

1-1-2013

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Susan C. Morse, *A Corporate Offshore Profits Transition Tax*, 91 N.C. L. REV. 549 (2013).Available at: <http://scholarship.law.unc.edu/nclr/vol91/iss2/4>

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A CORPORATE OFFSHORE PROFITS TRANSITION TAX*

SUSAN C. MORSE**

Congress might repeal the residual U.S. tax imposed when non-U.S. subsidiaries repatriate earnings to U.S. parent corporations. Repeal would raise the transition issue of how to tax the \$1 trillion to \$2 trillion of offshore earnings held by such non-U.S. subsidiaries. This Article proposes a 5–10% corporate offshore profits transition tax on non-U.S. subsidiaries' untaxed earnings and profits, without downward adjustment for a foreign tax credit. It suggests using the financial accounting measure of unremitted earnings to help determine pre-1987 earnings and police aggressive efforts to reduce the earnings and profits base. The Article's comprehensive policy analysis is based on the metrics of efficiency, administrability, and equity.

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** Associate Professor, UC Hastings College of the Law. Many thanks for helpful comments to participants in workshops and colloquia at UC Hastings, Loyola-LA, NYU, and the University of Toronto; and to Itai Grinberg, Mark Hoose, Edward Kleinbard, Daniel Shaviro, and Stephen Shay. The UC Hastings Summer Research Stipend Program helped fund this project.

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INTRODUCTION

What should happen to the \$1 trillion to \$2 trillion of untaxed earnings held offshore in the non-U.S. subsidiaries of U.S.-parented multinational corporations ("MNCs") in the event of corporate income tax reform?¹

Current U.S. rules are vulnerable to aggressive international tax planning² and encourage U.S.-parented MNCs to retain cash offshore in non-U.S. subsidiaries to avoid the residual U.S. income tax imposed, subject to foreign tax credits, on dividends repatriated to U.S. parents.³ A territoriality reform might address the situation by exempting non-U.S. business income from U.S. tax and attempting to carefully define non-U.S. income in order to protect the U.S. tax base.⁴ A worldwide consolidation reform would try to solve the

1. See DAVID ZION, AMIT VARSHNEY & NICHOLE BURNAP, CREDIT SUISSE, PARKING EARNINGS OVERSEAS 1 (2011) (giving a \$1.3 trillion estimate for the related, though distinct, financial accounting figure of permanently reinvested earnings).

2. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79, 85 (2009) (summarizing argument that the imperfections of various U.S. international tax rules produce a system that is even more favorable to U.S.-parented MNCs than territoriality); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 707-14 (2011) (arguing that the U.S. international corporate income tax system is an "ersatz territorial" system).

3. See Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 406 (2011).

4. See Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487, 494 (2003). One approach argues that worldwide efficiency concerns, under the theory of capital ownership neutrality, support territoriality. *Id.* ("The United States would reduce world welfare by taxing foreign income . . . since such a system encourages American firms to purchase assets in high-tax countries and foreign firms to

problems by including in U.S. MNCs' corporate income tax base all of the income earned by non-U.S. subsidiaries of a U.S.-parented MNC, with a deduction or a credit for foreign income taxes paid.⁵ Intermediate reform options include the taxation of non-U.S. business income at a rate less than the maximum U.S. rate, but more than zero.⁶

Reform proposals often include the repeal of the existing U.S. "residual" tax upon the repatriation of profits to U.S. parents.⁷ This raises the question considered here:⁸ What transition tax, if any, should be imposed on pre-enactment offshore earnings upon the repeal of the residual repatriation tax?

Such a transition tax might be called a corporate offshore profits transition tax. This Article considers the proper design of such a transition tax designed as a lump-sum tax that would fully satisfy

purchase assets in low-tax countries."); *see also infra* Part I.A (describing different arguments in favor of territoriality). *See generally* Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in *FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS* 319, 329–30 (John W. Diamond & George R. Zodrow eds., 2008) (describing territoriality and "constant burden worldwide taxation").

5. Capital export neutrality is a worldwide efficiency-based theory sometimes invoked in support of worldwide consolidation. *See* OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS* 26–42 (2000) (summarizing capital export neutrality-based literature).

6. *See, e.g.*, Shaviro, *supra* note 3, at 417 (proposing "serious consideration" of a low but nonzero rate of tax on non-U.S. income). Worldwide efficiency standards support either zero taxation of non-U.S. income (in the case of CON) or full taxation of non-U.S. income (in the case of CEN). However, national welfare standards may well be more appropriate benchmarks for the consideration of the domestic policy question of international corporate tax reform. A national welfare standard can support the taxation of non-U.S. business income at a rate between zero and the domestic rate, for example, in order to calibrate the rate to reflect the appropriate level of encouragement for U.S.-based businesses to invest outside the U.S. *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 *TAX L. REV.* 261, 280–82 (2001) (supporting national welfare, rather than worldwide efficiency, as a policy goal); Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 *TAX L. REV.* 155, 164–65 (2007) (contending that, even if worldwide welfare improves national welfare by encouraging cooperative behavior, unobserved defections should improve national welfare).

7. However, the Obama administration's "framework" is vague on this point. *See generally* WHITE HOUSE & DEP'T OF THE TREASURY, *THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM* (2012), <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf> (not specifying a repatriation policy).

8. This question has not been comprehensively analyzed, although Daniel Shaviro has given an outline defense of a transition tax at a rate of approximately twenty percent. *See* Shaviro, *supra* note 3, at 417–28 (analogizing to transition issue upon the adoption of corporate integration).

MNCs' U.S. income tax obligations with respect to pre-enactment untaxed earnings of non-U.S. subsidiaries. An MNC's payment of such a tax would permit the tax-free repatriation of such pre-enactment earnings after enactment.⁹

Several factors initially constrain the design of a corporate offshore profits transition tax. One is the political environment, which appears to favor a territorial reform (if any reform at all)¹⁰ and thus poses the question of how to design the transition tax in conjunction with territoriality. Constitutional boundaries based on a substantive due process analysis likely rule out an exact and explicit retroactive taxation approach.¹¹ Tax treaties present a third constraint: the imposition of a corporate offshore profits transition tax might generate a tax treaty controversy if an MNC could submit a credible claim that the transition tax should reduce taxes due to a treaty partner.¹²

Within these design constraints, there is a considerable range of choices for the design of the transition tax. In particular, the constraints permit a range of tax rates and tax bases. Both the tax rate question and the tax base question pose considerations of efficiency, administrability, and equity.

Taxpayer expectations are the key to the efficiency analysis of the appropriate transition tax rate presented in this Article. In particular, this Article takes the view that the transition tax should seek to match taxpayer expectations. This view is based on an assumption that legislators would prefer to avoid an abrupt departure from taxpayer expectations. Legislators would presumably worry that departing from taxpayer expectations would cause corporate taxpayers to take undesirable actions after the enactment of the law. For example, taxpayers might overinvest in handicapping future transition tax policy or use expatriation strategies to change to non-

9. See *infra* Part II.A.

10. See, e.g., MARTIN SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 83 (2011).

11. See *United States v. Carlton*, 512 U.S. 26, 35 (1994) (applying rational basis test and upholding one-year retroactivity for limitation of estate tax deduction for proceeds of sale of stock to employee stock ownership plan); *id.* at 38 (O'Connor, J., concurring) ("A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.").

12. A number of U.S. treaty partners have tax systems that include foreign tax credit provisions, even though their systems may also be territorial. See HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 448-64 (3d ed. 2010). Frequently, the types of taxes that are creditable are listed in treaties. See *id.* at 452.

U.S.-parented corporate structures in an effort to avoid similar adverse congressional action in the future.

There are at least three possible sources of taxpayer expectations about a likely transition tax. First, taxpayers may rely on information about transition tax policy, including information about other countries' transition taxes upon the adoption of territoriality. Second, they may analyze the issue under the assumption that Congress will seek to match transition tax burdens to the present value of the expected future burden of taxation of offshore earnings. Third, they may be unwilling or unable to perform the exercise of absorbing and/or acting on information about possible transition tax policy, resulting in a tax burden they expect to be, as in the second analytical approach, formed by existing law. This Article analyzes each of these factors and argues that they support a congressional proposal of a corporate offshore profits transition tax rate of between 5% and 10%, with no allowance for foreign tax credits ("FTCs").

Administrability concerns support a transition tax rate that is uniform across all companies. But a uniform transition tax rate raises equity considerations.¹³ One question concerns the horizontal equity relationship between different business groups with interests in the current tax reform debate. A corporate offshore profits transition tax would burden global incorporated businesses owned by a U.S. parent corporation, but this might offset benefits provided by territoriality reform to global multinationals relative to current law, depending on the details of the reform.¹⁴ Another question involves the relative equities of different groups of global multinationals, such as groups with higher FTCs and groups with lower FTCs. Since different groups

13. For purposes of this Article, equity considerations relating to the proper place of the corporate income tax in the U.S. system are set aside. One view holds that it is reasonable to assume that the corporate income tax largely falls on shareholders, and therefore the corporate tax is an important progressive element of the U.S. tax system. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 322–23 (2001) (arguing that the ability-to-pay feature of the U.S. federal income tax supports taxing corporations on their worldwide income). Related arguments defend the corporate tax from a regulatory perspective. See, e.g., Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1196 (2004). Both of these views may support a higher corporate offshore profits transition tax rate simply because the transition tax would be a corporate tax.

14. See, e.g., Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J. 811, 819–23 (2001) (emphasizing the importance of expense allocation including interest expense allocation and the incentives for shifting repatriation structures from royalties to dividends under a territorial system); see also Michael Graetz & Paul Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 774 (2001) (listing design options for defining business income).

of global multinationals are able to redress perceived inequities through the legislative process, including through adjustments to a tax reform package separate from the transition tax, transition tax liability does not necessarily need to reflect downward adjustments to account for FTCs.

The question of the proper transition tax base may also be analyzed from efficiency, administrability, and equity perspectives. One possible transition tax base is a tax measure—the untaxed offshore “earnings and profits” of U.S. MNCs.¹⁵ Another candidate is a financial accounting measure of unremitted earnings, including, but not limited to, any earnings designated as permanently reinvested earnings.

The earnings and profits base meets taxpayer expectations, thus furthering efficiency and, arguably, equity goals. But firms lack readily available records for all of their earnings and profits, particularly pre-1987 earnings and profits. Additionally, firms would have a tax incentive to reduce earnings and profits. Thus, the earnings and profits tax base raises efficiency, administrability, and horizontal equity challenges.

An unremitted earnings tax base has efficiency and administrability benefits, as it would likely facilitate the calculation of pre-1987 earnings and might check firms’ ability or desire to engage in planning to reduce the tax base. It would, however, deviate from taxpayer expectations, presenting an efficiency problem. An equity analysis also reveals drawbacks in the use of an unremitted earnings tax base. In particular, to the extent that the distribution of unremitted earnings among firms differs from the distribution of earnings and profits among firms, taxing the financial accounting-derived tax base would allocate the tax burden in a way that is different from the way in which the tax burden would be allocated if the tax measure were used.

