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## Running from the United States Treasury: The Need to Reform the Taxation of Multinational Corporations, 43 J. Marshall L. Rev. 1041 (2010)

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# RUNNING FROM THE UNITED STATES TREASURY: THE NEED TO REFORM THE TAXATION OF MULTINATIONAL CORPORATIONS

JENNIFER BARTON\*

## I. THE UNITED STATES SYSTEM OF TAXATION

### A. *The Corporate Income Tax*

“Where there is an income tax, the just man will pay more and the unjust less on the same amount of income.”<sup>1</sup> Plato’s words hold true in the United States (U.S.), where the government produces a majority of its revenue through income taxes.<sup>2</sup> The U.S. government asserts jurisdiction to tax income based on both nationality and territoriality.<sup>3</sup> Corporations<sup>4</sup> are subject to taxes

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\* Jennifer Barton is a third-year student at The John Marshall Law School and currently serves as a Student Publications Editor of The John Marshall Law Review. She would like to thank Professor Marc Ginsberg for all of his guidance and inspiration throughout her years in law school. Jennifer would also like to thank her family and friends, especially Ralph, Rick, and Barb Barton, for all of their support and help along the way.

1. IRS, Tax Quotes, <http://www.irs.gov/newsroom/article/0,,id=110483,00.html> (last visited Dec. 3, 2010) (quoting PLATO, THE REPUBLIC).

2. See Robertson Williams, Tax Policy Center, Urban Institute and Brookings Institution, *Where Does Federal Revenue Come From?* (June 4, 2007), [http://www.urban.org/UploadedPDF/1001082\\_federal\\_revenue.pdf](http://www.urban.org/UploadedPDF/1001082_federal_revenue.pdf) (noting that individual income taxes and payroll taxes account for nearly eighty percent, corporate taxes account for about thirteen percent, and excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts bring in about seven percent of government revenue).

3. This simply means that the government may tax income based on both residence and source. Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 175 (2008) (citing I.R.C. §§ 61; 872(a); 882(b) (2006)). To further explain, suppose a U.S. corporation is doing business in Italy. The corporation will be subject to taxation in the U.S. based on residence because the U.S. is where the corporation is incorporated. See Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 835 n.3 (2000) (defining a corporation’s residence as “the country in which it is managed or incorporated,” and an individual’s residence as where he or she resides). This exercise in jurisdiction based on residence is justified because companies generate many benefits from being a resident of a country and firms should contribute toward the public services provided for them by the country where they live. Reuven Avi-Yonah, Tax Justice Network, Tax Justice Briefing:

on their annual worldwide income earned, just as individual U.S. residents and citizens are required to pay income tax on their annual worldwide income earned.<sup>5</sup> This U.S. system of taxation is a varied form of a worldwide system.<sup>6</sup>

The shifting of technology across borders and the improvements in communication and transportation capabilities have made the world smaller and allowed for an increase in international trade.<sup>7</sup> In turn, regulating and enforcing corporate income taxes generated abroad has become increasingly difficult.<sup>8</sup>

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Source and Residence Taxation (Sept. 15, 2005), <http://www.taxjustice.net/cms/upload/pdf/Sourceresidence.pdf>. Also, the corporation will be subject to taxation in Italy because income was generated in that location. See WEST'S TAX LAW DICTIONARY 988 (2008) (defining source of earned income as "[t]he place where the taxpayer performs the services resulting in income"). The exercise in jurisdiction is justified because countries should have the right to tax companies when a host country provides the company with the opportunity for the production of income. Avi-Yonah, *supra*, at 1.

4. See I.R.C. § 11 (2006) (imposing a tax for each taxable year on the taxable income of every corporation); see also I.R.C. § 7701(a)(4) (2006) (defining a domestic corporation as a corporation created or organized in the U.S. or under the laws of the U.S. or of any state).

5. See I.R.C. § 61 (providing that except as otherwise noted, "gross income means all income from whatever source derived"). The IRS and the courts have held that I.R.C. § 61 includes worldwide income, which merely means any money earned in the U.S. or overseas. Vern Jacobs & J. Richard Duke, *The Offshore Tax Gauntlet*, THE OFFSHORE PRESS, 2004, <http://www.offshorepress.com/ostaxgauntlet.htm>; Kay Bell, *Taxpayers abroad can limit U.S. taxes: Tax Tip No. 45*, BANKRATE'S 2009 TAX GUIDE, Apr. 3, 2009, <http://www.bankrate.com/finance/money-guides/taxpayers-abroad-can-limit-u-s-taxes1.aspx>. Thus, under U.S. tax laws, all U.S. citizens, residents, and corporations are subject to U.S. taxation on income earned worldwide. *Id.*

6. See Chorvat, *supra* note 3, at 838-39 (citing I.R.C. §§ 1, 11, 61, and 901 (2006)) (defining a worldwide system as one "in which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions").

7. See U.S. Census Bureau, *U.S. Trade in Goods and Services-Balance of Payments (BOP) Basis* (June 10, 2009), available at <http://www.census.gov/foreign-trade/statistics/historical/gands.pdf> (noting that in 1960, the U.S. exported approximately \$25 billion and imported about \$22 billion worth of goods and services); see also U.S. Census Bureau, *U.S. International Trade in Goods and Services*, U.S. BUREAU OF ECON. ANALYSIS, Aug. 2009 (noting, in contrast, that in August 2009 exports were 128.2 billion dollars and imports 158.9 billion dollars).

8. See *Challenges Remain in Combating Abusive Tax Shelters: Testimony Before the Comm. of Fin., U.S. Senate*, 04 United States General Accounting Office Highlights 104T, at 6 (Oct. 21, 2003) (statement of Michael Brostek, Director of Tax Issues) [hereinafter *Testimony before the Comm. of Fin.*], available at <http://www.gao.gov/new.items/d04104t.pdf> (discussing how companies manipulate the tax code, because of the complexity and the large number of loopholes).

### B. The Need for Reform

This Comment will argue that the U.S. system of taxing multinational corporate income needs to be reformed<sup>9</sup> because, as Plato pointed out so many years ago regarding taxpayers in his own time, multinational corporations (MNCs) are paying less money in taxes by avoiding them in every way possible. This Comment is divided into four parts. Part II will explore the taxation of MNCs both in the current U.S. system and on a global spectrum. It will also discuss the strategies many companies are using to avoid taxation of their income. Part III will analyze three different approaches that could be used to reform the current system and each approach's strengths and weaknesses. Specifically, it will focus on formulary apportionment, a territorial system, and the general approach to eliminate loopholes and raise taxes. Part IV will propose that the U.S. should adopt a hybrid of the formulary system and the territorial system of taxation.

## II. U.S. TAXATION OF MNCs AND THE GLOBAL WORLD

### A. U.S. Taxation of MNCs

A general rule under the U.S. varied worldwide system of taxation is that U.S. based MNCs are subject to U.S. taxation on their worldwide income, no matter where or how it was earned.<sup>10</sup> Congress, however, has introduced a number of rules and regulations that apply to foreign-sourced income in an attempt to protect corporations from double taxation.<sup>11</sup> Often, this protection comes in the form of a limited exclusion of a credit<sup>12</sup> or a deduction

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9. A MNC is "a large corporation with operations and subsidiaries in several countries." RANDOM HOUSE UNABRIDGED DICTIONARY 1263 (2d ed. 1993). Usually the corporation has its headquarters in one country and operates subsidiaries in other countries, which report to the headquarters in the first country. *Id.* A subsidiary is defined as "a company whose controlling interest is owned by another company." *Id.* at 1886.

10. The corporate income tax was first enacted in 1894 and since has been a highly debated and controversial issue. GARY CLYDE HUFBAUER & ARIEL ASSA, U.S. TAXATION OF FOREIGN INCOME 26 (Peterson Inst. For Int'l Econ. 2007) [hereinafter ASSA]. Passive income, such as "dividends, interest, royalties, and similar kinds of income received by U.S. persons" is subject to U.S. income taxation. Chorvat, *supra* note 3, at 841 (citing I.R.C. § 61). The varied worldwide system is in place to prevent taxpayers from making decisions on where to locate production and headquarters based on tax consequences. ASSA, *supra*, at 52, 54.

11. PAUL R. MCDANIEL, HUGH J. AULT & JAMES R. REPETTI, INTRODUCTION TO U.S. INT'L TAXATION 87 (Kluwer Law Int'l 5th ed. 2005) [hereinafter INTRO. TO U.S. INT'L TAXATION].

