal Years 2014–2018*, https://www.jct.gov/publications.html?func=startdown&id=4663 and OFFICE OF MGMT. & BUDGET, *Fiscal Year 2016 Analytical Perspectives of the U.S. Government*, https://www. whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/spec.pdf.

58. Clausing, *supra* note 3.

59. *Id.*

Indonesia	7.4	20%	2.9	3.6	8%
Italy	31.0	23%	14.3	9.0	16%
Japan	129.9	35%	105.7	39.8	18%
Norway	19.2	23%	9.2	2.3	4%
Poland	8.4	14%	1.8	1.3	13%
Portugal	8.2	27%	4.7	1.1	19%
Russia	86.7	15%	21.1	5.8	7%
S Africa	21.6	25%	11.3	1.9	9%
S. Korea	56.9	19%	20.8	4.5	10%
Spain	33.1	25%	17.7	6.6	24%
Turkey	10.6	15%	2.6	2.3	14%
U.S.	800.2	30%	545.3	93.8	26%
Total	1,836		1,076	279	20.1%

Note: For countries other than the United States, the tax rate is the combined rate of federal and sub-federal rates (when countries have sub-federal taxation); for the United States, I use the same assumption as the above analysis. Corporate tax revenue data are not available for all countries, and not all countries with estimates are shown here.[60]

This table is based on an extension of this analysis to other countries without low tax rates, finding that the tax revenue cost from profit shifting for these countries was about $280 billion in 2012.[61] These large magnitudes of corporate tax base erosion were instrumental in motivating recent Group of Twenty (G20) and OECD efforts to address corporate profit shifting. After a flurry of work in recent years and nearly 2000 pages of final project reports (issued in October 2015), the OECD/G20 process has generated recommendations that aim to better connect taxable profits to economic activity.

Yet there are reasons to suspect that profit-shifting problems will continue. Country adoption of the OECD suggestions is likely to be

60. *Id.*

61. *See id.* at 2. This analysis includes the United States and other countries that headquarter a large number of sizable multinational firms. Due to data limitations, some of the assumptions behind these estimates are more speculative than in the U.S. analysis. Most developing countries are not considered in this analysis; see Crivelli, *supra* note 52, for an analysis of the revenue costs of profit shifting for developing countries.

partial and incomplete, and the suggestions themselves are also partial and incomplete. The task faced by the OECD was difficult indeed; establishing the source of income is a daunting task in a world where firms are globally integrated and much economic value is intangible. These difficulties are compounded by the large pools of financial resources and talent being directed toward global tax minimization. Small armies of accountants and lawyers are busy developing new strategies for tax avoidance, often several steps ahead of government treasuries as well as international efforts to improve tax base definition.

The OECD/G20 effort is certainly a helpful step toward greater international cooperation in this vexing area, and some of the recommendations, such as country-by-country reporting, are significant. Still, it remains to be seen whether these steps will be enough to stem the growing problem of tax base erosion due to profit shifting. Eventually, countries may turn to more fundamental reforms.

V. Reform Options

A. Why Bother?

Before discussing reform options, it is helpful to recall the usefulness of the corporate tax in the broader tax system. Otherwise, there would be the temptation to throw up one's hands and allow the corporate tax to wither away, leaving firms as tax competitive as possible. Yet a healthy corporate tax is important for several reasons.

The corporate tax is an essential tool for taxing capital income. Without a corporate tax, much income of profitable firms would go untaxed since many equities are held in tax-exempt form. A majority of individual passive income is held in tax-exempt form through pensions, retirement accounts, life insurance annuities, and non-profits, and new evidence suggests that perhaps as little as one-quarter of U.S. equities are held in accounts that are taxable by the U.S. government.[62] In addition, replacing corporate taxation with individual taxation would either worsen the lock-in problem for capital

62. Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, Tax Notes 926 (May 13, 2016), http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000790-The-Dwindling-Taxable-Share-of-U.S.-Corporate-Stock.pdf; *see also* Leonard E. Burman & Kimberly A. Clausing, *Is U.S. Corporate Income Double-Taxed?* (Nov. 2016) (working paper).