Policymakers might seek to claim some of the administrability and efficiency advantages of an unremitted earnings tax base while avoiding the taxpayer expectation efficiency problem and the equity question raised by exclusive reliance on an unremitted earnings base. For example, the law might give permission for firms to use an unremitted earnings measure to estimate their pre-1987 earnings and profits. It could also require disclosure of the gap between a firm’s

15. Shaviro, *supra* note 3, at 426 (describing a tax base consisting of “controlled foreign subsidiaries’ accumulated earnings and profits . . . under U.S. rules, through the effective date”).

offshore earnings and profits and a firm's book-tax basis difference for its non-U.S. subsidiaries and the reasons for such a gap. Such a disclosure would parallel the existing Schedule M-3, which is a book-tax income reconciliation required of large firms.¹⁶

This Article proceeds in four parts. Part I describes the political, constitutional, and tax treaty constraints that frame the consideration of a corporate offshore profits transition tax on untaxed offshore earnings in conjunction with the enactment of a territorial corporate income tax reform. Part II considers efficiency, administrability, and equity concerns that influence the choice of the transition tax rate. Part III evaluates efficiency, administrability, and equity factors in connection with the choice of the transition tax base. Part IV discusses the alternative prospect of worldwide consolidation reform and the prospect of a transition tax in connection with such a reform.

I. POLITICAL, CONSTITUTIONAL, AND TAX TREATY CONSTRAINTS

A. *Politics of Corporate Tax Reform*

The politics of corporate income tax reform do not favor change.¹⁷ The U.S. legislative process presents many sequential hurdles to enactment and therefore favors the status quo.¹⁸ In the corporate tax reform area, Jennifer Arlen and Deborah Weiss argue that agency costs further hamper reform because managers favor policies like accelerated depreciation that provide targeted incentives for new corporate investment, even though shareholders prefer policies that also enrich existing investment.¹⁹ Michael Doran builds on the Arlen and Weiss analysis with a public choice account of heterogeneity of interests among different corporations.²⁰ The result,

16. Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, available at <http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf>.

17. See SULLIVAN, *supra* note 10, at 3–10 (explaining the influence of interest groups and other concerns making reform unlikely).

18. See, e.g., WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, LEGISLATION AND STATUTORY INTERPRETATION 70 (2d ed. 2006) (“The most salient aspect of the modern legislative process is that it is filled with a complex set of hurdles that proponents of a new policy must overcome before their bill becomes law.”).

19. See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 336–38 (1995) (arguing that managers have incentives to favor policies that encourage additional investment or otherwise make possible increases to individual returns such as salaries).

20. See Michael Doran, *Managers, Shareholders and the Corporate Double Tax*, 95 VA. L. REV. 517, 536–42 (2009) (citing “unevenness resulting from the different use of corporate tax preferences, interest deductions, and tax shelters”).

he argues, is an incentive for corporations that disproportionately benefit from a certain tax break, for example, the research and development credit, to lobby energetically to keep that tax break rather than supporting more general reform proposals like base-broadening and rate-lowering.²¹

If corporate tax reform does make it to the legislative agenda sometime in the relatively near future, the international aspect of a package may include territoriality, the exemption of non-U.S. business income earned by corporations (including U.S.-parented MNCs) from U.S. income tax.²² This departs from the worldwide efficiency idea of capital export neutrality, or “CEN,”²³ which has strongly influenced thinking about international tax policy within government²⁴ since at least the Kennedy administration.²⁵ CEN is strongest if the critical question for the proper allocation of investment is the decision about the allocation of U.S. capital among various investments with flexible location.²⁶ CEN supports a system of worldwide residence-based taxation, including a system of worldwide consolidation for corporate income taxation.²⁷ Numerous scholars have advocated a policy of worldwide consolidation, relying on the theory of CEN to varying degrees.²⁸

21. *Id.*

22. See JANE G. GRAVELLE, CONG. RESEARCH SERV., 7-5700, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 1-3 (2012) (describing tax reform landscape including territoriality proposals).

23. Peggy Musgrave first articulated the idea of CEN within a worldwide efficiency framework and outlined other approaches to efficiency and international taxation. See generally PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS (1969). A more extreme view related to CEN is national neutrality, which prescribes a deduction, rather than a credit, for foreign income taxes. See Peggy B. Musgrave, *Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World*, in THE NEW PUBLIC FINANCE: RESPONDING TO GLOBAL CHALLENGES 167, 178 (Inge Kaul & Pedro Conceição eds., 2006) (“[U]nder what may be called a ‘national’ view of taxpayer equity the foreign tax is treated as a deduction from foreign source income (in effect, a cost of doing business), and the residence country’s corporate tax is applied to foreign earnings net of foreign tax.”).

24. For example, Treasury reports have emphasized CEN. See OFFICE OF TAX POLICY, *supra* note 5, at 34 (summarizing capital export neutrality-based literature).

25. Subpart F grew out of a worldwide consolidation proposal made by the Kennedy administration. See Special Message to the Congress on Taxation, 1961 PUB. PAPERS 290, 294 (Apr. 20, 1961) (proposing “[e]limination of tax deferral privileges in developed countries and ‘tax haven’ deferral privileges in all countries”).

26. See Jane G. Gravelle, *International Corporate Tax Reform: Issues and Proposals*, 9 FLA. TAX REV. 469, 479-81 (2009) (arguing that CEN trumps CON if capital is mobile).

27. See Wolfgang Schön, *International Tax Coordination for a Second-Best World*, 1 WORLD TAX J. 67, 78 (2009).

28. See, e.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1329-30 (1996) (describing tax planning

For some time, the international corporate tax reform battle lines were drawn between, on one hand, CEN and worldwide consolidation and, on the other hand, capital import neutrality (“CIN”) or capital ownership neutrality (“CON”) and territoriality.²⁹ CON, the more current worldwide efficiency theory invoked in favor of territoriality, assumes that the critical investment allocation question is the asset owner’s identity.³⁰ CON focuses on minimizing the likelihood that a capital asset will attract the wrong owner based on tax policy.³¹ CON supports territoriality because territoriality will result in the same tax, and therefore the same after-tax return, on the profits generated by a capital asset located in a particular jurisdiction regardless of the asset’s owner.³² The idea is that if the after-tax return is the same regardless of the asset’s owner, then the owner who can make the most productive use of the asset will own it. CON is most persuasive when applied to geographically fixed assets.³³

problem with territoriality); Fleming, Peroni & Shay, *supra* note 13, at 322–23; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 152–55 (2011) (listing advantages of worldwide consolidation, including: (1) satisfying CEN; (2) solving the problem of “stateless income”; and (3) finessing the “otherwise intractable” problems of transfer pricing and expense allocation).

29. See Michael S. Knoll, *Reconsidering International Tax Neutrality*, 64 TAX L. REV. 99, 100–03 (2011) (describing the traditional understanding of CEN/CIN tension).

30. See Desai & Hines, *supra* note 4, at 494 (“The United States would reduce world welfare by taxing foreign income . . . since such a system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries.”). The older concept of capital import neutrality, or CIN, also supports territoriality. It can be understood to incorporate two neutrality concepts, relating to ownership and to savings versus investment. CON continues to encompass the ownership neutrality component. See Knoll, *supra* note 29, at 119–21. However, the CIN idea that different tax rates imposed on different investors will distort savings and investment rates is not consistent with empirical work demonstrating that savings rates are not very sensitive to tax policy. See Schön, *supra* note 27, at 78. However, CIN’s ownership neutrality component survives in the form of CON.

31. See Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT’L TAX J. 937, 956 (2004) (“Global efficiency is characterized by ownership arrangements that maximize total world output, whereas national welfare (taking the tax policies of other countries as given) is characterized by tax policies that maximize home country incomes.”).

32. CON is satisfied if all nations have territorial systems. Its main policy directive is that, since most U.S. trading partners have territorial systems, the U.S. should also adopt such a system. However, CON is also consistent with all nations’ adoption of worldwide residence-based taxation with full foreign tax credits, even if nations have different tax rates, so long as the relationship between the tax rates is fixed. The reason is that capital owners resident in any jurisdiction will face the same after-tax return on all of their investments, so their investment choices will not be distorted by taxes. See Desai & Hines, *supra* note 4, at 494–95.

33. See *id.* at 495 (“The welfare implications of CON are less decisive in settings in which the location of plant, equipment, and other productive factors is mobile between countries . . .”).

The CEN/CON framework does not attract a consensus. Critics of the CEN/CON debate, including Michael Graetz and Daniel Shaviro, charge that worldwide efficiency is not the right metric to evaluate a tax system.³⁴ In a separate article, Shaviro criticizes the binary full-or-zero-taxation approach presented by the CEN/CON debate and proposes “serious consideration” of a low, but non-zero, rate of U.S. tax on foreign income.³⁵ Johannes Becker and Clemens Fuest argue that CON has failed to identify a satisfying welfare function.³⁶ David Hasen contends that the debate omits the important role of tax revenues in providing productivity-enhancing “tax amenities,” such as infrastructure, and proposes explicit consideration of the “competitive, allocative, and distributional properties of various possible tax regimes.”³⁷

Some scholars present an alternative justification for territoriality, arguing that territorial systems are consistent with the benefits taxation idea that each country should have “source” jurisdiction over items of active business income properly attributable to that country’s economy.³⁸ Julie Roin bases this argument on linkages between tax policy and government benefits.³⁹ Nancy

34. See Graetz, *supra* note 6, at 280–81 (“This contrasts with the case of trade policy, where free trade is thought to maximize national as well as global income, because the mechanism of floating consumer prices.” (citing Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT’L TAX & PUB. FIN. 471, 472 (1995))); Shaviro, *supra* note 6, at 164–65 (contending that even if worldwide welfare improves national welfare by encouraging cooperative behavior, unobserved defections should improve national welfare).

35. Shaviro, *supra* note 3, at 417.

36. See Johannes Becker & Clemens Fuest, *Foreign Income and Domestic Deductions—A Comment*, 63 NAT’L TAX J. 269, 271–72 (2010) (questioning CON welfare function). Michael Graetz has observed that increasing worldwide welfare does not necessarily increase national welfare in the case of international tax policy. See Graetz, *supra* note 6, at 312.

37. David Hasen, *Tax Neutrality and Tax Amenities*, 12 FLA. TAX REV. 57, 121–22 (2012) (suggesting that, because worldwide systems do not present a race-to-the-bottom problem, they are more likely than territorial regimes to promote welfare-enhancing national investment).

38. See Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1077–78, 1080–81 (1997) (describing the 1923 League of Nations “economic allegiance” principle and also the allocation of more jurisdiction to source countries under a subsequent, “more practical” 1925 United Nations report).

39. See Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 603 (2001) (“Source countries should remain free to use tax policies to attract business investment, just as residence countries should have the right to tax their residents to support the social services . . . that they enjoy.”).