12. I.R.C. §§ 27, 901-908 (2006). The foreign tax credit is limited to companies for foreign-sourced income taxes paid to foreign governments. *Id.*; ASSA, *supra* note 10, at 176-77, 179. The credit does not apply, for example, to foreign paid property taxes. *Id.*

from a corporation's gross income of foreign income taxes paid on income derived from foreign sources.<sup>13</sup> Some foreign-sourced income is also exempted from U.S. taxation by treaty.<sup>14</sup>

The U.S. system is not a pure worldwide system because the government, for the most part, exempts the earnings of foreign subsidiaries of U.S. corporations from U.S. taxation.<sup>15</sup> This

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13. See I.R.C. § 164 (2006) (allowing as a deduction foreign income taxes for the taxable year within which paid or accrued). There are many limitations to these two elections, and the taxpayer can usually only utilize the foreign tax credit or deduct the foreign income taxes paid from the corporation's tax return. INTRO. TO U.S. INT'L TAXATION, *supra* note 11, at 87. It is to the advantage of the taxpayer to "elect the foreign tax credit rather than the deduction," because the credit is a dollar-for-dollar offset against U.S. tax liability. *Id.* The deduction "is limited to the amount of foreign income taxes multiplied by the taxpayer's marginal [U.S.] tax bracket." *Id.* As mentioned, not all types of foreign taxes are creditable or deductible. ASSA, *supra* note 10, at 176-77, 179. Here is an example of a credit election: suppose Company Z is a U.S.-based MNC. Chorvat, *supra* note 3, at 840. The company earned \$100 in Italy, which assume for this problem has a corporate tax rate of eleven percent, and the company earned \$100 in the U.S., which has a corporate tax rate of thirty-five percent. *Id.* Italy will tax the company \$11 and the U.S. will tax it \$70, as the U.S. taxes both the \$100 earned in Italy and the \$100 earned in the U.S. at the thirty-five percent rate. *Id.* But if the company elects a tax credit, the company is only taxed by the U.S. for \$59, rather than \$70. *Id.*

14. Roin, *supra* note 3, at 176. The U.S. has income tax treaties with a number of foreign countries. IRS, Tax Treaty Overview, <http://www.irs.gov/businesses/small/international/article/0,,id=96454,00.html> (last visited Dec. 3, 2010). Generally the treaties apply to a foreign citizen living in the U.S. who becomes exempt from U.S. taxes due to the treaty or a U.S. citizen living in a foreign jurisdiction who becomes exempt from taxation by the foreign jurisdiction. *Id.* The exceptions are limited where U.S. taxes are reduced for the benefit of a U.S. citizen or resident. *Id.*

15. I.R.C. § 882(b) (2006); I.R.C. § 7701 (2006); Chorvat, *supra* note 3, at 841. A parent corporation and its corporate subsidiary are recognized as separate taxable entities, allowing the earnings of the foreign subsidiary to be exempted from U.S. tax. *Id.* The company avoids paying source country tax because the taxation is derived in exempt form, and the company avoids paying residence taxation because the entity resides in a foreign jurisdiction. Roin, *supra* note 3, at 176. There is a limitation on this concept, which is that the purpose for incorporation of the subsidiary must be the equivalent of business activities or the subsidiary must subsequently carry on business activities. *Moline Properties, Inc. v. Comm'r*, 319 U.S. 436, 438 (1943); *Britt v. United States*, 431 F.2d 227, 234 (5th Cir. 1970). This means that a corporation needs to have a good faith basis to operate an actual business function, and its existence cannot be solely for tax deferral purposes. Chorvat, *supra* note 3, at 842. The subsidiary will not be exempt from U.S. taxation when there is a finding that the entity or transaction was a sham, meaning performed solely for the tax exemption. Toussaint Tyson & Gerald V. Sack, *IRC 7701-General Discussion*, 1992 EO CPE Text (1992), available at <http://www.irs.gov/pub/irs-tege/eotopici92.pdf>. (citing *Moline Properties, Inc.*, 319 U.S. at 438; *Britt*, 431 F.2d at 234; I.R.S. G.C.M. 39326 (Jan. 17, 1985); I.R.S. G.C.M. 35719 (Mar. 11, 1974)).

There is also an exception to the rule on subsidiary taxation, which is a controlled foreign corporation (CFC). I.R.C. § 957 (2006); Roin, *supra* note 3, at

benefits many companies that have a presence abroad because it allows tax payments to be deferred until the profits earned are brought back into the U.S.; this tax break is generally called deferral.<sup>16</sup> One of the reasons for deferral is that the U.S. cannot tax a foreign corporation if its income is not effectively connected with conduct of a trade or business within the U.S.<sup>17</sup> Once the income is effectively connected with conduct of a trade or business within the U.S., then it will become subject to U.S. taxation.<sup>18</sup> When profits are brought back into the U.S., they are usually in the form of a dividend from a foreign subsidiary to its U.S. parent.<sup>19</sup> But often the money never comes into the reach of the U.S. treasury so it is never subject to taxation.<sup>20</sup>

In 1997, Congress adopted the entity classification

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n.19. A CFC is a foreign corporation in which more than “50 percent of either the total combined voting power of all classes of stock entitled to vote or of the total value of all stock is owned by U.S. shareholders.” *Id.*; INTRO. TO U.S. INT’L TAXATION, *supra* note 11, at 115. CFCs are governed by a separate category of rules under Subpart F of the IRC and all income earned by CFCs in tax haven jurisdictions are fully taxed by the U.S. treasury without deferral. ASSA, *supra* note 10, at 68; Roin, *supra* note 3, at n.19.

16. Citizens for Tax Justice, *Taxing Multinational Corporations*, at 1 (Mar. 1993, updated 2006) [hereinafter Citizens for Tax Justice], available at <http://www.ctj.org/pdf/fortaxcredit.pdf>. A second way to describe deferral: when income is earned indirectly by a foreign subsidiary, the income is not taxed until it is repatriated to the U.S. Chorvat, *supra* note 3, at 841. This tax is also referred to as the repatriation tax. *Id.*

17. See I.R.C. § 882 (2006) (stating that taxable “gross income includes only gross income which is effectively connected with the conduct of a trade or business within the [U.S.]”). A foreign subsidiary is not effectively connected to the U.S. because its profits are not earned in the U.S., nor is it a resident of the U.S. *Id.*; Chorvat, *supra* note 3, at 841.

The original motivation for the implementation of deferral stemmed from the role of the U.S. in the world economy post-World War II. Interview with Ronald Domsy, Income Tax Professor, The John Marshall Law School, in Chicago, Ill. (Oct. 7, 2009); ASSA, *supra* note 10, at 2. The U.S. emerged as the world’s dominant political and economic power, and it took the political and military lead in rebuilding the world economy. *Id.* In doing so, Congress created incentives, some in the form of deferral, for companies to invest abroad in an attempt to create and maintain U.S. presence in the global world. *Id.* The practice has been maintained, for the most part, for political reasons. *Id.*

18. Once the income is effectively connected with conduct of a trade or business within the U.S., then it will become subject to U.S. taxation. I.R.C. § 882 (2006).

19. It is also important to note that companies are usually not required to report this type of foreign income on their U.S. tax returns until they are repatriated to the U.S. Citizens for Tax Justice, *supra* note 16, at 1. When repatriation occurs, the income is usually in the form of a dividend payment and the dividends are paid out of the after-tax income of foreign subsidiaries. *Id.* The U.S. foreign tax credit mentioned above can then be elected. *Id.*

20. See generally ASSA, *supra* note 10 (focusing on the incentives that the U.S. tax system provides companies to shift their production activities and headquarters overseas, and how these incentives facilitate U.S. tax evasion).

regulations under Section 7701 of the Internal Revenue Code (IRC), also referred to as the check-the-box regulations.<sup>21</sup> These check-the-box regulations drastically changed the rules governing classification of entities for federal income tax purposes.<sup>22</sup> Congress enacted the regulations to make it easier to determine how to treat a foreign entity connected to a U.S. corporation for U.S. tax purposes.<sup>23</sup> The regulations essentially allow taxpayers the freedom to choose the tax status of their foreign business entity.<sup>24</sup> U.S. based MNCs consolidate their foreign activities under an offshore holding entity and then simply check-the-box.<sup>25</sup> These rules have allowed U.S. firms to make subsidiaries essentially disappear for U.S. tax purposes.<sup>26</sup>

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21. I.R.C. § 7701 (2006); ASSA, *supra* note 10, at 62.

22. Pillsbury Tax Page, *Internal Revenue Service Adopts "Check-the-box" Classification Regulations*, P'SHIP TAX BULLETIN, Dec. 1996, <http://pmsstax.com/part/bull9612.shtml>.