gains or necessitate mark-to-market taxation.[63] Mark-to-market taxation would raise liquidity concerns and increase the instability of the tax base in times of market fluctuations. Further, without a corporate tax, the corporate form could also provide a tax-sheltering opportunity, particularly for high-income individuals. Sheltering opportunities exist when corporate rates fall below personal income tax rates and corporations retain a large share of their earnings.[64]

The corporate tax adds progressivity to the tax system. Corporate taxes fall primarily on shareholders and capital-owners, not employees. The best cross-country evidence shows *no clear link* between levels of corporate taxation and wages.[65] A review of the prior literature and an exhaustive examination of cross-country evidence is provided in other articles by the author; no wage effects from corporate taxation were found.[66] Even if the corporate tax were to fall partially on labor, it is important to note that most alternative tax instruments to finance government fall *entirely* on labor.

Further, capital income is far more concentrated than labor income, and capital income has become a larger share of GDP in recent decades, making the corporate tax an important part of the progressivity of the tax system.[67] Since income inequality has increased dramatically in recent years,[68] the equity case for taxing capital is stronger. In addition, recent economic theory has buttressed the

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63. Mark-to-market taxation would tax capital gains based on the current market value of an asset, even if gains had yet to be realized.

64. JANE G. GRAVELLE & THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., RL34229, CORPORATE TAX REFORM: ISSUES FOR CONGRESS (2011), http://www.cfr.org/united-states/congressional-research-service-corporate-tax-reform-issues-congress/p26926. A reduced corporate tax rate of 27% would provide sheltering opportunities for corporations that distribute less than 73% of their earnings. *Id*.

65. Cross-country evidence is needed to consider the open-economy tax incidence mechanism that suggests capital will move in response to taxation, lowering the marginal product of labor and wages in high-tax countries.

66. *See* Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 434 (2012); Kimberly A. Clausing, *Who Pays the Corporate Tax in a Global Economy?* 66 NAT'L TAX J. 151, 152 (2013).

67. This is confirmed by several different sources documented in Jacobson and Occhino. Margaret Jacobson & Filippo Occhino, *Labor's Declining Share of Income and Rising Inequality*, ECON. COMMENT., Sept. 25, 2012, 1, 1–2. Data collected from the BEA, the BLS, and the CBO confirm these trends.

68. KIMBERLY A. CLAUSING, WASHINGTON CENTER FOR EQUITABLE GROWTH, STRENGTHENING THE INDISPENSABLE U.S. CORPORATE TAX 21 (2016) (summarizing income inequality trends), http://cdn.equitablegrowth.org/wp-content/uploads/2016/09/12110047/091216-corporate-tax.pdf.

efficiency case for taxing capital.[69] This work suggests that the economic rationale for robust capital taxation is alive and well.[70] In models with real world features such as finitely-lived households, bequests, imperfect capital markets, and savings propensities that correlate with earning abilities, capital taxation has an important role to play in an efficient tax system.

Henceforth, I will take as given the desirability of preserving the corporate tax. The remainder of the Article will discuss fundamental reform options for the corporate tax, focusing on three possible reforms: 1) a move toward a purer territorial system, 2) a worldwide consolidation system, and 3) formulary apportionment.[71]

B. A Tough Territorial System?

As discussed above,[72] a territorial system could easily raise tax burdens on foreign income for U.S. multinational firms. Yet the multinational corporate community advocates for a territorial system that would instead *lighten* the U.S. tax treatment of foreign income, and the political process may indeed generate such an outcome. While moving toward the pure territorial end of the tax system spectrum would reduce any concerns about competitiveness and tax disincentives for repatriation, it comes with a distinct downside. In particular, exempting foreign income from taxation entirely would dramatically relax the remaining constraint on shifting income abroad; this downside has the potential to generate large revenue losses.

A tough territorial system would be a better compromise between competing tax system goals, though it may generate political economy concerns if one expects the "toughness" to be challenged or eroded over time. Still, there are several ways to combine a territorial system (that would remove the lock-out effect on repatriating dividends) with

69. Kimberly A. Clausing, *The Future of the Corporate Tax*, 66 TAX L. REV. 419, 425–28 (2013) (reviewing recent economic theory).

70. Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Inheritance Taxation*, 81 ECONOMETRICA 1851 (2013); Emmanuel Farhi et al., *Non-Linear Capital Taxation Without Commitment*, 79 REV. ECON. STUD. 469 (2012); Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSPS. 165 (2011); Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Capital Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 17989, 2012).

71. Discussion of formulary apportionment and worldwide consolidation borrows from prior work produced by the author, including Clausing, *supra* note 17, at 21–29, and Clausing, *supra* note 3.

72. *See Supra* Part II.

base protection measures. Such measures would need to be carefully designed so that they are not subject to work-arounds. Fleming, Peroni, and Shay offer a careful analysis of some measures that would be helpful including an updated Subpart F regime,[73] disqualification from exemption for royalty income,[74] and a realistic allocation of expenses to foreign source income.[75] Others have emphasized a minimum tax approach, including the most recent proposals from the Obama Administration.[76] Still, Fleming, Peroni, and Shay warn that many recent proposals to move toward exemption have fundamental weaknesses,[77] raising important concerns about base erosion[78] and profit shifting.[79]

Thus, while it is possible to design a "tough" territorial system, caution is warranted about whether the requisite political will can be mustered to make such a system suitably tough. Since the main push for adopting a territorial system comes from business interests that would oppose truly "tough" features of a territorial regime, the details of any such proposal are crucial.

C. Worldwide Consolidation

Under worldwide consolidation discussed by the JCT and favored by Kleinbard and Avi-Yonah, a multinational firm would be required to consolidate the income earned across the parent firm and its affiliates, and all income would be taxed currently, allowing a credit for foreign taxes.[80] JCT summarizes the approach, applied to the United States:

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73. 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, 425–28 (2012).

74. *Id.* at 431–34.

75. *Id.* at 451–52.

76. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 19 (2015), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

77. Stephen E. Shay, J. Clifton Fleming Jr. & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173, 174 (2013).

78. *Id.* at 191–203.

79. *Id.* at 189, 203 n.142.

80. STAFF OF JOINT COMM. ON TAXATION, *supra* note 5; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 101 (2011); Reuven S. Avi-Yonah, *Hanging Together: A Multilateral Approach to Taxing Multinationals* 1–2 (U. Mich. Law & Econ.

> The U.S. group would include on its return the foreign corporation's items of income, gain, deduction and loss, the character of such items would be preserved, and the foreign tax credit would be retained.
>
> [U]nder the consolidation approach, losses of foreign subsidiaries would be included on the U.S. return . . . [and] apply only to U.S. corporate shareholders of foreign subsidiaries.[81]

One pragmatic issue concerns the degree of ownership that would act as a threshold for the required consolidation: options discussed by JCT include 80%, 50%, and 10%.[82]

A worldwide consolidation approach has several benefits relative to the current system: there would be less tax-motivated shifting of economic activity or less book income to low-tax locations, since such shifting would be less likely to affect a multinational firm's overall tax burden.[83] There would thus be fewer concerns about inefficient capital allocation or corporate tax base erosion. Also, there would be no "trapped cash" problem since income would be taxed currently.

However, depending in part on the corporate tax rate that would accompany this change, the proposal may still raise competitiveness concerns for those U.S. multinational firms with rising foreign tax burdens under consolidation. Of course, if the U.S. corporate tax rate were lowered substantially alongside this change, as proponents typically suggest, this would reduce the concerns about decreased competitiveness.

Some also worry that this proposal would put stress on the definition of residence. Although some have argued that residence is increasingly elective,[84] others contend that relatively simple legislation would make it difficult to change residence for tax purposes. Governments could require that corporate residence indicate the true location of the "mind and management" of the firm; Avi-Yonah and

Working Papers, Paper No. 116, 2015), http://repository.law.umich.edu/law_econ_current/116.

81. STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 100–01.

82. *Id.* at 101.

83. For firms with excess tax credits, there would still be an incentive to avoid earning income in high-tax countries and to instead earn income in low-tax countries. Excess tax credits are only likely if the average effective foreign income tax rate exceeds the residence country tax rate.