Kaufman frames it as an issue of inter-nation equity.⁴⁰ However, this benefits-taxation-based argument is not fully persuasive either, since the relationship between business profit and the government benefits facilitating that profit is so attenuated. Hugh Ault and David Bradford have expressed the view that the idea of geographic income source is meaningless.⁴¹

Another argument for a territorial system derives from the observation that firms do not pay much tax on non-U.S. business income under the current system, so the enactment of a properly structured territorial system might actually increase federal income tax collections from U.S.-parented MNCs.⁴² Under applicable anti-deferral rules, a U.S.-parented MNC must currently pay tax on the income of its foreign subsidiaries, known as controlled foreign corporations (“CFCs”),⁴³ to the extent such income falls into the definition of “subpart F income,”⁴⁴ subject to the reduction of U.S. tax under applicable foreign tax credit provisions.⁴⁵ Thus, U.S.-parented MNCs face an incentive to engage in planning to minimize subpart F income, maximize tax savings via foreign tax credit planning, and navigate other rules in order to reduce U.S. tax

40. See Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL’Y INT’L BUS. 145, 198 (1998) (basing an international equity analysis on the question of the “economic allegiance” of “income produced by international transactions”); see also Jinyan Li, *Improving Inter-Nation Equity through Territorial Taxation and Tax Sparing*, in GLOBALIZATION AND ITS TAX DISCONTENTS: TAX POLICY AND INTERNATIONAL INVESTMENTS 117, 128 (Arthur J. Cockfield ed., 2010) (“[T]erritorial taxation of business profits would promote inter-nation equity . . .”).

41. See Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 31 (Assaf Razin & Joel Slemrod eds., 1990) (“Income . . . attaches to someone or something that consumes and that owns assets. Income does not come from some place . . .”); see also Kleinbard, *supra* note 2, at 750–52 (2011) (describing “[t]he [f]ruitless [s]earch for [s]ource”).

42. See, e.g., Grubert, *supra* note 14, at 814 (providing a static revenue gain estimate of \$9 billion based on 1996 Treasury data and evaluating possible behavioral responses to territoriality adoption including “adjustments to overhead expenses and royalty payments”).

43. See I.R.C. § 957(a) (2006) (defining a foreign corporation as a “controlled foreign corporation” if more than half of the foreign corporation’s stock is owned by U.S. shareholders).

44. *Id.* § 951(a). Subpart F is intended to describe most categories of mobile and passive income. See, e.g., Stephen E. Shay, *Exploring Alternatives to Subpart F*, 82 TAXES 29, 29 (2004) (referring to subpart F’s targeting of passive and base company income).

45. See I.R.C. § 901 (2006) (granting foreign tax credit); *id.* § 902 (providing for deemed paid foreign tax credit when foreign corporations distribute dividends to certain U.S. corporate shareholders); *id.* § 904 (providing foreign tax credit limitation rules).

on non-U.S. income.⁴⁶ It is estimated that U.S. tax is currently imposed on non-U.S. business income earned by non-U.S. subsidiaries in MNC groups at a rate between 3% and 6%.⁴⁷ U.S.-parented MNCs may also seek ways to allocate income related to U.S. operations to low-taxed non-U.S. affiliates and, conversely, to allocate deductions away from low-taxed non-U.S. affiliates and toward U.S. operations.⁴⁸

Despite competing theoretical arguments about territoriality and worldwide consolidation, territorial models lead current U.S. international corporate income tax policy discussions. Proposals in Congress include a discussion draft released by Representative David Camp in 2011⁴⁹ and a bill proposed by Senator Michael Enzi in 2012.⁵⁰ Bipartisan tax reform committees have also recommended territoriality.⁵¹ The Obama administration has not declared support

46. See, e.g., Fleming, Peroni & Shay, *supra* note 2, at 85 (outlining U.S. corporate international income tax planning opportunities); Kleinbard, *supra* note 2, at 706–15 (same); Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 184, 202–06 (2005) (considering possible solutions to the weakening of the subpart F rules as a result of the rules permitting entities to “check the box” to elect to be treated as flow-through entities for U.S. tax purposes).

47. See HARRY GRUBERT & JOHN MUTTI, *TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM* 31–32 (2001) (reporting a 3.3% estimate for the overall burden of a dividend repatriation tax assuming an excess limitation foreign tax credit position and a non-U.S. effective tax rate below 10%); Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT’L TAX J. 787, 797 (2001) (calculating a rate of 5.4% based on certain assumptions drawn in part from 1992 Treasury tax return data; the rate also reflects the assumption that intangible assets produce royalty income that bears the full U.S. top statutory rate for excess limitation firms); Melissa Costa & Jennifer Gravelle, *Taxing Multinational Corporations: Average Tax Rates*, 65 TAX L. REV. 391, 404 (2012) (calculating an average residual tax rate imposed by the U.S. of 3.3% of foreign book income based on tax year 2007 data).

48. See, e.g., Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT’L TAX J. 703, 711, 717 (2009) (estimating “financial” income-shifting and “real” productive asset location-shifting responses to higher U.S. tax rates and concluding that the financial effects, producing lost tax revenue of about \$87 billion in 2002, were more than double the real effects).

49. See Press Release, Representative Dave Camp Releases Technical Explanation of International Tax Reform Plan (Oct. 26, 2011), <http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=266168> (describing an international corporate tax reform proposal featuring a territorial tax system).

50. See United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. § 245A (2012) (recommending a territorial system featuring a 95% dividend deduction for certain non-U.S. dividends). See generally GRAVELLE, *supra* note 22, at 24–28 (outlining and comparing several proposals).

51. See THE NAT’L COMM’N ON FISCAL RESPONSIBILITY AND REFORM, *THE MOMENT OF TRUTH* 33 (2010) (recommending a “territoriality” system for active “foreign-source income”); see also JOINT COMM. ON TAXATION, *JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* 189 (2005)

for a territorial plan, but instead supports a system that would provide for a “minimum” rate of tax on foreign income.⁵² Yet a consensus may be building, even among historically stalwart supporters of worldwide consolidation, or at least one that takes careful measures to minimize U.S. tax base erosion.⁵³

Another reason for the focus on a territorial reform derives from the fact that all U.S. trading partners have territorial regimes. Others’ adoption of territoriality may be driven by a different policy analysis and, in particular, the greater risk of capital flight in a small open economy as opposed to a large open economy.⁵⁴ However, similar risks concern U.S. policymakers, even though the U.S. economy still leads the global economy. The adoption of worldwide consolidation might produce an immediate reduction in the value of non-U.S. assets held by U.S. firms.⁵⁵ There is also concern that a worldwide consolidation reform would incentivize U.S.-headquartered firms to adopt non-U.S.-parented ownership structures.⁵⁶

Another way to explain the prevalence of territoriality in the current U.S. international tax policy discourse is to posit that the global corporate tax lobby is strong enough that only a territoriality

(recommending territoriality); PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 102–05 (2005) (recommending territoriality).

52. See WHITE HOUSE & DEP’T OF THE TREASURY, *supra* note 7, at 13–15 (proposing a “minimum” rate of tax on non-U.S. income).

53. See Martin A. Sullivan, *The Economic Case for Unlocking Foreign Profits*, 136 TAX NOTES 7, 11 (2012).

54. See, e.g., *How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market and Create Jobs: Hearing Before the Comm. on Ways and Means*, 112th Cong. 4 (2011) [hereinafter *Hearing*] (statement of Stephen Edge), available at <http://waysandmeans.house.gov/uploadedfiles/edgetest.pdf> (“Like any market place, you first have to attract the traders to set up business and then make it attractive for people to come to the UK and do business with them.”).

55. Shaviro, *supra* note 3, at 394 (describing clientele effects that could produce “asset swaps” between U.S. and non-U.S. investors upon the imposition of a worldwide tax).

56. See, e.g., Roger H. Gordon, *Discussion*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS, *supra* note 4, at 365–67 (noting that worldwide consolidation will incent multinationals owned by U.S. investors to locate outside the United States or will incentivize U.S. investors to increasingly invest in non-U.S. corporations instead of U.S.-parented MNCs). These are risks, rather than quantifiable certain costs. For example, U.S.-headquartered companies might continue to incorporate in the United States despite an increased incentive to expatriate. Cf. Eric Allen & Susan Morse, *Tax Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet* 21 (Dec. 20, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760 (finding that only forty-seven firms in a sample of almost 3000 U.S. IPOs were headquartered in the United States and incorporated outside the United States).

reform realistically presents an option.⁵⁷ Pragmatic reformers who prioritize a more logical system, including the repeal of a tax on repatriation, may sensibly choose to consider how to optimize territoriality in light of its higher political likelihood.⁵⁸ In any case, the leading place of territoriality in current tax reform debates makes it the most practically important policy frame of reference for consideration of the appropriate transition tax in the event of corporate income tax reform enactment; most of this Article proceeds under this assumption.

B. Constitutional Boundaries for Retroactive Taxes

The modern Supreme Court has refused to strike down any retroactive tax statute on constitutional grounds,⁵⁹ roundly dismissing challenges to retroactive taxes under the Ex Post Facto Clause⁶⁰ and the Equal Protection Clause (absent a situation that calls for a standard of review other than rational basis).⁶¹ However, it has taken seriously recent claims that retroactive taxes violate substantive due process.⁶² For example, in the 1994 case *United States v. Carlton*,⁶³ the Court upheld a retroactive statute against a due process challenge but emphasized the “modest” length of time—about one year—between

57. See generally Arlen & Weiss, *supra* note 19, at 368–69 (discussing realistic corporate tax reform through a political theory lens); Doran, *supra* note 20, at 587–93 (theorizing the operation of public choice in the context of corporate tax reform).

58. See Sullivan, *supra* note 53, at 11 (“Instead of reflexively opposing any territorial proposal, Democrats may want to begin carefully studying the details of a territorial system that are necessary for preventing abuse.”).

59. Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. 265, 270 n.12 (1993); see Charlotte Crane, *Constitutional Limits on the Power to Impose a Retroactive Tax*, in BLESSINGS OF LIBERTY: THE CONSTITUTION AND THE PRACTICE OF LAW 245, 248–49 (1988) (noting that the Court has invalidated only a few retroactive gift and other transfer taxes at “initial enactment,” even at the height of the Court’s substantive due process jurisprudence of the 1920s).

60. The Ex Post Facto Clause limits changes in criminal, but not civil, statutory law. See *Calder v. Bull*, 3 U.S. (3 Dall.) 386, 390 (1798).

61. See *Welch v. Henry*, 305 U.S. 134, 144–45 (1938).

62. In addition, a small set of cases involving the retroactive repeal of savings and loan benefits, which awarded damages based on the loss of expected regulatory and tax benefits, relies on a contract analysis. See Charlotte Crane, *Legitimate Expectations in Tax Transitions: Are Roth IRA Conversions Different?* 12–13 (August 2009) (unpublished manuscript) (citing *United States v. Winstar Corp.*, 518 U.S. 839 (1996) and *Centex Corp. v. United States*, 49 Fed. Cl. 691 (2001), *aff’d*, 395 F.3d 1283 (Fed. Cir. 2005)), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1505120 (considering the possibility that a Roth IRA conversion is “tantamount to a contract” and, therefore, its benefits may not be constitutionally withdrawn without payment of damages).

63. 512 U.S. 26 (1994).

the enactment of the statute and the retroactive amendment to the statute.⁶⁴

In a concurrence, Justice O'Connor suggested that more than one year's retroactivity would be problematic.⁶⁵ At least one state court has held that a retroactive tax violated the due process clause under the *Carlton* precedent because its retroactivity exceeded a "modest" length of time.⁶⁶ The *Carlton* Court also placed some importance on the fact that the retroactive amendment corrected an apparent mistake in the original statute.⁶⁷

The constitutional issue is not a significant obstacle to the imposition of some kind of tax that burdens the untaxed offshore earnings of MNCs. However, it may affect the design of such a tax, especially if policymakers have little appetite for constitutional litigation.⁶⁸ Substantive due process questions would be raised by an explicit retroactive taxation approach that asked a U.S.-parented MNC to go back to each tax year of its non-U.S. subsidiaries and determine the tax that would have been due if the non-U.S. income of such subsidiaries had been subject to U.S. tax. On the other hand, a lump-sum transition tax should not raise any colorable constitutional claim based on a retroactive taxation argument. Corporate taxpayers cannot reasonably have relied on an expectation that no transition tax

64. See *id.* at 35 (applying rational basis test and upholding one-year retroactivity for limitation of estate tax deduction for proceeds of sale of stock to employee stock ownership plan).