23. Yet it is still difficult to determine whether an entity is to be treated as a corporation or as a transparent partnership under U.S. law, and the regulations permit hybrid entities. Gary Clyde Hufbauer & Jisun Kim, *U.S. Taxation of Multinational Corporations: What Makes Sense, What Doesn't*, PB09 PETERSON INST. FOR INT'L ECON. 07, at 4 (Mar. 2009) [hereinafter Hufbauer & Kim], available at <http://www.iie.com/publications/pb/pb09-7.pdf>. "A hybrid entity is an entity that is classified differently under the laws of different countries." *Id.* at 4 n.15. Suppose entity Z is formed in China by a U.S.-based MNC. *Id.* Ascertaining how to tax income earned by entity Z in the U.S. is very complex. *Id.* China and the U.S. likely have different definitions of how to label entity Z: one country may treat entity Z as a corporation and the other as a transparent partnership. *Id.*

24. See Interview with Ronald Domsy, *supra* note 17 (noting that I.R.C. § 7701 allows a company to merely check-the-box when identifying an entity).

25. See I.R.C. § 7701 (2006) (defining the various entities); ASSA, *supra* note 10, at 63.

26. THE WHITE HOUSE, EXECUTIVE OFFICE OF THE PRESIDENT, PRESS RELEASE, LEVELING THE PLAYING FIELD: CURBING TAX HAVENS AND REMOVING TAX INCENTIVES FOR SHIFTING JOBS OVERSEAS 8 (2009), [http://www.whitehouse.gov/the\\_press\\_office/](http://www.whitehouse.gov/the_press_office/) [hereinafter PRESS RELEASE]; Entity Classification Working Group, *Talking Points-Why the Obama Administration's "Check-the-Box" Proposal is the Wrong Proposal at the Wrong Time*, Pace 4 Jobs, at 1 (Aug. 25, 2009), available at <http://www.pace4jobs.org/files/Check-the-Box%20-%20Key%20Points.pdf>.

These regulations also encourage, and international tax allows, a number of arbitrage opportunities, which are often used in an effort to avoid U.S. taxation. THEO EICHER, JOHN MUTTI & MICHELLE TURNOVSKY, *INTERNATIONAL ECONOMICS* 596 (7th ed. 2009). Arbitrage is defined as "the simultaneous purchase and sale of the same securities, commodities, or foreign exchange in different markets to profit from unequal prices." RANDOM HOUSE UNABRIDGED DICTIONARY, *supra* note 9, at 107. For example, suppose that a U.S. corporation that manufactures baking pans creates a subsidiary to perform the manufacturing in France. Roin, *supra* note 3, at 181-82. The Baking pans cost \$60 to make. *Id.* The French subsidiary sells the baking pans to a related entity in a low tax country, for example, Ireland, for \$62. *Id.* The entity in Ireland sells them to another related company in the U.S. for \$80. *Id.* That U.S. Company sells them to customers for \$90, after incurring an

### B. *The Global World and the Impact on U.S. MNCs*

On a global spectrum, corporate tax rates vary significantly between countries.<sup>27</sup> Data from the Organization for Economic Cooperation and Development (OECD) shows that the average tax rate of all industrialized OECD nations is 26.5%.<sup>28</sup> In contrast, the U.S. imposes an average combined federal and state statutory rate of 39.1%, which is the second highest rate among industrialized countries.<sup>29</sup> Companies gain tax advantages by moving their operations and investments to countries where there are low tax rates.<sup>30</sup> The high U.S. corporate tax rate and the U.S. varied worldwide system create incentives for taxpayers to place capital in foreign jurisdictions.<sup>31</sup>

Simply stated, a U.S.-based MNC has three options. First, it can maintain its operations in the U.S. and pay U.S. corporate income tax. Second, it can generate business income abroad and pay U.S. taxes while electing a credit or a deduction for foreign-sourced income taxes paid.<sup>32</sup> It should be noted that this option

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additional cost of about \$5 per pan. *Id.* This means that the first baking pan company pays \$2 in U.S. taxes, and the last U.S. company pays \$5 in U.S. taxes. *Id.* The company that makes the most income out of this transaction, \$18, does not pay U.S. taxes, but is subject to Ireland's taxes, which is a much lower corporate rate. *Id.* See SCOTT A. HODGE & ANDRE DAMMERT, U.S. LAGS WHILE COMPETITORS ACCELERATE CORPORATE INCOME TAX REFORM, Fiscal Fact No. 184, at 4, (Aug. 2009), available at <http://www.taxfoundation.org/publications/show/24973.html> (noting that Ireland is considered a low-tax country, and has tremendously benefited from capital flight of companies from high-tax jurisdictions).

27. HODGE & DAMMERT, *supra* note 26, at 1.

28. OECD nations include France, Belgium, Canada, Germany, and United Kingdom. See *id.* at 1 (noting that countries such as Canada, the Czech Republic, and Sweden have cut their corporate tax rates in 2009, thus lowering the average statutory corporate tax rate for all OECD nations).

29. The combined rate is calculated by adding the federal corporate rate to the average state corporate rate. *Id.* The only country with a higher combined corporate income tax rate than the U.S. is Japan. *Id.* at 5.

30. See ASSA, *supra* note 10, at 42 (discussing tax competition and saying that it starts when one country lowers its tax rates to attract outside investment because companies flock to low tax rates; other countries may lower their tax rates in turn, causing a tax battle).

31. Chorvat, *supra* note 3, at 854. Another disincentive within the U.S. system is that U.S. corporations face the same tax rate on capital gains as on ordinary income. Mihir Desai & William M. Gentry, *The Character and Determinants of Corporate Capital Gains*, National Bureau of Economics and Research Working Paper No. 10153 (Dec. 2003), available at <http://www.nber.org/papers/w10153.pdf>. Capital gains taxes imposed on corporations deter corporations from realizing gains, thus "impeding the reallocation of assets to their most efficient owners." *Id.*

32. I.R.C. §§ 901-908, 960 (2006); Chorvat, *supra* note 3, at 850. IRS data shows that foreign corporations doing business typically pay far less in income taxes than do purely American firms with comparable sales and assets. Citizens for Tax Justice, *Hidden Entitlements*, at 1, [hereinafter *Hidden*



has tax neutral consequences for the company.<sup>33</sup> Third, the U.S.-based MNC can form a foreign entity abroad, check-the-box, and pay the subsidiary residence country's lower tax rate.<sup>34</sup> A conclusion to be drawn from these three options is that the U.S. corporate tax system discourages domestic investment and production while foreign countries encourage it.<sup>35</sup>

Many countries with low tax rates make it easy for U.S. taxpayers to evade and avoid U.S. taxation.<sup>36</sup> First, these countries give favorable tax treatment, which entices investment. Thus, many companies shell their corporations in these countries to avoid paying U.S. taxes on income generated from the foreign entities.<sup>37</sup> Second, many countries aid tax avoiders by withholding information from the IRS about U.S. accounts because it results in investment and revenue flow to the foreign countries.<sup>38</sup> The U.S. corporate tax system fails to mitigate this avoidance because it allows companies to shift the movement of goods and services between a company's parent and foreign operations.<sup>39</sup>

Many U.S. companies set up subsidiaries in countries with low tax rates and then assign ownership of their assets and intellectual property to their foreign operations.<sup>40</sup> Hence, the companies avoid paying U.S. tax on money earned as a result of those assets and intellectual property and unmistakably benefit by paying the lower tax rate of the subsidiary's residence country.<sup>41</sup> It has been a recent trend for companies whose assets consist of intellectual property to shift them to overseas entities.<sup>42</sup> These types of assets are easily exported to places where the royalties they produce are subjected to lower tax rates.<sup>43</sup> Some companies use legal loopholes to avoid paying taxes and shift profits and

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*Entitlements*], available at [http://www.ctj.org/hid\\_end/part-2/part2-3.htm](http://www.ctj.org/hid_end/part-2/part2-3.htm).

33. I.R.C. §§ 27, 164, 901-908, 960 (2006); INTRO. TO U.S. INT'L TAXATION, *supra* note 11, at 87-89. The company would face tax neutral consequences because the company will pay the foreign jurisdiction's tax rate, and then either elect a credit or a deduction for the amount paid and would then pay U.S. taxes on the remaining amount due. *Id.* Thus, the taxpayer is going to end up paying the same percentage of income tax regardless. *Id.*

34. I.R.C. §§ 901-908 (2006); Chorvat, *supra* note 3, at 7.

35. *See generally supra* notes 32-34 and accompanying text.