84. *See, e.g.*, Daniel Shaviro, *The Rising Tax-Electivity of US Corporate Residence*, 64 TAX L. REV. 377 passim (2011).

Kleinbard suggest that a similar UK definition of residence would be effective.[85] It is also feasible to develop anti-inversion measures along the lines of those suggested above.

Finally, while there is little real-world experience with such a system, it still falls within international norms since it prevents double-taxation by offering foreign tax credits. The proposal could be implemented without disadvantaging major trading partners, and adopted unilaterally, though Avi-Yonah recommends that countries take a multilateral approach.[86]

This proposal has some advantages over simply ending deferral. While eliminating deferral (presumably alongside a corporate tax rate reduction) would entail some of the same tradeoffs illustrated here (less distortion to repatriation decisions, reduced income shifting, more efficient capital allocation, potential competitiveness concerns, and a greater stress on the definition of residence), it would not truly consolidate the affiliated parts of a multinational firm. Under worldwide consolidation, for example, if losses are earned in foreign countries, they can be used to offset domestic income.

D. Formulary Apportionment

Under formulary apportionment, worldwide income would be assigned to individual countries based on a formula that reflects their real economic activities. Some favor a three-factor formula (based on sales, assets, and payroll), but others, including Avi-Yonah and Clausing, have suggested a single-factor formula based on the destination of sales.[87]

The essential advantage of the formulary approach is that it is provides a concrete way for determining the source of international income that is not sensitive to arbitrary features of corporate behavior such as a firm's declared state of residence, its organizational structure, or its transfer pricing decisions. Thus, if a multinational firm changes

85. Kleinbard, *supra* note 80, at 156 (2011); *see* Avi-Yonah, *supra* note 80, at 7-8.

86. Avi-Yonah, *supra* note 80, at 2.

87. *E.g.*, Reuven S. Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, *in* PATH TO PROSPERITY: HAMILTON PROJECT IDEAS ON INCOME SECURITY, EDUCATION, AND TAXES 319, 319 (Jason Furman & Jason E. Bordoff eds., 2008). As an example, if a multinational company earned $1 billion worldwide and had 30% of its payroll and assets in the United States but 60% of its sales in the United States, its U.S. tax base would be $400 million under an equal weighted formula (((.3+.3+.6)/3) * $1 billion), and $600 million under a single sales formula ((.6) * $1 billion).

these variables, it would not affect its tax burden under formulary apportionment.[88]

Importantly, the factors in the formula are real economic activities, not financial determinations. Saez, Slemrod, and Giertz; Slemrod and Bakija; and Auerbach and Slemrod summarize a vast body of research on taxation that suggests a hierarchy of behavioral response: real economic decisions concerning employment or investment are far less responsive to taxation than are financial or accounting decisions.[89] For multinational firms, this same pattern is clearly shown in the data. There is no doubt that disproportionate amounts of income (compared to assets, sales, or employment) are booked in low-tax countries.[90]

In this way, a formulary approach addresses aspects of both the competitiveness and tax base erosion concerns. Firms have no incentive to shift paper profits or to change their tax residence, since their tax liabilities are based on their real activities. However, concerns about efficient capital allocation may remain. Under a three-factor formula, there is still an incentive to locate real economic activity in low-tax countries, which raises concerns regarding efficient capital allocation. This is somewhat less of a concern under a sales-based formula, since firms will still have an incentive to sell to customers in high-tax countries regardless.[91] Also, prior experience in the United States, which uses formulary apportionment to determine the corporate tax base of U.S. states, has indicated that formula factors (payroll, assets, and sales) are not particularly tax-sensitive.[92]

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88. This assumes that the multinational firm has a taxable presence (i.e., nexus) in the locations where it has employment, assets, and sales.

89. *See* Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LITERATURE 3 (2012); JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES (5th ed. 2008); Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. ECON. LITERATURE 589 (1997).

90. *E.g.*, Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT'L TAX J. 703, 720 (2009); Kimberly A. Clausing, Commentary, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580, 1580 (2011); Clausing, *supra* note 3, at 1.