65. See *id.* at 38 (O'Connor, J., concurring) ("A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions."); see also *id.* at 40 (Scalia, J., concurring) ("[T]he critical event is the taxpayer's reliance on the incentive . . .").

66. See *Tesoro Ref. and Mktg. Co. v. State, Dep't of Revenue*, 246 P.3d 211, 218 (Wash. Ct. App. 2010) (holding unconstitutional a Washington statute made retroactive for twenty-four years), *rev'd en banc*, 269 P.3d 1013 (Wash. 2012); see also *Tate & Lyle, Inc. v. Comm'r*, 87 F.3d 99, 107–08 (3d Cir. 1996) (reversing Tax Court and upholding six-year retroactive Treasury regulation in part because one-year retroactivity rule suggested in O'Connor concurrence should not apply with equal force to regulations); *In re Garden City Med. Clinic*, 137 P.3d 1058, 1064 (Kan. Ct. App. 2006) (overturning amendment to Kansas tax refund statute which reduced refund period from three years to one year on due process grounds); *Oberhand v. Dir.*, 22 N.J. Tax 55, 62 (2005) (holding one-year retroactive New Jersey statute invalid under state "manifest injustice" equitable doctrine), *rev'd*, 23 N.J. Tax 431 (2006).

67. See *Carlton*, 512 U.S. at 32 ("Congress acted to correct what it reasonably viewed as a mistake in the original . . . provision that would have created a significant and unanticipated revenue loss. There is no plausible contention that Congress acted with an improper motive . . .").

68. Cf. Peter Baker, *Supporters Slow to Grasp Health Law's Legal Risks*, N.Y. TIMES, June 24, 2012, at A1 (recounting Affordable Care Act supporters' refusal to acknowledge potential of constitutional challenge to law).

would be imposed, since the possibility is an important part of the discussions about a change to territoriality. In addition, a lump-sum tax could be analyzed as a separate excise tax; the corporate income tax was originally held constitutional under a similar excise tax argument.⁶⁹

C. Tax Treaty Concerns

In its network of bilateral tax treaties, the United States enters into reciprocal undertakings to avoid double taxation of income.⁷⁰ The relevant treaty provision between the United States and the UK, for example, states:

United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States . . . shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed.⁷¹

In other words, roughly speaking, to the extent the UK taxes U.S.-source income, the UK must reduce the tax liability due to account for income taxes charged by the United States. A parallel provision states that to the extent the U.S. taxes UK-source income, the United States must reduce the tax liability due to account for income taxes charged by the UK.⁷²

The United States uses the foreign tax credit as its main tool to fulfill this obligation. A foreign tax credit generally provides a domestic firm with a credit for taxes paid to foreign jurisdictions with respect to foreign source income.⁷³ Some important U.S. trading partners also extend foreign tax credits.⁷⁴ However, countries with

69. Cf. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 151–52 (1911) (holding a corporate income tax constitutional, i.e., not a direct tax subject to apportionment, because of its nature as an “excise” tax). The Court subsequently overruled *Flint* on a different point of law. See *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 542 (1985).

70. See REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME* 169–81 (2007).

71. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. 23, Dec. 31, 1975, U.S.-Gr. Brit.-N. Ir., 31 U.S.T. 5668, 5686.

72. See *id.*

73. See AULT & ARNOLD, *supra* note 12, at 446–47, 454–57. However, “[a]ll systems have limitations on the extent to which foreign tax paid can displace domestic tax liability.” *Id.* at 454; see, e.g., I.R.C. § 901 (2006) (foreign tax credit provision).

74. See AULT & ARNOLD, *supra* note 12, at 449–54.

territorial systems have a smaller need for a foreign tax credit, since, to the extent a territorial system eliminates domestic tax on foreign income, a foreign tax credit is not needed to reduce domestic tax on foreign income.⁷⁵

A U.S. tax treaty partner could object to a corporate offshore profits transition tax if it reduced the tax revenue of the treaty partner. The incursion of a transition tax into the pre-enactment jurisdiction of a U.S. treaty partner would not necessarily present a technical problem under U.S. law. The “last in time” rule provides that a later-enacted statute trumps a U.S. tax treaty.⁷⁶ Nevertheless, because of the advantages of cooperative working relations with one’s treaty partners, a possibility of tax treaty partners’ dissatisfaction with a transition tax should present a legitimate concern for U.S. policymakers. Stated differently, the question of treaty partners’ reactions may provide a negotiation opportunity, since U.S. provision of relief from concerns about creditability of the transition tax might be made contingent on appropriate treaty partner concessions.

A tax treaty partner objection to a corporate offshore profits transition tax might arise if a U.S.-parented MNC claimed that the transition tax should be credited against the tax liability due to the treaty partner.⁷⁷ This possibility is remote but not impossible.⁷⁸ A claim that a transition tax liability should support a foreign tax credit in a non-U.S. jurisdiction makes little sense if source rules are well aligned. This is because a corporate offshore profits transition tax, by definition, is imposed on earnings over which the United States has

75. See *id.* at 464 (noting that dividend exemption systems have fully or partially replaced indirect foreign tax credit rules in Canada, France, Sweden, Germany, Australia, Japan, the UK, and the Netherlands).

76. See I.R.C. §§ 894(a)(1), 7852(d) (2006). The tax-specific last-in-time rule is consistent with a more general rule relating treaties and statutes. See *Whitney v. Robertson*, 124 U.S. 190, 194–95 (1888). For a succinct summary of key last-in-time jurisprudence and literature, see generally Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 YALE J. INT’L L. (forthcoming 2012).

77. If a transition tax payment were deductible against non-U.S. income for purposes of non-U.S. tax law, it might also reduce tax paid to a treaty partner. Analysis of this possibility is beyond the scope of this Article. However, in many cases a deduction should be barred because the liability to pay the transition tax would lie with the U.S. parent rather than with the non-U.S. subsidiary, and the latter is likely the taxpayer in the non-U.S. jurisdiction.

78. A claim for deductibility of a corporate offshore profits transition tax against non-U.S. income would also be unlikely, but for a different reason. In this case, the reason is that the income of the relevant taxpayer, which is the non-U.S. subsidiary of the U.S. parent, is likely determined by reference to expenses incurred by that subsidiary. But the transition tax would be imposed on the parent, not on the subsidiary. Hence it should not be deductible by the subsidiary.

not exercised jurisdiction, roughly suggesting that the earnings derive from non-U.S. source income. The non-U.S. jurisdiction to which the non-U.S. source income is attributable should not extend a foreign tax credit to a tax on income sourced to that non-U.S. jurisdiction. This is because foreign tax creditability in a particular domestic jurisdiction is generally limited to taxes on foreign-source, not domestic-source, income.

Nevertheless, a claim that a transition tax should be credited might come about for non-U.S. parents of first-tier U.S. subsidiaries that own second-tier non-U.S. subsidiaries. Assume, for example, that the U.S. company in the middle of this structure pays the transition tax without recognizing repatriated income from the second-tier non-U.S. subsidiary. The recognition of additional taxes without the recognition of related income could support a claim of “supercharged” foreign taxes deemed paid upon repatriations from the U.S. subsidiary to the non-U.S. parent.⁷⁹

A claim that a transition tax should be credited might also arise in a U.S.-parented structure because of differences in source rules between taxing jurisdictions; efforts at tax arbitrage; or some synergy between the enumeration of creditable taxes in tax treaties and the legislative description of the transition tax. If it were desirable to address such tax treaty partner objections, it should be possible to provide as a result of treaty negotiations or in the enacting legislation that the transition tax is not intended to be a tax creditable against non-U.S. tax under applicable tax treaties. The transition tax is not structured as a usual income tax would be; rather, it can be understood as a tax on a certain type of corporate wealth. Describing the transition tax as an excise tax for this purpose might further the goal of foreclosing creditability against non-U.S. income taxes, as excise taxes are generally not creditable under bilateral income tax treaties.⁸⁰

II. TRANSITION TAX RATE

Efficiency, administrability, and equity are three classic metrics of tax policy. They focus respectively on economic productivity; ease of administration and enforcement; and fairness, including both

79. Thanks to Itai Grinberg and Steve Shay for helpful discussion of these points relating to U.S.-parented and non-U.S. parented structures and foreign tax credit concerns.

80. See, e.g., U.S. Model Income Tax Convention art. 23 (providing for relief of double taxation via foreign tax credit); *id.* art. 2 (providing that covered taxes constitute U.S. income taxes).

vertical equity, or distributive justice, and horizontal equity, or treatment of like-situated parties similarly.⁸¹ Part II applies these metrics to the question of the appropriate transition tax rate. Part III will apply the same metrics to the question of the appropriate transition tax base.

A. Efficiency

The tax policy metric of “efficiency” refers to economic efficiency. Its goal is to minimize the interference of a tax with decisions taxpayers would make in the absence of the tax.⁸² The idea is that decisions taxpayers make, in the absence of the tax, achieve more optimal resource allocation, and therefore greater economic productivity, than decisions they make in the presence of the tax.⁸³

1. Match Taxpayer Expectations for Transition Tax Efficiency

This Article argues that efficiency goals will be best advanced by a corporate offshore profits transition tax on untaxed offshore earnings if the burden of the transition tax matches pre-enactment taxpayer expectations about likely tax burdens on offshore earnings. These expectations may be formed by an independent estimate of a likely transition tax, by a calculation of the net present value of the expected eventual income tax on offshore earnings, or by unchanged planning under existing law.

For taxes that have no prospective effect, like a one-time transition tax imposed on a snapshot measure of accumulated untaxed offshore earnings,⁸⁴ the main efficiency concerns do not

81. See, e.g., WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 7, at 13–15 (citing “economic neutrality,” fairness and equity (both actual and “perceived”), and “simplicity” as goals of fundamental tax reform).

82. See HARVEY ROSEN & TED GAYER, PUBLIC FINANCE 329–47 (9th ed. 2010).

83. See LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS xvii (2008) (noting basic income tax “tradeoff between distribution and distortion”). The principle that taxes should not interfere with non-tax decisions is not always determinative. For example, the Pigouvian tax theory posits that a tax detriment may serve to discourage a negative externality that otherwise skews decisions away from their economically efficient balancing point. See ROSEN & GAYER, *supra* note 82, at 84. A carbon tax is one example of a Pigouvian tax. See Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499, 500 (2009) (identifying a carbon tax as a particularly broad Pigouvian tax). However, the efficiency analysis in this Article does not attempt to justify the transition tax based on a theory that it will reduce a negative externality or otherwise purposefully incentivize taxpayer behavior.