36. PRESS RELEASE, *supra* note 26, at 7.

37. *Id.*

38. *Id.*

39. The problems with the U.S.'s system stem from an unworkable approach it uses to determine how much of a corporation's worldwide earnings relate to U.S. trade and business. *Hidden Entitlements*, *supra* note 32, at 1. The IRS has to look at every move between its parent company and foreign operation and "attempt to assure that a fair, arm's length transfer price was assigned on paper to each transaction." *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

investments into tax havens,<sup>44</sup> while other companies use illegal tax schemes that are sometimes so complicated that the IRS cannot even detect or measure them.<sup>45</sup>

An example of a company shifting assets and intellectual property overseas is Microsoft's Irish venture, a subsidiary called Round Island One Ltd., located in Dublin, Ireland.<sup>46</sup> The subsidiary controls more than \$16 billion in Microsoft assets and helps the computer giant shield at least \$500 million from its annual U.S. tax bill.<sup>47</sup> This is an example of a U.S. MNC creating an entity in a country with a low tax rate in order to prevent the U.S. treasury from taxing the profits made off of the company's assets.<sup>48</sup>

In January 2009, a U.S. Government Accountability Office report found that 83 out of the 100 largest U.S. corporations have subsidiaries in tax havens.<sup>49</sup> The Cayman Islands, for instance, has constructed a regulatory regime that attracts many offshore operations.<sup>50</sup> In 2003, one-third of all foreign profits reported by

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44. The term tax shelter is most frequently used to describe a circumstance in which a taxpayer "shelters" income from tax liability. JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 514 (15th ed. 2009). A company may generate deductions in excess of income from one activity and use that excess to avoid tax on some or all of the income from another unrelated activity. *Id.* The unrelated income from the second activity is sheltered from tax liability by the excess deductions generated by the first. *Id.* Tax shelters may take many forms. *Id.* The IRS generally characterizes tax shelters as complicated transactions that sophisticated tax professionals promote to corporations and wealthy individuals, exploiting tax loopholes and reaping large and unintended tax benefit. *Challenges Remain in Combating Abusive Tax Shelters: Testimony Before the Comm. Of Fin., U.S. Senate, supra* note 8, at 6.

45. Abusive tax shelters manipulate the tax code and are typically buried among legitimate transactions reported on tax returns. *Id.* When a transaction has certain abusive characteristics defined by § 6111 of the IRC, the IRS has to register it, and this allows the IRS to analyze and detect illegal transactions. *Id.* (citing I.R.C. § 6111 (2006)); PRESS RELEASE, *supra* note 26, at 11 (noting the current proposal to extend the statute of limitations for international tax enforcement to six years after the taxpayer submits required information because so many of these illegal transactions take a number of years to detect).

46. Microsoft has placed much of its intellectual property and other assets into tax havens and assigned the rights to many of its copyrights to subsidiaries. Glenn R. Simpson, *Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe*, WALL ST. J., Nov. 7, 2005, at A1. The eight-year-old Irish subsidiary mentioned has very few employees and yet has gross profits of nearly \$9 billion per year. *Id.*

47. *See id.* (estimating that the subsidiary pays the Irish government about \$300 million annually).

48. *Id.*

49. PRESS RELEASE, *supra* note 26, at 8.

50. In the Cayman Islands, "one address alone houses 18,857 corporations, very few of which even have a physical presence in the islands." *Id.* at 1. In the Cayman Islands, the financial services industry represents approximately

U.S. corporations came from just three small, low-tax countries: Bermuda, the Netherlands, and Ireland.<sup>51</sup> In October 2000, Robert McIntyre, director of the Institute on Taxation and Economic Policy, released a study that looked at the tax rates of 250 large U.S. MNCs.<sup>52</sup> The study demonstrated that the average effective tax rate companies are paying is thought to be about 15%, rather than the statutory rate of 39.1%.<sup>53</sup> McIntyre believes that the rates have dropped to this level because there are so many IRC loopholes and offshore tax shelters.<sup>54</sup> These corporate transactions create a hunger to minimize taxes among U.S. MNCs.<sup>55</sup> Beginning in the 1990s, it became a competition between the major corporate players to play up their financial statements, resulting in a sharp decline in revenue derived from corporate taxation.<sup>56</sup> The IRS attempts to close the loopholes that allow MNCs to avoid paying taxes on money that the U.S. Treasury should be entitled to tax.<sup>57</sup> Yet these practices have essentially created a game of cat and mouse, and companies always seem one step ahead of the government.<sup>58</sup> The international consequences of corporate taxation heavily influence many foreign governments when they establish corporate tax rates.<sup>59</sup> Yet the U.S. has rarely taken international consequences into consideration when forming its tax structure.<sup>60</sup> In recent years, there has been an increased

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percent of the country's gross domestic product (GDP), and thus, it is not surprising that the country makes it financially attractive to much of the industrial, high taxing jurisdictions. Natasha Lance Rogoff, *Haven or Havoc: A Look at why the Cayman Islands has been called a tax haven, how the island defends itself and what reforms the international community has proposed*, FRONTLINE, Feb. 19, 2004, available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/schemes/cayman.html>.

51. PRESS RELEASE, *supra* note 26, at 1.

52. *Tax Me If You Can* (Frontline broadcast Feb. 4, 2004).

53. *Id.*

54. Another study in 2004, the most recent year for which data is available, U.S. MNCs "paid about \$16 billion of U.S. tax on approximately \$700 billion of foreign active earnings—an effective U.S. tax rate of about 2.3%." PRESS RELEASE, *supra* note 26, at 1.

55. *Tax Me If You Can*, *supra* note 52.

56. *Id.* Companies would play up their financial statements in the sense that their statements would reflect the MNC's high worldwide revenue, while failing to note the various deductions and credits received because of the transactions abroad. *Id.*

57. *Id.*

58. *Id.*

59. ASSA, *supra* note 10, at 25.

60. A study found that corporate taxes have the potential to be the most harmful revenue-raising tool on economic growth. HODGE & DAMMERT, *supra* note 26, at 2-3. The reason is because corporate taxes have such a large impact on capital accumulation, which can negatively affect productivity, and thus, GDP per capita. *Id.* Because of these issues, many believe that the corporate tax is soon to be subject to change, and according to a survey conducted by Miller & Chevalier, about seventy percent of leading corporate tax executives

concern about the U.S. position in the global economy, and U.S. citizens worry about the long-term loss of manufacturing jobs and intense competition from emerging countries.<sup>61</sup>

The goals of the worldwide system of taxation—to promote tax neutral transactions—are far from being achieved. And the high corporate tax rates are causing U.S.-based companies to flee abroad.<sup>62</sup> Reformation of the U.S. corporate system of taxation should not be overlooked but rather approached with vigor.

### III. HOW CAN THE CURRENT SYSTEM BE CHANGED?

Three different approaches have been suggested by academics and bureaucrats to reform the current U.S. system: (1) implementation of a formulary apportionment system; (2) implementation of a territorial system; and (3) elimination of tax loopholes accompanied by a raise in the corporate tax rate.

#### A. Formulary Apportionment

First is the discussion of formulary apportionment.<sup>63</sup> This approach treats a parent corporation and its subsidiaries as a single taxpayer<sup>64</sup> and refers to the company as a unitary business.<sup>65</sup> The company's worldwide income is then calculated<sup>66</sup> using a mathematical formula that reflects the distribution of economic activity and divides the income of the business among the jurisdictions in which it operates.<sup>67</sup> The formula can include

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believed that change is on the horizon for U.S. taxation of MNCs. ASSA, *supra* note 10, at 1.

61. See Hufbauer & Kim, *supra* note 23, at 2 n.6 (discussing the downward trend of the U.S. position in the world economy, and how the U.S. is losing its competitive advantage against the emerging economies of the famous BRICK countries: Brazil, Russia, India, China and Korea).

62. PRESS RELEASE, *supra* note 26, at 1.

63. This is a concept that can be traced as far back as the 1930's. Ian Benshalom, *Taxing The Financial Income of Multinational Enterprises by Employing A Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619, 621 (2009).

64. Kimberly Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Policy Brief No. 2007-08, at 12 (Brookings Inst. 2007) [hereinafter Policy Brief No. 2007-08]. The Brookings Institute is working on a project called the Hamilton Project, which is aimed to propose reformation of the taxation of MNCs. *Id.* at 1. The Hamilton project exists because of the current failures and successes of the current U.S. system. Roin, *supra* note 3, at 199.

65. A unitary business is defined as a parent corporation and all of the subsidiaries over which it exercises legal and economic control. Policy Brief No. 2007-08, *supra* note 64, at 12.

66. See *id.* at 15 (calculating worldwide income by adding worldwide gross income and subtracting worldwide expenses from worldwide income).