91. This is particularly the case for final goods. For intermediate goods, this is more problematic.

92. See Kimberly A. Clausing, *The U.S. State Experience Under Formulary Apportionment: Are there Lessons for International Taxation?*, 69 NAT'L TAX J. 353 (2016) for an in-depth analysis of this question. Whether this tax-insensitivity would hold at higher corporate tax rates

If all countries were to adopt formulary apportionment, there would be few concerns about competitiveness. Multinational firms would be taxed based on their real economic activities (in terms of production and sales) in each country, so firms would be on an even-footing with other firms (based in different countries) with similar local operations. If only some countries adopt formulary apportionment, it is uncertain what competitive effects would result; such effects likely depend on the circumstances of particular firms.[93] Ideally, formulary apportionment would be adopted on a multilateral basis. However, if some countries adopt, there are mechanisms that would encourage other countries to follow early adopters.[94]

Another related approach is to utilize a formulary profit-split method. The tax base would be calculated as a normal rate of return on expenses, with residual profits allocated by a sales-based formula. With careful implementation, such an approach might lessen concerns regarding tax competition under a formulary approach. Elsewhere, I provide more detail on the advantages and disadvantages of formulary approaches.[95]

VI. CONCLUSION

There is nearly universal agreement that the U.S. system of international corporate taxation is in desperate need of reform. The system is distortionary along many margins, and the U.S. government raises less revenue (as a share of GDP) than most peer countries. Foreign countries often have tax systems that appear quite different than the U.S. tax system: they have lower statutory rates and they purport to exempt foreign income from taxation. Still, if we look beyond the labels, multinational firms face similar *effective* tax burdens in the United States and elsewhere, and most major countries have

is an empirical question. Still, the forces of tax competition (mobility of production, competitive pricing, etc.) are likely stronger between U.S. states than between foreign countries.

93. This also generates the potential for double-taxation or double non-taxation, although this is also a problem under the present system.

94. Avi-Yonah, *supra* note 87, at 319–44 (explaining that there is a natural incentive for countries to adopt formulary apportionment). In particular, once some countries adopt formulary apportionment, remaining separate accounting (SA) countries would lose tax base, since income can be shifted away from SA countries to FA countries without affecting tax burdens in FA locations (since they are based on a formula). *See id.*

95. *See generally id.*; Reuven S. Avi-Yonah et al, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

hybrid systems of international taxation, with both territorial and worldwide aspects.

Nonetheless, the U.S. system does have distinctive features: the combination of deferral and insufficient base protection measures generates vexing problems. These include “lock-out” effects that deter firms from repatriating income to shareholders, due in part to hopes for more favorable tax treatment in the future; there are also incentives to undertake corporate inversions if such hopes appear futile.

Many observers emphasize the elements of the U.S. tax system that are exceptional in order to argue for tax reforms that would bring the U.S. system “in line” with those in other countries; such observers often fear that U.S. multinational firms have a “competitiveness” problem. Yet close inspection of markers of “competitiveness” indicate that U.S. multinational firms are competitive, both in terms of narrow notions of tax competitiveness and in general.

Still, the status quo also generates large revenue losses due to profit shifting that likely exceed $100 billion per year at present. The data suggest that corporate tax base erosion is a substantial and increasing problem. Proposals to move the United States toward the “pure territorial” end of policy spectrum would make this problem worse.

Better reform options range from incremental proposals to a wholesale rethinking of how we tax multinational firms. Incremental changes that would improve the U.S. tax system include a lowering of the statutory tax rate combined with serious corporate tax base protection measures including tougher earnings stripping rules, stricter anti-inversion provisions, and minimum taxes on foreign income. Such measures would help stem corporate tax base erosion and reduce the inefficiencies associated with a high statutory rate. Yet none of these measures would address the fundamental problem of determining the source of income in a global economy where corporate tax-payers are agile and highly globally-integrated. Two fundamental reform options show more promise in this regard: worldwide consolidation and formulary apportionment. Regardless of the reform path chosen, corporate tax reform should pay careful attention to details. A healthy corporate tax has an important role to play in the tax system for reasons of efficiency, equity, and revenue.