84. Such a tax would be similar to a transition tax imposed in connection with a corporate integration reform. See Alan J. Auerbach, *Debt, Equity and the Taxation of Corporate Cash Flows*, in DEBT, TAXES, AND CORPORATE RESTRUCTURING 91, 94–97

derive from a concern that taxpayers will plan to reduce the tax base since the base for a one-time transition tax is formed by decisions made before the measurement date for the transition tax base.⁸⁵ Rather, the efficiency analysis related to a one-time transition tax focuses mainly on the chance that taxpayers in the future will behave differently as a result of the possibility that unexpected transition taxes might be imposed again.⁸⁶ In particular, U.S. multinational taxpayers in the wake of an unexpected transition tax might invest excess resources in handicapping or planning for other future transition taxes⁸⁷ or increase their use of expatriation strategies in an effort to avoid similar adverse congressional action in the future.⁸⁸

The possibility of changed behavior in the future is framed by the fact that an explicit transition tax, like the transition tax proposed here, would be unusual. Typically, Congress enacts changes in tax law that implicitly affect taxpayers' economic position in a retroactive fashion, for example, because the value of assets changes when the tax law applicable to future income or consumption supported by those assets changes.⁸⁹ However, Congress does not typically enact retroactive tax laws that explicitly tax income already earned.⁹⁰ If

(John B. Shoven & Joel Waldfogel eds., 1990) (describing the American Law Institute proposal to avoid windfall gains to old equity by tracing dividend payments to pre-enactment earnings and the alternative of imposing a one-time tax on accumulated earnings at the time of enactment).

85. See DANIEL SHAVIRO, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY 19–25 (2000) (outlining the importance of taxpayers' expectations about future policy changes); Shaviro, *supra* note 3, at 423–24.

86. See SHAVIRO, *supra* note 85, at 19–25 (2000) (arguing that rational expectations are “a useful benchmark” in assessing how taxpayers “anticipate *ex ante* and respond *ex post* to retroactive rule changes.”); Shaviro, *supra* note 3, at 423–24.

87. It is not clear whether a U.S.-parented corporation would in fact face less exposure to adverse congressional action compared to a non-U.S. parented corporation. See Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation*, 13 FLA. TAX REV. (forthcoming 2013) (proposing that uncertainty about future congressional action adverse to tax haven-parented corporations may disincentivize startup corporations from choosing tax haven incorporation).

88. See, e.g., Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429, 430–36 (2012) (describing three situations in which corporate inversions can occur).

89. See, e.g., Alan J. Auerbach, Book Review, 39 J. ECON. LIT. 590, 590 (2001) (reviewing DANIEL SHAVIRO, WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY (2000)) (“[V]irtually all policy changes are retroactive . . .”).

90. See SHAVIRO, *supra* note 85, at 104–10 (describing “anti-nominal retroactivity” norm, acknowledging the “arbitrariness” of anti-nominal retroactivity, and offering supporting arguments based on lower contracting costs, public choice limitation, and consistency with short-term budgetary windows). The relevant statutory construction

Congress did enact a similar retroactive tax, such as a corporate offshore profits transition tax, taxpayers in the future might change their behavior in anticipation of other similar future transition taxes.

Michael Graetz⁹¹ and Louis Kaplow⁹² have separately articulated theories founded on taxpayers' formation of rational expectations about transition tax policy. These theories do not necessarily comport with the conclusion suggested in this Article that a corporate offshore profits transition tax should seek to match taxpayer expectations. The work of Graetz and Kaplow can be read to support a retroactive transition tax policy, or, in other words, one in which changes to steady-state tax rules are explicitly applied retroactively.⁹³ The argument is that a fully retroactive rule might beneficially increase rational taxpayers' anticipation of possible future changes in policy when they make asset pricing and other decisions.⁹⁴ This increased anticipation of possible future changes in tax rules presumably has benefits if the anticipated rule change is good policy, as Daniel Shaviro has pointed out.⁹⁵

This Article argues, however, that in the case of an underlying territorial international corporate income tax reform, the transition policy should not match the steady-state reform. The approach of conforming transition tax policy to a steady-state policy of territoriality would result in no transition tax at all, since a territorial approach would exempt all non-U.S. business income from tax. And so long as U.S.-parented MNCs do not in fact predict a retroactive policy of territoriality, but rather expect to pay some tax on their pre-

principle holds that statutes have prospective effect absent a clear expression of retroactive legislative intent. See, e.g., *Landgraf v. USI Film Prods.*, 511 U.S. 244, 270 (1994) ("Since the early days of this Court, we have declined to give retroactive effect to statutes burdening private rights unless Congress had made clear its intent.").

91. See Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 78–79 (1977) (rejecting the claim that fairness requires transition relief, in part because affected parties should be able to predict a legislative change with more and more confidence as it makes its way through the legislative process).

92. See Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 551–60 (1986).

93. See Graetz, *supra* note 91, at 87 (noting "no overwhelming preference for grandfathering"); Kaplow, *supra* note 92, at 551 ("Sometimes new legal rules should be made fully retroactive . . .").

94. See Graetz, *supra* note 91, at 65–66 ("Reasonable expectations in the political context may . . . consist of only those which assess some subjective probability of change in the law."); Kaplow, *supra* note 92, at 522–33.

95. See SHAVIRO, *supra* note 85, at 98–99 ("Transitional protection should be denied when preferences and dispreferences are curtailed, and granted when they are expanded.").

enactment offshore earnings, refraining from imposing a transition tax leaves tax revenue on the table from an efficiency point of view. In other words, in the absence of a transition tax, U.S.-parented MNCs would enjoy a windfall.⁹⁶ The point of a transition tax that meets taxpayer expectations is to convert the potential windfall into tax revenue.

The following discussion identifies three possible sources of taxpayer expectations about transition taxes: estimates based on transition tax data points, estimates based on the assumption that Congress will enact a transition tax policy that avoids windfall gain or loss, and estimates based on the assumption that taxpayers do not anticipate or cannot act on estimates of future transition tax policy. The first estimating approach draws on examples of taxes in the range of 0–10.5% and on descriptions of “small” or “modest” taxes. The second and third approaches suggest a calculation of the present value of the eventual tax on offshore earnings. The back-of-the-envelope calculation offered below indicates a tax rate under the second and third approaches of approximately 10%.

2. Estimates Based on Transition Tax Policy

One approach to expectations about a transition tax involves estimating what transition tax the government might apply without reference to any expectation about the present value of eventual tax on untaxed offshore earnings. Taxpayers might refer to transition tax proposals made in Congress, to the 2004 repatriation tax holiday offered to U.S.-parented MNCs, to the UK’s 2009 adoption of territoriality, to Japan’s 2009 adoption of territoriality, and to references to transition tax options in the academic literature.

The 2004 U.S. repatriation holiday applied an effective rate of 5.25%, assuming a 35% marginal statutory rate. It used an 85% dividends received deduction and allowed foreign tax credits to be applied to “extraordinary” cash dividends distributed within a one-year period to U.S. parents of MNCs.⁹⁷ Repatriated funds exceeded \$300 billion,⁹⁸ and some corporations have called for a repeat of the

96. See Shaviro, *supra* note 3, at 417–28 (identifying the “windfall” issue).

97. See I.R.C. § 965 (2006). To be precise, the 2004 law’s operative provision allowed an 85% deduction for such dividends, producing the shorthand description of a 5.25% tax rate, since the top corporate statutory rate of 35% multiplied by (100% minus 85%) equals 5.25%. Although foreign tax credits were not allowed for the deductible portion of the dividend, they were allowed for the remaining 15%. See *id.* § 965(d).

98. See Thomas J. Brennan, *What Happens After a Holiday?: Long-Term Effects of the Repatriation Provision of the AJCA*, 5 NW. J.L. & SOC. POL’Y. 1, 1 (2010) (“[F]oreign

holiday on essentially the same terms.⁹⁹ The Camp territoriality proposal uses a similar approach, producing an effective 5.25% rate for its transition tax on untaxed offshore earnings and profits.¹⁰⁰

The bill introduced by Senator Michael Enzi in 2012¹⁰¹ follows a similar strategy but offers a lower 70% dividends received deduction for a transition tax base that assumes a dividend of all accumulated earnings and profits.¹⁰² This results in an effective rate of 10.5% assuming a 35% marginal statutory rate.¹⁰³ Under the Enzi bill, taxpayers must elect into the transition tax regime.¹⁰⁴ Taxpayers not electing to pay the transition tax would instead pay tax at full rates when they repatriated pre-enactment earnings, and pre-enactment earnings would be deemed to be paid before post-enactment earnings, which would be exempt from tax upon repatriation.¹⁰⁵

The UK reform fully exempted dividends paid by non-UK subsidiaries to UK parent corporations from UK income tax subject to “limited tax avoidance related exemptions.”¹⁰⁶ Pre-enactment earnings were not taxed as a transition matter and likewise fully escaped UK tax upon distribution. One commentator cited several reasons for the decision: a belief that many taxpayers might reasonably have expected to pay no UK tax upon such earnings under pre-enactment law, a desire to minimize complexity, and a concern

subsidiaries distributed more than \$300 billion in qualifying dividends to their U.S. parents.”).

99. See Sullivan, *supra* note 53, at 7 (describing the “WIN coalition” as a “group formed solely for the purpose of securing a repeat of the one-time tax holiday for repatriated foreign profits”).

100. Representative Dave Camp made an international corporate tax reform proposal in October 2011 that featured a territorial tax system and included a transition rule that would deem the inclusion of a CFC’s “accumulated deferred foreign income” in a U.S. shareholder’s income upon enactment. Under the Camp proposal, the inclusion would be reduced by an 85% deduction, producing a rate of 5.25%; foreign tax credits would be allowed on a pro-rated basis, and U.S. shareholders could elect to pay the transition tax across eight annual installments. See Dave Camp, *Camp Releases Technical Explanation of International Tax Reform Plan*, TAX NOTES TODAY, Oct. 27, 2011, LEXIS, 2011 TNT 208–28 (describing § 303 of the discussion draft and proposed changes to § 965 of the Code).

101. United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong., (2d. Sess., 2012).

102. See *id.* § 104 (providing for transition tax on shareholder’s appropriate share of earnings and profits of non-U.S. corporation subject to 70% dividends received deduction).

103. A 70% dividends received deduction produces the shorthand description of a 10.5% tax rate, since the top corporate statutory rate of 35% multiplied by (100% minus 70%) equals 10.5%.

104. See S. 2091, § 104 (providing election for immediate transition tax).

105. See *id.* § 101 (proposing a new § 245A, including ordering rule).

106. *Hearing*, *supra* note 54, at 6 (statement of Stephen Edge).

that UK corporations might expatriate, especially as the UK lacks a rule like the U.S. anti-inversion provision contained in § 7874.¹⁰⁷ The UK experience provides a 0% transition tax data point.

Japan imposed no transition rule with respect to pre-enactment offshore earnings.¹⁰⁸ Amounts distributed after the new law's effective date are subject to the new rule, which exempts 95% of foreign dividends but disallows related foreign tax credits. This rule generates an effective tax rate of about 2% on repatriated foreign earnings.¹⁰⁹

There are also suggestions in academic literature that "previously unrepatriated income . . . could be subjected to a small one-time tax,"¹¹⁰ perhaps at a rate between 1% and 5%.¹¹¹ In the Camp proposal, the revenue estimate produced by an effective 5.25% transition tax happened to make the important revenue-neutrality calculation come out even, suggesting the ability to adjust the rate to fit the needs of a revenue-neutrality plug.¹¹² Although the 5.25% rate is not a round number, it may have acquired some salience that encourages corporate taxpayers to grab onto it as they form expectations about transition tax possibilities.