67. Kimberly Clausing, *International Taxation: How Would Formulary Apportionment Work?*, Tax Policy Center: Urban Institute and Brookings Institution, Entry 5 (Oct. 2007) [hereinafter *International Taxation: Entry 5*],

chosen factors such as the firm's worldwide sales, assets, and payroll, or it could merely be the fraction of worldwide sales destined for U.S. customers.<sup>68</sup> The jurisdiction where a unitary business is operating then applies its tax rate to the income that has been allocated to that jurisdiction by the formula and collects the tax.<sup>69</sup> Basically, a corporation would pay U.S. taxes only on the share of worldwide income that is in some way allocated to the U.S., depending on the particular formula chosen.<sup>70</sup>

### 1. Strengths of Formulary Apportionment

Moving to a formulary system would address many issues that exist under the current U.S. system.<sup>71</sup> First, formulary apportionment would diminish the incentives for MNCs to shift their production and headquarters to tax havens.<sup>72</sup> In recent years, most industrial countries have lowered their corporate income tax rates, while U.S. rates have changed little.<sup>73</sup> The

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available at <http://www.taxpolicycenter.org/briefing-book/key-elements/international/formulary-apportionment.cfm>. As mentioned above, under the current system, U.S. MNCs determine their tax bill by determining what they owe separately in each jurisdiction in which they operate, and moving to a formulary system would simplify this process. Kimberly Clausing, *International Taxation: How would formulary apportionment work?*, Tax Policy Center: Urban Institute and Brookings Institution, Entry 4 (Oct. 2007) [hereinafter *International Taxation: Entry 4*]. The method that U.S. states use to allocate national income across states is similar to the system of formulary apportionment. *Id.* The states use mathematical formulas based on "real economic factors," such as a taxpayer's sales, payroll, and property to decipher the tax liability to a particular state. Roin, *supra* note 3, at 173-74. Basically, such an approach disregards the separate existence of related corporate entities, and instead treats the corporation as a single entity and allocates the income among the states based on "each state's relative contribution of the identifiable economic factors of the corporate group as a whole." *Id.*; Benschalom, *supra* note 63, at 621. The states are highly integrated, thus it would be impractical to tax in any other way. *International Taxation: Entry 4, supra*. As the world gets smaller and the economy more globalized, it is becoming just as impractical to try to determine how much of a firm's income is earned in one country and how much in another based on the current structure. *Id.*

68. *International Taxation: Entry 4, supra* note 67.

69. Policy Brief 2007-08, *supra* note 64, at 12. The Hamilton Project has proposed a system that would use a sales-based formula. *Id.* This formula considers only sales in each location. *Id.* The reason for this is because customers are far less mobile than are firm production and assets. *Id.* Other suggestions made in regards to a formula include those based on worldwide economic activity of a company, taking into account sales, assets, and payroll shares, and the U.S. would tax based on the fraction of that activity which relates back to the U.S., subtracting the expenses. *Id.*

70. *Id.*

71. *International Taxation: Entry 4, supra* note 67.

72. Policy Brief No. 2007-08, *supra* note 64, at 14.

73. Kimberly Clausing, *International Taxation: What are the consequences of the U.S. international tax system?*, Tax Policy Center: Urban Institute and

discrepancy between domestic and foreign tax rates creates incentives for companies to shift income abroad and, in some cases, has led U.S.-based MNCs to shift the formal incorporation of their parent company offshore without changing the location of their real business activities—a practice called inversion.<sup>74</sup> Implementing a formulary apportionment approach would prevent inversion and remove such artificial incentives to shift income and production to tax havens because it would base a MNC's tax liability on measures of its real economic activity in each location, rather than its legal residence or legal form.<sup>75</sup> This would result in a substantial increase in collected tax revenues and a potential for a decrease in corporate tax rates.<sup>76</sup> In turn, an increase in domestic investment by foreign- and U.S.-based companies would follow.<sup>77</sup>

Second, implementing formulary apportionment would simplify the U.S. system of taxation because, once it is determined which business units are part of the corporate whole, a corporation with many entities is treated as a single entity for tax purposes.<sup>78</sup> Once a single entity has been defined, the corporation would need to establish the fraction of a firm's activity that occurred in the U.S., depending on the chosen formula.<sup>79</sup> Formulary apportionment would avoid dealing with the often complex calculations of foreign tax credits and deductions, as well as the entire process of deferral.<sup>80</sup>

## 2. Weaknesses of Formulary Apportionment

The implementation of a formulary system could, however, result in a number of drawbacks. First, the shift to a formulary system would require foreign cooperation to ensure proper implementation.<sup>81</sup> Without foreign cooperation, there would be circumstances where MNCs would face double taxation or would

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Brookings Institution, Entry 2 (Oct. 2007) [hereinafter *International Taxation: Entry 2*], available at <http://www.taxpolicycenter.org/briefing-book/key-elements/international/consequences.cfm>.

74. *Id.*

75. *International Taxation: Entry 4*, *supra* note 67. This system would increase revenue in the U.S. because “under the current system firms’ shares of real economic activity” in the U.S. exceeds the share of income they report on their returns as derived from the U.S. *Id.*

76. A mixture of the two factors would likely result. Policy Brief No. 2007-08, *supra* note 64, at 14. Clausing and Avi-Yonah estimate that the U.S. tax rate could get as low as twenty-six percent, while still raising the same amount of revenue as the current system. *Id.*

77. See Hufbauer & Kim, *supra* note 23, at 2 (discussing systems which are tailored to attract new investment).

78. Roin, *supra* note 3, at 199.

79. *Id.* at 5.

80. Policy Brief No. 2007-08, *supra* note 64, at 15.

81. Hufbauer & Kim, *supra* note 23, at 6.

avoid taxation entirely, because a foreign country's formula for taxation may not match up to that of the U.S.<sup>82</sup> Yet this problem already exists under the current system because not all worldwide methods of taxation complement each other; regardless of the chosen approach, inconsistencies will exist.<sup>83</sup> Despite this concern, if the U.S. unilaterally adopted formulary apportionment, it would be an incentive for other countries to follow.<sup>84</sup> The European Union (EU) is already debating adopting the approach, and the European Commission and the members of its Working Group have been meeting quarterly to fine-tune their proposal to implement

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82. Without a common formula, the formulary system could result in more than one jurisdiction claiming parts of the corporate tax base. *Id.* Absence of international cooperation would also leave room for MNCs to manipulate the formulas and the variations between countries. *International Taxation: Entry 4, supra* note 67; Policy Brief No. 2007-08, *supra* note 64, at 21.

83. Chorvat, *supra* note 3, at 854. An illustration of how the current system already experiences inconsistencies, due to the incompatibility of foreign jurisdictions' tax codes in relation to the U.S. is in the case *Guardian Industries Corp. v. United States*, 65 Fed. Cl. 50 (2005). Guardian, a Delaware corporation, owned a Luxembourg entity called Guardian Industries Europe (GIE), which owned several other Luxembourg entities that did business globally. *Id.*; Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May be Less Than Enthusiastic about the Idea (And Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 761 (2006). The Luxembourg government treated GIE and the other entities as one group, with GIE as the parent, which paid Luxembourg income tax. *Id.* For U.S. tax purposes, GIE was a transparent entity, and the other entities constituted corporations. *Id.* at 762. "Guardian claimed a credit for all the Luxembourg tax paid by GIE, but it only included its GIE income in its U.S. income of calculation, and not the income of the other Luxembourg entities." *Id.* Because GIE was a disregarded entity for U.S. tax purposes and owned by Guardian, its liability was considered liability of Guardian, and it was considered to have paid GIE's Luxembourg taxes. *Id.* Basically, Guardian did not actually pay any U.S. income taxes on the income of the lower-tier Luxembourg entities but was allowed a credit for the taxes paid by GIE for that income. *Id.* This points to the conclusion that the current system is already failing, and the allegations that a non-uniform global formula would equate to failure of formulary apportionment is invalid because, while formulary apportionment would address many problems, in this instance the result could be no worse than it already is because inconsistencies exist. *See id.* (noting that the outcome of this case is inconsistent with the policy of the foreign tax credit to alleviate double taxation because the company did not pay any tax at all, yet received a credit).

84. Lokken, *supra* note 83, at 762. The U.S. is the largest economy in the world, thus the largest consumer of goods and services in the world. ECONOMYWATCH.COM, TopWorld Economies, <http://www.economywatch.com/economies-in-top/> (last visited Oct. 2, 2010). Not only would other countries be inclined to follow the U.S., but this would bring investment back into the U.S. because, if taxation is based on the amount of actual business that took place, it can be inferred that the artificial incentives to move business abroad would cease and investment would return to the U.S. *See* Policy Brief No. 2007-08, *supra* note 64, at 14-15 (discussing the advantages of implementing formulary apportionment).

formulary apportionment in the member countries.<sup>85</sup>

Second, it has been argued that U.S. execution of formulary apportionment may create rifts in the relationships the U.S. has with countries it has tax treaties with because, along with adoption of the new system, there may need to be a renegotiation of treaties.<sup>86</sup> Nevertheless, adopting the system would not necessitate the renegotiation of every existing tax treaty.<sup>87</sup>

Third, formulary apportionment could negatively impact a number of industries, for example, the oil industry. However, while some industries would lose, some would benefit, for example, U.S. exporters.<sup>88</sup>

The current system of taxation is being exploited<sup>89</sup> by MNCs, resulting in a shift of billions of dollars from the U.S. to foreign jurisdictions.<sup>90</sup> Formulary apportionment would address many of the shortcomings of the current system.<sup>91</sup> For example, it would eliminate artificial incentives to invest abroad, which would simplify our complex system of corporate taxation.<sup>92</sup>

### B. Territorial Approach

Under a territorial approach—in some instances also called an exemption system—a U.S. taxpayer's foreign-sourced income, whether carried on directly or indirectly through subsidiary corporations, is exempted from U.S. taxation.<sup>93</sup> Expenses

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85. The EU, in a response to the hardships that face EU businesses operating in over twenty different taxing jurisdictions, has proposed replacing the current rules for taxing source income of MNCs with a formulary system. Roin, *supra* note 3, at n.8; *see generally* European Comm'n, An Internal Market Without Company Tax Obstacles—Achievements, Ongoing Initiatives and Remaining Challenges (Nov. 24, 2003), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0726:FIN:EN:PDF>.