107. See *id.* at 8 ("There was clearly concern within government that past untaxed profits should not be brought back tax free, especially when they might be the fruits of CFC planning. Many commentators pointed out, however, that the idea that the government would collect tax on those unremitted amounts was illusory. Unless there was a sensible settlement on the CFC rules, many large groups would leave the UK (the threat was a real one) and so those overseas unremitted profits would never, in fact, be repatriated. The government decided, probably for practical reasons, to make no distinction.").

108. See Jonathan Stuart-Smith, Yang-Ho Kim & Nicholas Walters, *Ruling Party Releases 2009 Tax Reform Proposals*, 53 TAX NOTES INT'L 50, 50 (2009) ("The well-publicized centerpiece of the reform proposals is the corporate income tax exemption for foreign dividends repatriated to Japan from overseas subsidiaries.").

109. *Hearing*, *supra* note 54, at 1 (statement of Gary Thomas) (explaining the revised Japanese rule). A Japanese tax rate of 40% imposed on 5% of foreign dividends translates to a 2% tax on total foreign dividends. See Tom Neubig & Barbara M. Angus, *Japan's Move to Territorial Contrasts with U.S. Tax Policy*, 54 TAX NOTES INT'L 252, 252 (2009) (reporting the enactment of Japan's reform and citing a 41.3% 2009 Japanese statutory corporate tax rate); see also Stuart-Smith, Kim & Walters, *supra* note 108, at 50 (discussing Japan's 2009 tax reform proposals).

110. Grubert & Altshuler, *supra* note 4, at 347.

111. See Grubert, *supra* note 14, at 818 (pointing out the "simple" option of a one-time charge on accumulated earnings).

112. *International Tax Reform: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. 8 (2011) (statement of Martin A. Sullivan, Ph.D., Economist and Contributing Editor, Tax Analysts), available at <http://waysandmeans.house.gov/uploadedfiles/sullivansrm1117.pdf> ("There is nothing magical about the 5.25 percent rate. It can be raised or reduced depending on how much revenue needs to be raised.").

3. Existing Law and Taxpayer Expectations

An analysis of the tax burden on offshore earnings under existing law can inform taxpayers' expectations about transition tax policy if one of two premises is true. The first possible premise is that taxpayers expect Congress to craft a transition tax that matches windfall gain. The second possible premise is that taxpayers fail to think about transition tax policy at all and instead assume that existing law will simply continue.

The idea that taxpayers might expect a transition tax that matches windfall gain¹¹³ means that taxpayers would expect transition tax liability based on taxpayer expectations about the present value of the eventual tax due on untaxed offshore earnings. This approach draws support from the observation that Congress avoids increasing taxes in an explicitly retroactive fashion, or what Daniel Shaviro calls Congress's "anti-nominal retroactivity norm."¹¹⁴ One possible interpretation of the anti-nominal retroactivity norm is that taxpayers should not expect the tax treatment of already-realized¹¹⁵ but deferred items to change relative to their treatment under pre-enactment law.¹¹⁶

It is also possible that taxpayers do not develop, or do not act on, rational expectations about future changes in tax law.¹¹⁷ Corporate tax directors may simply not perform the exercises of discovering and

113. See Shaviro, *supra* note 3, at 419 (arguing that transition tax policy should feature an "aversion to windfall gain" because in the absence of a transition tax "shareholders at the time of enactment would reap an enormous transition benefit").

114. SHAVIRO, *supra* note 85, at 104–05.

115. For example, pre-enactment accumulated offshore earnings have been accounted for in controlled foreign corporation ("CFC") earnings and profits under U.S. tax principles. See I.R.C. § 959 (2006) (providing ordering rules for distributions out of CFC earnings and profits).

116. See, e.g., JOINT COMM. ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 13 (2011) ("One issue is the treatment of earnings attributable to periods before the enactment of the territorial legislation. One approach is to have the exemption system apply only in respect of CFC earnings generated after the effective date.").

117. This is consistent with the more general empirical observation that "taxes are not a cost that taxpayers inevitably avoid." Douglas A. Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321, 326 (2001); see also Michelle Hanlon & Shane Heitzman, *A Review of Tax Research*, 50 J. ACCT. & ECON. 127, 129 (2010) ("[T]axes potentially affect many 'real' corporate decisions but their order of importance is still an open question."). Hanlon and Heitzman emphasize the importance of differentiating between types of investment in order to tease out the effect of taxes on investment decisions. See *id.* at 148 (giving the example of bonus depreciation provisions that appear to have increased investment in some favored assets but not aggregate investment).

handicapping the disorganized web of tax policy change possibilities presented by multiple jurisdictions and the interaction among them.¹¹⁸ The task of developing expectations must also consider the significant legislative obstacles to change.¹¹⁹ Taxpayers may instead rely on the heuristic of planning based on existing law.¹²⁰

In addition, corporate taxpayers may not be able to act quickly on rational expectations about future changes in international tax law because of a lack of liquidity in the market for the assets whose values might change because of anticipated law changes. Michael Graetz developed a theory about the valuation impact of anticipated legal transitions in the context of the highly liquid municipal bond market.¹²¹ The market for wholly owned non-U.S. subsidiaries of U.S. parents is far less liquid and prices may not fluctuate easily.¹²²

4. Calculating the Present Value of Future Tax on Untaxed Offshore Earnings Under Existing Law

An analysis of the tax burden on offshore earnings under existing law requires an estimate of the present value of future tax on such earnings. The so-called “new view” of dividend taxation¹²³ suggests

118. See MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 170–72 (4th ed. 2009) (explaining that sufficiently high transaction costs should block tax planning); Shackelford & Shevlin, *supra* note 117, at 341 (reporting on studies that find, for example, that “firms facing high information and transaction costs will sacrifice both tax and financial reporting benefits”).

119. For example, in a much simpler situation involving a binary likelihood of a continued or expired dividend tax cut as indicated by the likelihood of a Bush or Kerry 2004 presidential victory, empirical studies have reached mixed results regarding the link between estimates of future dividend policy and relative changes in the value of high-dividend-paying and low-dividend-paying firms. See Kevin A. Hassett & Kathryn Newmark, *Taxation and Business Behavior: A Review of the Recent Literature*, in *FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS*, *supra* note 4, at 191, 203–04 (reporting conflicting studies).

120. See SHAVIRO, *supra* note 85, at 23 (“[T]he evidence for [anchoring] may suggest that, in more dynamic and ongoing settings, people continue using obsolete rules of thumb and struggle for a while to reconcile new information with them.”); cf. Sarah B. Lawsky, *Unknown Probabilities and the Tax Law*, 65 STAN. L. REV. (forthcoming 2013) (arguing that taxpayers’ aversion to uncertainty affects how they respond to tax law).

121. See Graetz, *supra* note 91, at 54–57 (describing the effect of a change in law on municipal bond pricing).

122. Cf. Kleinbard, *supra* note 2, at 771 (arguing that the market for non-U.S. subsidiaries of U.S.-parented MNCs is thin and that such MNCs enjoy a rate of return that exceeds “world after-tax norms . . . as a result of planning opportunities available only to a subset of potential investors”).

123. See Alan J. Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q.J. ECON. 433, 434 (1979). This view has been applied in the context of repatriation taxation by David G. Hartman. See David G. Hartman, *Tax Policy and Foreign Direct Investment*, 26 J. PUB. ECON. 107, 119–20 (1985) (arguing that the allocation of capital between U.S.

one approach to a systematic calculation of the present value of the expected future tax on offshore untaxed earnings. This view concludes that “dividend taxes do not increase the tax burden on investment financed with retained earnings,”¹²⁴ assuming that residual income after investment will be distributed as dividends and that tax rates are constant. Under these assumptions, “shareholders can get a dividend now or let the firm reinvest at a constant rate of return and pay a bigger dividend later.”¹²⁵ Although these assumptions are incomplete, the “new view” offers a starting point for the analysis of the present value of a future tax on dividends.¹²⁶

The new view concludes that the tax burden is the same on a present value basis regardless of when the income on such retained earnings is distributed.¹²⁷ Thus, it suggests that corporations should estimate the present value burden of the eventual tax on repatriated earnings financed with retained earnings using their full effective rate. If the effective rate equals the maximum U.S. statutory rate, this suggests an expected tax burden equal to 35% of untaxed offshore earnings, and accordingly a transition tax imposed at a rate of 35% of untaxed offshore earnings.

Yet several assumptions underlying this view are not valid in the instant case. First, not all controlled foreign corporation (“CFC”) earnings are financed with retained earnings, and, therefore, the new view cannot predict the present value of a tax on all untaxed offshore earnings.¹²⁸ Fleming, Peroni, and Shay calculate the benefit of deferral, comparing relative after-tax returns for new investment in a CFC subject to a zero tax rate relative to new investment in a U.S. parent, assuming earnings repatriation, constant rates of return, and constant tax rates.¹²⁹

parent and non-U.S. subsidiary should depend on the comparative after-tax rates of return).

124. George R. Zodrow, *On the “Traditional” and “New” Views of Dividend Taxation*, 44 NAT’L TAX J. 497, 500 (1991).

125. Hanlon & Heitzman, *supra* note 117, at 161.

126. See Kimberly A. Clausing, *Tax Holidays (and Other Escapes) in the American Jobs Creation Act*, 57 NAT’L TAX J. 331, 334–35 (2005) (noting that despite the new view, incentives to repatriate can vary over time if a firm views the repatriation tax “not as an unavoidable eventuality . . . but as something that can be avoided through careful tax planning or simply patience”).

127. See Hartman, *supra* note 123, at 119–20 (arguing that the allocation of capital between U.S. parent and non-U.S. subsidiary should depend on the comparative after-tax rates of return).

128. See Zodrow, *supra* note 124, at 497 (“There is general agreement that dividend taxes reduce the return to investment financed with new share issues . . .”).

129. See Fleming, Peroni & Shay, *supra* note 2, at 96–104 (2009) (calculating benefit of deferral for a new investment decision).

Second, there is reason to think that corporate tax rates will be lower in the future. There is support from several corners for a general reduction in the U.S. corporate tax and interest rates in a repeat of the 2004 repatriation holiday.¹³⁰ Repeats of tax amnesties are sometimes thought to be bad policy because they may undermine the general perception of the fairness of the tax system and reduce ongoing compliance with the regular rules.¹³¹ But if the amnesty tax burden approaches the present value of the tax burden that would be legally obtained under existing law, these objections have less force.

Third, using the maximum U.S. statutory rate is not appropriate because foreign tax credits will reduce firms' effective tax rate.

Fourth, the assumption that non-U.S. subsidiaries will eventually repatriate earnings to the U.S. parent under current law is almost certainly not correct. Substantial investment opportunities outside the United States should attract at least some reinvestment of earnings offshore.¹³² Constraints related to the accounting disadvantages of reducing "permanently reinvested earnings" accounts discourage repatriation.¹³³ Finally, borrowing by the U.S. parent is a good economic substitute for repatriation in many cases.¹³⁴

For all of these reasons, it is reasonable to think that the present value of the expected future U.S. tax on offshore untaxed earnings is substantially lower than the maximum U.S. statutory rate multiplied by such earnings.