86. Hufbauer & Kim, *supra* note 23, at 6.

87. *See* Policy Brief No. 2007-08, *supra* note 64, at 25 (discussing transfer prices, the arm's length principal, and a recommendation to insert the language of the OECD model into treaty negotiations; all things that are beyond the scope of this Comment).

88. *Id.* at 19. The oil industry, for example, has argued that a formula based on payrolls, assets, and sales would be unfair to oil companies because most of many oil companies' profits are derived from the oil reserves, which are not reflected in the formula. *Id.* On the other hand, major U.S. exporters would benefit from an application of formulary apportionment because of the "simplicity and transparency of the" formulary apportionment regime. *Id.*

89. *See* Roin, *supra* note 3, at 221 (noting that "taxpayers have learned how to exploit its weaknesses to reduce their tax burdens, perhaps at unacceptably low levels").

90. PRESS RELEASE, *supra* note 26, at 1.

91. Policy Brief No. 2007-08, *supra* note 64, at 14; International Taxation: Entry 4, *supra* note 67; Roin, *supra* note 3, at 199.

92. Roin, *supra* note 3, at 199.

93. In 2005, the Advisory Panel on Federal Tax Reform has proposed a change in the current system of corporate taxation, and the first of the two



attributable to the income earned would not be deductible and the foreign income tax credit would cease.<sup>94</sup> In recent years, there has been a global trend toward lower corporate tax rates and territorial systems.<sup>95</sup>

### 1. *Strengths of the Territorial Approach*

Advocates for this approach ensure that shifting to a territorial system would guarantee that the U.S. remains an attractive location for MNC headquarters.<sup>96</sup> This is an issue that formulary apportionment fails to address.<sup>97</sup> Research suggests that reformation in this fashion would lead to both “efficiency and simplification gains.”<sup>98</sup> The current U.S. varied, worldwide system

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plans proposed is to shift from the present system to a territorial system. Lokken, *supra* note 83, at 753. There are two applications of the territorial system. *Id.* The first is a true territorial system, which exempts from taxation all income, whatever the source. *Id.* “Hong Kong is one of the few jurisdictions having such a system.” *Id.* at n.19 (citing Govnt’ of Hong Kong Special Admin. Region, Inland Revenue Dep’t, A simple Guide on the Territorial Source Principle of Taxation, available at [http://www.ird.gov.hk/en/paf/bus\\_pft\\_tsp.htm](http://www.ird.gov.hk/en/paf/bus_pft_tsp.htm)). The second is a system, which only exempts active foreign business income, which meets a specific set of criteria, and the remaining sources of income retain the present approach. *Id.* This type of a system still taxes the passive foreign-source income of their residents, because passive income is viewed as having no natural location. Chorvat, *supra* note 3, at 841. Countries such as France and the Netherlands use a territorial system like the second form. Kimberly Clausing, *International Taxation: How Does the Current system of International Taxation Work?*, Tax Policy Center: Urban Institute and Brookings Institution, Entry 1 (Dec. 2007) [hereinafter *International Taxation: Entry 1*], available at <http://www.taxpolicycenter.org/briefing-book/key-elements/international/international-work.cfm>. In either approach, the country where income is actually earned taxes the companies. Jim Saxton, *Reforming the U.S. Corp. Tax System to Increase Tax Competitiveness*, A Joint Economic Committee Study, at 4, available at <http://www.house.gov/jec/CorporateTaxReform.pdf>.

94. The CFC rules, regulated by subpart F, mentioned above, would also continue to be applicable. Lokken, *supra* note 83, at 753.

95. Most of the important trading partners of the U.S. have adopted a territorial system. Chorvat, *supra* note 3, at 836. In addition to countries like France and the Netherlands, Japan has recently taken steps toward changing its current corporate tax system to a more territorial approach. HODGE & DAMMERT, *supra* note 26, at 2-5. Japan is the only country with a higher corporate tax rate than the U.S., and the change in attitude has been prompted by a similar corporate reluctance to invest domestically, but rather a corporate trend toward shifting investment into low-taxing jurisdictions. *Id.* Great Britain and Canada have also made recent moves to change and update their current system of taxation. *Id.*

96. See Hufbauer & Kim, *supra* note 23, at 5 (noting that “since the active business income for foreign subsidiaries would no longer be subjected to a residual” U.S. corporate tax rate, U.S. MNCs would seek to stay put in the U.S.).

97. See generally *supra* notes 63-92, and accompanying text.

98. Lokken, *supra* note 83, at 756; Chorvat, *supra* note 3, at 836.

of taxing corporate income earned abroad when deferred to the U.S. while allowing foreign tax credits and deductions, raises very little revenue for the U.S. Treasury and imposes heavy administrative costs.<sup>99</sup>

Many foreign jurisdictions already implement the territorial system, and it is economically unwise to subject U.S. corporations to substantially higher tax rates than those that are imposed on their foreign competitors engaged in similar activities.<sup>100</sup> When foreign countries succeed in collecting taxes under a territorial system, domestic corporations are at an economic disadvantage relative to those competitors because they will offer investors lower returns, have less capital for expansion, and have less room for price concessions.<sup>101</sup> Proponents emphasize that implementing a territorial system would raise infusions of capital into U.S. MNCs and increase competitiveness of U.S. companies in the global marketplace, thus enhancing worldwide economic efficiency.<sup>102</sup>

## 2. Weaknesses of the Territorial Approach

First, critics of the approach believe that under a territorial system there would be incentives to masquerade all income as active income.<sup>103</sup> Thus, companies would avoid taxation on income owed to the U.S. Treasury.<sup>104</sup> Although this factor is an obstacle, advocates of the territorial approach believe it does not prevent its success.<sup>105</sup>

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99. ASSA, *supra* note 10, at 5.

100. Roin, *supra* note 3, at 170.

101. *Id.*

102. The U.S. system places a higher burden on U.S. companies, which decreases their after-tax return to investors. Chorvat, *supra* note 3, at 846. Because lower returns result in higher costs of capital, U.S. MNCs have potential for lower infusions of capital and allocation of a lower portion of its capital compared to foreign MNCs. *Id.* This reduces efficiency and causes the allocation of capital between U.S. and foreign MNCs to be uneven. *Id.* By implementing a territorial system, proponents vow that worldwide efficiency, including U.S. company efficiency, will increase because U.S. MNCs will now have after-tax reserves equal to that of foreign companies. *Id.*

103. Companies may attempt to masquerade income such as portfolio income, which has sometimes been referred to as mobile income, as active business income, thus avoiding U.S. taxation. Hufbauer & Kim, *supra* note 23, at 5. The drawback of this argument, however, is that companies are already shielding large amounts of money from the U.S. Treasury and masquerading income derived from the U.S. parent as income derived from the subsidiary abroad, thus avoiding U.S. taxation. *See generally* PRESS RELEASE, *supra* note 26.

104. *See generally* PRESS RELEASE, *supra* note 26.

105. In order to solve this problem, there needs to be a set of bright line rules defining what exactly active income is in comparison to mobile income. *See* Hufbauer & Kim, *supra* note 23, at 5 (discussing how the U.S. should adopt a territorial approach to the taxation of foreign operations of U.S. based MNCs).

Next, it has been suggested that a territorial system would encourage investments in low-tax jurisdictions because foreign-sourced active business income would be exempted from U.S. taxation.<sup>106</sup> According to the Advisory Panel on Federal Tax Reform, which in 2005 was charged with developing plans for reforming the federal tax system, and the Joint Committee on Taxation, there is no evidence that location incentives would be changed at all, and confidence that companies would maintain headquarters in the U.S. is enough of an incentive for the U.S. to shift toward this approach.<sup>107</sup> Another oversight in this critique is that it overlooks the fact that the U.S. tax system does not tax active foreign income until it is repatriated to the U.S.<sup>108</sup> Because MNCs hold onto the income in the foreign entity for as long as possible, it would change investment behavior very little.<sup>109</sup>

Again, changing the current system of taxation of foreign-sourced business income would not be easy. But by switching to a territorial system, proponents urge, the U.S. would increase efficiency, competitiveness, and confidence in the continuity of MNCs headquartered in the U.S.<sup>110</sup>

### *C. Eliminate Loopholes and Raise Taxes*

Third, many proponents of reform, particularly within the Obama administration, advocate for closing loopholes entirely and raising the corporate tax rate in an effort to raise revenue from corporate taxes.<sup>111</sup> This means that U.S. firms that invest overseas would no longer be able to make their subsidiaries disappear for tax purposes, and companies would be subject to taxation on all income regardless of source.<sup>112</sup>

#### *1. Strengths of Eliminating Loopholes and Raising Taxes*

Eliminating loopholes and raising taxes would level the playing field between domestic firms and MNCs, subjecting companies that invest overseas and those that invest solely at home to the same level of taxation.<sup>113</sup> Further, by closing loopholes and raising taxes, the administration could raise billions of dollars

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106. Lokken, *supra* note 83, at 757.

107. *See id.* (discussing the implications of implementing a territorial system).

108. Chorvat, *supra* note 3, at 841.

109. This concept applies at least to mature U.S.-based MNCs. *Id.*

110. Lokken, *supra* note 83, at 757.

111. PRESS RELEASE, *supra* note 26, at 8.

112. I.R.C. §§ 27, 164 901-908, 911 (2006); PRESS RELEASE, *supra* note 26, at 8. This rule would still be subject to credit or deduction elections for foreign income taxes paid abroad. *Id.*

113. PRESS RELEASE, *supra* note 26, at 8.

more per year.<sup>114</sup> There is a serious concern over the federal deficit and tax revenue is now needed more than ever.<sup>115</sup> One commentator has opined that the only option is to raise taxes because the federal deficit is so high.<sup>116</sup>

## 2. Weaknesses of Eliminating Loopholes and Raising Taxes

Eliminating loopholes and raising corporate tax rates may negatively impact operations of MNCs abroad and at home. This approach would increase the amount of money many corporations owe the U.S. government, and thus, decrease the amount of money the corporations have in their reserves.<sup>117</sup> This could cripple companies and cause a large loss of jobs domestically and abroad.<sup>118</sup> American companies support about 20 million American jobs worldwide, and this will put many of those jobs in jeopardy because when taxes are arbitrarily raised, but not revenue, someone pays the price.<sup>119</sup>

Another concern is that, at the point in its history, the U.S. is struggling economically.<sup>120</sup> Some point to the high U.S. corporate tax rate as a cause of the economic struggles because it discourages domestic and foreign companies from investing here.<sup>121</sup> Most industrial countries have lowered their corporate income tax rates in recent years, while U.S. rates have changed little.<sup>122</sup>

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114. By closing foreign tax credit loopholes, according to the administration, the government could raise up to \$43 billion from 2011-2019. *Id.* at 3. By reforming the check-the-box rules described in Part II, the administration could raise upwards of \$86.5 billion from 2011-2019. *Id.* The administration is also discussing reforming the practice of deferral, which will raise, according to the Obama administration, \$60.1 billion between the same time period from 2011-2019. *Id.*

115. Jocelyn Yin, *Obama Seeks to Eliminate Tax Benefits for Multinational Corporations*, OBAMA WATCH, June 24, 2009, <http://www.ombwatch.org/node/10147>.

116. Ronald Domsy, *Income Tax Class Lecture*, The John Marshall Law School, Chicago, Ill. (Oct. 19, 2009).

117. Chorvat, *supra* note 3, at 846, 850.

118. Evidence shows that domestic employment expands when U.S. based MNCs operate successfully abroad. Hufbauer & Kim, *supra* note 23, at 1. This debate regarding the role of MNCs in creating or destroying jobs can be traced back to the at least the 1960s. *Id.* at 2. It is has been found that “[c]orporate income taxes appear to have a particularly negative impact on GDP per capita.” HODGE & DAMMERT, *supra* note 26, at 2. Empirical findings also note that lowering corporate taxes raises growth and investment. *Id.*

119. Susanne Stirling, *Another Voice: Closing This ‘Loophole’ Would Kill Jobs*, SACRAMENTO BUS. J. July 31, 2009, <http://sacramento.bizjournals.com/sacramento/stories/2009/08/03/editorial2.html>.

120. Hufbauer & Kim, *supra* note 23, at 2.

121. *Id.*

122. Thus, American businesses with overseas operations have already paid the second highest corporation tax rate in the world. Stirling, *supra* note 119.

The Obama administration seeks to raise revenue by increasing the corporate tax rates and eliminating loopholes.<sup>123</sup> But that is possible only if business went on as usual, and opponents of the new administration's plan argue that companies would not be able to withstand the pressures of foreign competition.<sup>124</sup> As the global world lowers taxes and shifts its systems to formulary and territorial systems, it would be unwise to swim against the current.

#### IV. IS THERE A SOLUTION?

##### A. *Introduction to a Hybrid Solution*

The current system of U.S. taxation is causing companies to move their operations to overseas, low tax jurisdictions at a very high rate, taking jobs and capital with them.<sup>125</sup> Thus, MNCs are avoiding taxation on income earned.<sup>126</sup> In the worst economic climate since the Great Depression, the U.S. is in dire need for corporate tax reformation.<sup>127</sup>

This Comment proposes reformation of the U.S. system of taxing worldwide income of MNCs. This section proposes that the U.S. adopt a hybrid of the formulary system and the territorial system. At the same time, the U.S. should slightly lower the corporate tax rate, but still maintain portions of the current U.S. regulatory system. This cohesive combination would increase both the domestic and international activities of U.S.-based MNCs and bring foreign investment to American shores.<sup>128</sup>

##### B. *Part I: Formulary System*

First, the U.S. should adopt the formulary system. The formula used should be a three-factor formula, according to the amount of sales, assets, and payroll in each jurisdiction.<sup>129</sup> This would simplify the corporate tax regime and result in a reduction of tax compliance costs for MNCs.<sup>130</sup>

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123. PRESS RELEASE, *supra* note 26, at 1.

124. Hufbauer & Kim, *supra* note 23, at 1.

125. PRESS RELEASE, *supra* note 26, at 1.

126. *Id.*

127. Hufbauer & Kim, *supra* note 23, at 7. "As President Obama emphasized, this is 'an economic crisis as deep and dire as any since the days of the Great Depression.'" *Id.* (quoting Trish Turner & The Associated Press, *Obama, Lawmakers Battle to Close Stimulus Divide Before Self-Imposed Deadline*, FOXNEWS.COM, Feb. 5, 2009, <http://www.foxnews.com/politics/2009/02/05/obama-lawmakers-battle-close-stomulus-divide-self-imposed-deadline/>).

128. Hufbauer & Kim, *supra* note 23, at 3.

129. *Id.* at 6; *International Taxation: Entry 5*, *supra* note 67.

130. The current system allows for an immense amount of abuse, allowing MNCs to avoid U.S. taxation on billions of dollars. PRESS RELEASE, *supra* note

The government should start the implementation of this approach by negotiating this suggested formula with our two North American Free Trade Agreement (NAFTA) partners: Canada and Mexico.<sup>131</sup> Due to NAFTA and location incentives, U.S. corporations have vast ties in North America, and it would be best to first implement a formulary approach with our closest trade allies prior to fully implementing the system.<sup>132</sup> While formulary apportionment is being implemented, the current treaty arrangements should stand.<sup>133</sup>

Again, it is impractical to account separately for what income is earned in each jurisdiction when international transactions occur in such an economically integrated global world.<sup>134</sup> Attempts to assign profits to individual countries are laden with opportunities for companies to avoid and evade U.S. taxation.<sup>135</sup> Implementation of formulary apportionment, as merely one portion of a cohesive reform package, would be better suited for

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26, at 1. By treating a company as a unitary business and taxing a company based on the amount of sales, assets, and payroll in the U.S., it simplifies many aspects of taxation and leads to fewer computations for companies and IRS employees. Hufbauer & Kim, *supra* note 23, at 6.

131. Hufbauer & Kim, *supra* note 23, at 6. On January 1, 1994, Canada, Mexico, and the U.S. entered into the North American Free Trade Agreement (NAFTA). Office of the United States Trade Representative: Executive Office of the President, North American Free Trade Agreement (NAFTA), <http://www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta> (last visited Dec. 3, 2010). NAFTA created the world's largest area of free trade, producing \$17 trillion worth of goods and services. *Id.* The only setback to the agreement's functioning is that the three countries "continue to maintain their own distinct tax regimes." ARTHUR COCKFIELD, NAFTA TAX LAW AND POLICY: RESOLVING THE CLASH BETWEEN ECONOMIC AND SOVEREIGNTY INTERESTS (University of Toronto Press) (2005), available at [://taxprof.typepad.com/taxprof\\_blog/2005/10/cockfield\\_publi.html](http://taxprof.typepad.com/taxprof_blog/2005/10/cockfield_publi.html). "At times, these different tax systems harm the economic welfare of the trade bloc by imposing barriers to cross-border flows of capital." *Id.* Although harmonization of taxation policies seems dim for the three countries, it has been opined that a strategy toward tax coordination would rid them of the problems that exist due to the differences in the systems. *Id.* Thus, NAFTA would function in the way it was designed to. *Id.*

132. Hufbauer & Kim, *supra* note 23, at 6.

133. See *id.* Hufbauer & Kim, *supra* note 23, at 6 (overriding "multiple tax treaties . . . [may] not [be] a good step for an administration that wants to restore a multilateral character to [U.S.] foreign policy"). On the other hand, formulary apportionment is practiced by the U.S. states, and "[d]espite decades of trying, the various U.S. states have never agreed on a common formula for dividing up the corporate tax base within the [U.S.]." *Id.* Thus, it can be inferred that even without full cooperation, the approach may still be successful, particularly if it is discussed with foreign jurisdictions prior to implementation.