But how much lower than 35%? Shaviro suggests that an appropriate transition tax rate might be in the range of 20% if gauged to approximately equal the present value of taxpayers' future tax

130. See Clausing, *supra* note 126, at 335 (noting the possibility that firms may anticipate additional repatriation holidays).

131. See Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 GEO. MASON L. REV. 667, 701–05 (2007) (outlining fairness and compliance disadvantages of repeat amnesties).

132. See Lisa Bryant-Kutcher, Lisa Eiler & David A. Guenther, *Taxes and Financial Assets: Valuing Permanently Reinvested Earnings*, 61 NAT'L TAX J. 699, 717 (2008) (evaluating firms' investment in non-U.S. operating assets versus financial assets).

133. See John R. Graham, Michelle Hanlon & Terry Shevlin, *Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions*, 49 J. ACCT. RES. 137, 181 (2011) (finding that "the accounting expense deferral is important to companies and appears to provide an incentive . . . to move operations and investments overseas and to reinvest foreign earnings overseas").

134. See, e.g., Rosanne Altshuler & Harry Grubert, *Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy*, 87 J. PUB. ECON. 73, 94–95 (2002) (listing strategies involving borrowing and foreign tax credit planning that "achieve the equivalent of repatriation . . . without incurring the tax costs of repatriation"); Kleinbard, *supra* note 2, at 762–68 (describing practical aspects of "lock-out" effect).

liability related to offshore earnings.¹³⁵ This rate would be a flat tax rate, without allowance for foreign tax credits. Shaviro cites two calculations in support. One is Harry Grubert and Rosanne Altshuler's calculation that worldwide consolidation would permit a tax rate of 28%, rather than 35%, on non-U.S. earnings.¹³⁶ The other is Shaviro's own work with Kimberly Clausing that calculates rates of U.S. tax on foreign income that would be necessary to effect a "burden-neutral" change of policy from a foreign tax credit to foreign tax deductibility.¹³⁷

The Grubert and Altshuler calculation is based on a static analysis that examines the amount of tax collected from multinational corporations in 2002 and estimates the tax rate that would have to be imposed on non-U.S. business income in order to match that tax collection under a worldwide consolidation setting. The calculation of a 28% rate equivalence, however, does not support the use of a similar rate for a flat-rate transition tax for at least two reasons.

First, as Shaviro points out, the 28% rate assumes the continued granting of foreign tax credits. If a transition tax seeks to match taxpayer expectations about the present value burden of eventual taxes on non-U.S. earnings without actually allowing FTCs, it should make a downward adjustment to account for foreign tax credits.¹³⁸ These could be substantial. Grubert's recent work suggests that the average effective tax rate on foreign income was about 21% in 1996 and 16% in 2004.¹³⁹ These figures might suggest an average tax rate across all affected taxpayers of between 7% and 12%, after foreign tax credits, if the burden-neutral 28% rate were adopted.¹⁴⁰

135. Shaviro, *supra* note 3, at 427.

136. See Grubert & Altshuler, *supra* note 4, at 347 ("[T]he burden-neutral rate based on 'static' calculations is about 28 percent.").

137. See Kimberly Clausing & Daniel Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?*, 64 TAX L. REV. 431, 435–38 (2011) (deriving equivalent tax rates algebraically).

138. For example, the petroleum firms that Grubert and Altshuler identify as continuing in excess credit positions under the burden-neutral 28% proposal would presumably not expect to pay tax upon repatriation. See Grubert & Altshuler, *supra* note 4, at 348 & n.28.

139. See Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247, 281 (2012) (reporting a decline in the average effective foreign tax rate from about 21% in 1996 to about 16% in 2004); see also Kevin S. Markle & Douglas A. Shackelford, *Cross-Country Comparisons of Corporate Income Taxes*, 65 NAT'L TAX J. 493, 511 (2012) (finding that effective tax rates have fallen steadily over the past two decades).

140. In other words, 28% minus 21% equals 7%; 28% minus 16% equals 12%.

Second, the 28% rate is based on 2002 numbers. There is evidence that effective foreign tax rates have declined.¹⁴¹ This might prompt taxpayers to refrain from repatriating income, which would reduce the benchmark tax collection that a worldwide consolidation system sought to match and would, therefore, reduce the burden-neutral worldwide consolidation rate, even after considering the impact of reduced foreign tax credit availability.¹⁴²

The Clausing and Shaviro approach assumes that a certain foreign tax amount is deemed paid when a dividend is distributed from a non-U.S. subsidiary to a U.S. parent, and it asks what U.S. tax rate should apply under a system that only permits deductibility of foreign taxes to make the result the same as a 35% U.S. tax rate under a tax credit system.¹⁴³ The burden-neutral U.S. tax rate under a foreign tax deductibility system is higher if the foreign tax is lower.¹⁴⁴ As Shaviro points out, this approach has the advantage of accounting for the difference between foreign tax credits and a deduction for foreign taxes; however, it does not account for the possibility that accumulated foreign earnings will never be repatriated.¹⁴⁵ Translating a rate under a foreign tax credit system to a rate under a foreign tax deduction system has relevance because a corporate offshore profits transition tax would be imposed on a base that reflected a deduction for foreign taxes.¹⁴⁶

Shaviro explains that if the foreign tax rate is 20% with foreign tax credits,¹⁴⁷ the burden-neutral tax rate with only a deduction for foreign taxes is 18.8%.¹⁴⁸ This means that at the moment of dividend distribution, either a foreign tax credit system with a U.S. tax of 35% or a foreign tax deduction system with a U.S. tax of 18.8% would produce the same U.S. tax. In this example, a tax of fifteen cents on

141. See Grubert, *supra* note 139, at 281 (reporting a decline in the average effective foreign tax rate from about 21% in 1996 to about 16% in 2004); see also Costa & Gravelle, *supra* note 47, at 394 (reporting a foreign average tax rate for all industries of 15.6% based on 2006 tax return data).

142. See Altshuler & Grubert, *supra* note 134, at 74–75 (2002) (noting the connection between lower foreign tax rates and higher incentives to avoid repatriation).

143. See Clausing & Shaviro, *supra* note 137, at 436 (listing equivalent tax rates).

144. *Id.*

145. Shaviro, *supra* note 3, at 426–27 (2011).

146. See *infra* note 200 and accompanying text (explaining that earnings and profits are reduced by foreign income taxes paid).

147. This figure of 20% is roughly consistent with evidence suggesting that the average foreign effective tax rate was about 21% in 1996 and 16% in 2004. See Grubert, *supra* note 139, at 281.

148. See *infra* Part III (discussing two tax bases—the tax base of earnings and profits and the accounting base of unremitted earnings—both reflecting a deduction for foreign taxes incurred).

the dollar of pre-tax foreign income would accrue to the U.S. Treasury under either system.¹⁴⁹

The burden-neutral rate assuming full eventual repatriation should be reduced further to account for the likelihood that U.S. MNCs will never repatriate some of their untaxed accumulated offshore earnings. The amount of the reduction depends on the percentage of these earnings that MNCs leave overseas permanently. The available measure of this percentage is an accounting figure, drawn from the percentage of unremitted earnings measured for accounting purposes and designated as permanently reinvested earnings ("PRE").¹⁵⁰

Across all firms, Jennifer Blouin, Linda Krull, and Leslie Robinson report PRE as a percentage of all unremitted earnings of about 73%.¹⁵¹ This translates to a lower bound of about 27% for the percentage of unremitted earnings corporations, in the aggregate, plan to repatriate. This is because PRE can result from the designation of elements of outside book-tax basis differences that do not arise from unremitted earnings.¹⁵² In addition, PRE levels may overstate firms' overseas investment intentions, since designating earnings as PRE permits firms to avoid stating a deferred tax liability and reduce current earnings.¹⁵³

Because 27% represents a lower bound measure of firms' repatriation intentions, the calculations in the table below use assumptions of 40% and 50% to illustrate the effect on the appropriate transition tax rate of firms' repatriation intentions. The calculations in the table below also use foreign tax rates of 15% and

149. Under the foreign tax credit system, \$1 multiplied by 35% equals a tentative U.S. tax of \$0.35, which is reduced by a foreign tax credit of \$0.20 to \$0.15. Under a foreign tax deduction system, taxable income would equal \$1 minus \$0.20 or \$0.80. Therefore, \$0.80 multiplied by a U.S. tax rate of 18.8% also equals \$0.15.

150. See *infra* Part III.C for further discussion on PRE.

151. See Jennifer Blouin, Linda Krull & Leslie Robinson, *Where in the World Are "Permanently Reinvested" Foreign Earnings?* 39 (Working Paper, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154662 (reporting PRE of about \$882 billion and total foreign retained earnings of about \$1.2 trillion for sample of about 700 firms).

152. See EDWARD ABAHOONIE & LEAH ALFONSO, PRICEWATERHOUSECOOPERS, DEFERRED TAXES ON FOREIGN EARNINGS: A ROAD MAP 6 (2010), available at <http://www.pwc.com/us/en/tax-accounting-services/assets/deferred-taxes-foreign-earnings.pdf> (giving a list of possible other contributors to outside book-tax basis differences including currency translation adjustments, acquisitions accounted for using the purchase method of accounting, and differences related to stock-based compensation).

153. See, e.g., Linda K. Krull, *Permanently Reinvested Foreign Earnings, Taxes, and Earnings Management*, 79 ACCT. REV. 745, 746, 765 (2004) (noting earnings management incentives).

20% to illustrate the effect on the appropriate transition tax rate of average historic foreign taxes imposed upon the pool of untaxed accumulated offshore earnings. The tax rates are calculated as if the tax would be imposed upon a base of untaxed offshore earnings that reflected a deduction for foreign taxes, but would not be reduced by foreign tax credits.

Table 1: Transition Tax Rates Under Certain Foreign Tax Rates and Repatriation Percentage Assumptions

Foreign Tax Rate	Burden-Neutral U.S. Rate if Deduction, not Credit, Granted ¹⁵⁴	Implied Transition Tax Rate under 40% Repatriation Assumption	Implied Transition Tax Rate under 50% Repatriation Assumption
15%	23.5%	9.4%	11.75%
20%	18.8%	7.52%	9.4%

A final approach to determine firms' estimates of the present value cost of their eventual repatriation of earnings would refer to the incremental cost to firms of using unrepatriated funds.¹⁵⁵ For example, a firm that borrows against its offshore earnings will incur some costs in order to do so. As another example, a firm may accept a lower rate of return on non-U.S. investments in order to avoid repatriation. There exist positive estimates of the "excess burden" associated with avoiding the repatriation of offshore funds, although these are expressed as a percentage of annual earnings and profits, rather than total accumulated offshore earnings.¹⁵⁶ There also exists a positive estimate of the loss in value that firms may suffer if they keep offshore earnings in cash rather than investing the earnings in foreign operations or repatriating the earnings.¹⁵⁷

154. The burden-neutral rates are calculated in Clausing & Shaviro, *supra* note 137, at 436.

155. See Altschuler & Grubert, *supra* note 134, at 74–75 (noting the connection between lower foreign tax rates and higher incentives to avoid repatriation).