134. Policy Brief No. 2007-08, *supra* note 64, at 5. This discussion arose in the context of the states. *Id.* The states are so economically integrated that it is impractical to apply any approach other than formulary apportionment. *Id.*

135. *Id.*

the U.S. government in a global economy.<sup>136</sup>

### C. Part II: Territorial System

Second, the U.S. should adopt a territorial approach regarding the taxation of active income earned abroad by MNCs.<sup>137</sup> This means that active foreign business income will not be taxed whether earned directly or indirectly by a U.S.-based company.<sup>138</sup> The territorial approach would ensure that the U.S. remains an attractive place for corporate headquarters because U.S. parent corporations and their foreign subsidiaries would no longer be subjected to income tax on foreign earned active business income.<sup>139</sup> Consequently, foreign taxes paid on active business income will no longer be deducted or credited against U.S. income tax.<sup>140</sup>

Meanwhile, the U.S. should continue to tax passive income earned by parent corporations and their subsidiaries operating abroad.<sup>141</sup> The purpose of maintaining the taxation of passive foreign income is to prevent passive investment decisions based on taxation.<sup>142</sup> This would avoid situations where a company merely invests in a foreign corporation, and income earned via the investment is taxed only in the low tax jurisdiction.<sup>143</sup>

MNCs doing business in Canada, Mexico, and the U.S. will be treated as a single unitary taxpayer, and the parent company and subsidiaries will be subject to U.S. taxation for all U.S. derived

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136. Firms would no longer be motivated to shift income abroad by artificial tax incentives. *Id.* And the administrative burden to closely regulate corporate transactions would decrease. *Id.*

137. Hufbauer & Kim, *supra* note 23, at 5; Chorvat, *supra* note 3, at 860.

138. Chorvat, *supra* note 3, at 855-56.

139. *Id.* at 856. Because active income earned abroad would no longer be subject to U.S. taxation, companies would have incentives to remain here rather than revert to the practice of inversion. *Id.*

140. *Id.*

141. *Id.* Passive income should be taxed, whether earned directly or indirectly. *Id.* Generally, this would prevent the exemption of passive investments in foreign corporations from U.S. taxation. *Id.* at 857. If there is a tax advantage to investing in a French corporation as opposed to a U.S. corporation the system will distort investment decisions." *Id.* Although the difference between active business income and passive income is not the subject of this paper, it is an important distinction in the implementation of a new approach.

142. *Id.*

143. *Id.* It has been argued that if the U.S. taxed passive income while foreign countries did not, that it would place U.S. MNCs at a disadvantage. *Id.* To rebut this opinion, it seems that encouraging U.S. MNCs to passively invest in foreign companies would defeat many of the incentives to adopt a new system. *Id.* Next, it is a trend with countries that already implement the territorial system to tax domestic corporations based on passive income earned abroad. *Id.*; HUGH AULT & BRIAN ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 402-06 (Kluwer Academic Publishers 2004).

sales and U.S.-based assets and payroll. In conjunction, all U.S.-based MNCs will be taxed on worldwide-sourced passive income as well as U.S.-sourced active income.<sup>144</sup> This integrated hybrid approach allows the U.S. to create a friendly environment for foreign investment and limit constraints on overseas operations of U.S.-based MNCs.<sup>145</sup>

This hybrid approach would simplify corporate taxes because it would remove the credit and deduction computations entirely.<sup>146</sup> This system would do away with the arbitrary regulations defining foreign business entities as well as the distorted motivations to move production and headquarters offshore that exist under the current worldwide system.<sup>147</sup>

#### D. Part III: What About the Tax Rate?

Third, the U.S. should cease the endeavor to increase the corporate tax rate, but rather, it should lower the current corporate tax rate. It would be detrimental to many companies to increase the corporate tax rate.<sup>148</sup> Overall, the U.S. federal government does not collect much of its revenue from the corporate tax, and it is evident that the U.S. needs reform, but the changes should target failures that exist in the current system rather than “populist sound bites.”<sup>149</sup> Increasing the statutory tax rate will only result in more companies’ fleeing abroad, rather than an effective increase in revenue.<sup>150</sup>

The best result would be acquired if Congress lowered the current statutory corporate rate in an effort to compete globally.<sup>151</sup> More countries would invest in the U.S. and move production here

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144. Chorvat, *supra* note 3, at 857-58.

145. *Id.*

146. See Hufbauer & Kim, *supra* note 23, at 5 (noting that this would eliminate the heavy administrative costs required to calculate credits and deductions).

147. See Chorvat, *supra* note 3, at 859 (noting that the territorial system “does not set up arbitrary distinctions between the taxation of foreign subsidiaries and foreign branches”). It is also important to note that by restructuring the corporate tax in this manner, it will not rid of the check the box regulations entirely because, even though defining a foreign entity becomes insignificant for tax purposes, it will not rid of the regulation entirely in terms of defining domestic companies. See generally *supra* notes 21-26, and accompanying text (discussing I.R.C. § 7701 (2006), the check-the-box regulations).

148. As mentioned, there is a large concern about the U.S. position in the global economy, and many point to the U.S. corporate system of taxation as a cause. Hufbauer & Kim, *supra* note 23, at 2. The system discourages firms from around the world, including U.S. firms, from locating their headquarters and production in the U.S. *Id.*

149. *Id.* at 3.

150. *Id.* at 1.

151. *Id.*



if the corporate tax rate was anywhere near the level of the average OECD country. Thus, as the third leg of the hybrid reform approach, the income derived from U.S. sales, assets, and payroll, in addition to the remaining U.S.-derived active and all worldwide passive income, should all be taxed at a lower rate, rather than at an increased rate, as the current administration urges.<sup>152</sup>

Anti-abuse rules should still remain in place.<sup>153</sup> Companies are going to continue to attempt tax avoidance in every way possible, and IRS officials need to track transactions that appear to be abusive in order to halt tax evasion by MNCs.<sup>154</sup> Finally, the government should continue to close loopholes because, under the suggested hybrid approach, the taxation of MNCs and foreign-sourced business income is simpler, so there should be less room for exploitation.<sup>155</sup>

## V. CONCLUSION

This Comment proposes a reformation of the U.S. taxation of foreign-sourced income derived from MNCs. The advocated cohesive approach responds to the reality of an increasingly global world and removes the complexities that exist under the current system.

In the end, changing the current system of taxation would be costly.<sup>156</sup> Nothing in this Comment suggests that this hybrid approach will remedy all of the current system's shortcomings, and there are drawbacks that exist in any system.<sup>157</sup> Nevertheless, change is essential.

This hybrid approach, at the very least, will ensure that the U.S. remains a location for corporate headquarters and will remove the incentives to move production offshore.<sup>158</sup> This

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152. Evidence shows that "lowering statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make the largest contribution to GDP growth." HODGE & DAMMERT, *supra* note 26, at 3.

153. PRESS RELEASE, *supra* note 26, at 1; Chorvat *supra* note 3, at 859.

154. *Testimony before the Comm. of Fin.*, *supra* note 8, at 10-11.

155. PRESS RELEASE, *supra* note 26, at 1.

156. Roin, *supra* note 3, at 239-40. In the end, there may not be a solution to the taxation of international transactions. *Id.* "Governments and their populations may be forced with choosing between continuing the operation of very imperfect tax system or switching to a tax system based on a metric other than income." *Id.*

Furthermore, without effective international tax enforcement and the transfer of information between jurisdictions, the issues associated with enforcement of taxing policies will likely never be solved. *Id.*

157. Lokken, *supra* note 83, at 771. Nor does this paper "completely catalogue the shortcomings of current law." *Id.*

158. See generally Roin, *supra* note 3; Chorvat, *supra* note 3; Hufbauer & Kim, *supra* note 23; Lokken, *supra* note 83 (discussing the various aspects of the approach advocated for within this Comment).

cohesive approach will result in simplification and, in the long run, lower administrative costs. The U.S. government should reform the current system of corporate taxation and adopt the hybrid approach advocated in this Comment.