156. *Id.* at 79 (reporting efficiency losses of about 1% and 0.7% of total pre-tax income).

157. See Bryant-Kutcher, Eiler & Guenther, *supra* note 132, at 717 (finding that firms who invest permanently reinvested earnings in cash rather than operating assets suffer a decline in valuation).

B. Administrability

The principal transition alternative to the lump-sum corporate offshore profits transition tax outlined here (leaving aside possibilities of full exemption for accumulated untaxed offshore earnings) is a tracing rule that would match post-enactment dividend distributions to pre-enactment earnings and tax such dividends out of pre-enactment earnings.¹⁵⁸ One can imagine last-in-first-out, first-in-first-out, ratable, or other tracing rules, as well as the incredible complexity involved with complying with and administering any such rules.¹⁵⁹

This Article advocates a lump-sum corporate offshore profits transition tax largely for reasons of administrability.¹⁶⁰ Such a tax would substitute for any actual taxation of pre-enactment untaxed offshore earnings; after payment of the transition tax, a firm would face no further U.S. tax liability with respect to pre-enactment earnings and could no longer claim credits relating to pre-enactment foreign taxes.¹⁶¹ Even though the transition tax considered here is a lump-sum tax, it still raises design questions, the resolution of which could result in less or more complexity.

One question is whether a corporate offshore profits transition tax should be assessed at a flat rate or at a rate that varies in accordance with a taxpayer's marginal tax rate. This Article advocates a flat rate because of its administrability advantages and despite its horizontal equity drawbacks, as discussed further below.¹⁶² Another question is whether foreign tax credits should be allowed to reduce the transition tax. As suggested by the approach taken in the above calculations of equivalent tax burdens, this Article advocates a transition tax that does not allow any reductions for foreign tax credits.

To frame the consideration of complexity, consider the basic technical outlines of the 2004 tax holiday on dividends repatriated by

158. See GRAVELLE, *supra* note 22, at 22 (outlining transition options).

159. See Auerbach, *supra* note 84, at 115–18 (describing the ALI proposal to avoid windfall gains to old equity by tracing dividend payments to pre-enactment earnings and alternative of imposing a one-time tax on accumulated earnings at the time of enactment).

160. To relieve liquidity constraints, the lump-sum transition tax could be payable over a number of years. The Camp proposal suggests an eight-year payment period. See GRAVELLE, *supra* note 22, at 25–26 (describing Camp proposal). An eight-year period should ensure that payments are actually made within the ten-year revenue estimate window.

161. Pre-enactment losses present another issue not covered here. See GRAVELLE, *supra* note 22, at 22–23 (raising the issues of pre-enactment losses and foreign tax credits).

162. See *infra* Part II.D.

U.S. parents of MNCs. The section applied to “extraordinary” cash dividends, distributed within a one-year period and used for a purpose specified in the corporation’s “domestic reinvestment plan.”¹⁶³ Its operative provision allowed an 85% deduction for such dividends, producing the shorthand description of a 5.25% tax rate, since the top corporate statutory rate of 35% multiplied by 15%¹⁶⁴ equals 5.25%. Although foreign tax credits were not allowed for the deductible portion of the dividend, they were allowed for the remaining 15%.¹⁶⁵

In the case of the 2004 repatriation holiday, some of the complexities relate to the determination of the tax base. Part III of this Article will consider related tax base issues for a COPE transition tax. Other complexities of the 2004 repatriation holiday relate to the tax rate. First, the rate of tax varies by taxpayer; it is not really 5.25%, but rather the particular corporate taxpayer’s marginal rate multiplied by 15%.¹⁶⁶ The inclusion of the residual dividend in income means that the tax is lower if the taxpayer’s marginal tax rate in the year of inclusion is lower. Second, the allowance of foreign tax credits with respect to the nondeductible portion of the dividend affects the final amount of the tax and, therefore, the rate of tax actually paid to the U.S. government with respect to the tax base.¹⁶⁷ The foreign tax credit means that the tax is lower if the taxpayer’s non-U.S. tax rate is higher.

163. See I.R.C. § 965 (2006). Although such plans were intended to ensure that cash dividends covered by § 965 were used by the repatriating company to invest in the U.S. economy, they failed to do so. Most of the repatriated funds have been traced to transfers to shareholders through dividends or share repurchases. See Jennifer Blouin & Linda Krull, *Bringing it Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004*, 47 J. ACCT. RES. 1027, 1029 (2009) (reporting that repatriating firms increased share repurchases).

164. 15% equals 100% minus the permitted deduction of 85%.

165. See I.R.C. § 965(d).

166. See Brennan, *supra* note 98, at 4 (“The mechanism used was a temporary tax deduction for U.S. parent corporations in the amount of 85% of cash dividends that were received from foreign subsidiaries and met the requirements of the newly created I.R.C. § 965. Thus, if the normal corporate tax rate was 35%, an 85% deduction resulted in an effective tax rate of 5.25%.”).

167. See I.R.S. Notice 2005-64, 2005-36 I.R.B. 471 § 4 (outlining rules disallowing “credit or deduction for foreign taxes on deductible portion of qualifying dividends”); Dr. Anthony P. Polito, ¶ 7150.04.A. *Controlled Foreign Corporations*, Tax & Acct. Center (BNA), http://taxandaccounting.bna.com/btac/T6200/split_display.adp?fedfid=15887973&vname=tpsporft&wsn=500868000&fn=15887973&split=0 (last visited Jan. 4, 2013) (subscription required) (“[T]he taxpayer was allowed to pick those dividends that received the 85% deduction and those that did not, receiving instead the foreign tax credit.”).

A corporate offshore profits transition tax could use a flat rate, itself adjusted to account for foreign tax credit deductibility rather than creditability as described above, and deny explicit foreign tax credits to avoid the complications described above. However, as discussed below in Part II.C, a flat rate without foreign tax credit allowances presents equity costs. Part II.D suggests a resolution of the tension between administrability and equity.

C. Equity

Three equity comparisons present themselves in considering the proper structure of a corporate offshore profits transition tax. First, there is the question of the equitable role of the corporate taxes in general. Second, there is the question of relative winners and losers in the event of a revenue-neutral business tax reform effort. Third, there is the question of relative winners and losers among the global multinationals expected to pay the transition tax.

The first question, relating to the role of corporate taxes in general, is beyond the scope of this paper. One approach emphasizes the regulatory origins of the corporate income tax in the United States.¹⁶⁸ Another approach posits that the incidence of corporate taxes falls on shareholders,¹⁶⁹ and, assuming that shareholders are

168. Several scholars have told the story of the origins of the U.S. corporate income tax in 1909 as, at least in part, a way to “express the social antipathy towards monopoly power.” See, e.g., Ajay K. Mehrotra, *The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective*, 11 THEOR. INQ. LAW. 497, 537 (2010). Compare Avi-Yonah, *supra* note 13, at 1247 (arguing that the corporate income tax reduces the wealth of corporations and therefore the power of corporate managers), and Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 113 (1990) (noting that a corporate tax was expected to provide advantages of federal supervision and increased disclosure), with Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 452 (2001) (arguing that corporate tax was meant as a “substitute or ‘proxy’ for taxing corporate shareholders directly”).

169. Arnold Harberger’s classic analysis of corporate tax incidence reached the conclusion that capital bears the burden of a corporate income tax under an assumption that the economy was closed, so that capital had to choose between a taxed or untaxed sector and would, in the long run, accept lower after-tax rates of return from both corporate stock ownership and other investment opportunities. See Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 227–30 (1962). Some capital owners would bear the burden of the tax through reductions in asset prices and some through reductions in returns on investment. See Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, in 20 TAX POLICY AND THE ECONOMY 1, 12 (James M. Poterba ed., 2006). In contrast, a model that assumes an open economy where imported and home-produced goods are perfectly substitutable and capital is perfectly mobile concludes that the corporate income tax falls at least in part on labor. See WILLIAM M. GENTRY, DEP’T OF THE TREASURY, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 16 (2007) (“If capital is mobile (and labor

relatively well off, concludes that corporate taxes therefore improve the progressivity of a tax system. But the incidence assumption in particular is open to debate, and the debate involves an enormous amount of inconclusive literature, which this Article will not discuss.¹⁷⁰

The second question relates to the possibility of revenue-neutral business tax reform, which is how some recent proposals have been framed. For example, a proposal to reduce the U.S. corporate tax rate to 25% and pay for the rate reduction within the four corners of a corporate tax package required the identification of base-broadening revenue raisers worth about \$1 trillion over the ten-year budget window.¹⁷¹ Some revenue could be raised by familiar base-broadening measures, such as the repeal of accelerated depreciation and the domestic production activities deduction,¹⁷² in addition to the repeal of deferral itself.¹⁷³ However, such revenue raisers appear insufficient to reduce the U.S. federal corporate tax rate to 25%.¹⁷⁴ Further, the

is immobile) across jurisdictions, then labor's share of the tax burden can be high."). But if, despite the theoretical openness of the economy, capital is not perfectly mobile, or imports and local goods not perfectly substitutable, it becomes more likely that capital bears the burden of the corporate income tax, consistent with the original Harberger theory. See, e.g., Jane G. Gravelle, *The Corporate Income Tax: Economic Issues and Policy Options*, in TAX POLICY IN THE REAL WORLD 15, 22 (Joel Slemrod ed., 1999).

170. See, e.g., Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 434–44 (2012) (surveying and critiquing corporate tax incidence literature).

171. See SENATOR GREGG & SENATOR WYDEN, ESTIMATED REVENUE EFFECTS OF S. 3018 1–2 (2010), <http://www.wyden.senate.gov/download/joint-committee-on-taxation-estimated-score-of-the-bipartisan-tax-fairness-and-simplification-act-of-2010> (giving a "very preliminary" ten-year cost estimate of the Wyden-Coats 24% "corporate flat tax" as \$1.1 trillion).

172. See generally Memorandum from Thomas A. Barthold to Undisclosed Recipients, Chief of Staff, Joint Comm. Taxation (Oct. 27, 2011), http://www.novoco.com/hottopics/resource_files/jct-memo_tax-expenditure-repeal_102711.pdf (citing "very preliminary" estimates provided in connection with Camp bill that show ten-year revenue of about \$724 billion from repeal of accelerated depreciation, \$164 billion from repeal of the "domestic production activities" deduction, \$160 billion from repeal of R&D expensing, and \$70 billion from repeal of LIFO accounting).

173. See CONG. BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 186 (2011) (providing a revenue estimate of about \$114 billion); GREGG & WYDEN, *supra* note 171, at 1–2 (providing a ten-year revenue estimate of \$583 billion for deferral repeal together with the application of per-country foreign tax credit rules); see also Grubert & Altshuler, *supra* note 4, at 347 (reporting "static calculations" of a burden-neutral 28% rate on foreign corporate income only under worldwide consolidation assuming no changes to domestic corporate income tax rules and no taxation of "the pool of previously unrepatriated income").

174. See Jane G. Gravelle, *Reducing Depreciation Allowances to Finance a Lower Corporate Tax Rate*, 64 NAT'L TAX J. 1039, 1052–53 (2011) (arguing that repealing accelerated depreciation will not raise as much revenue as suggested outside the constraint of the budget window and pointing out that some suggested base broadening measures

stated revenue increases include the effects of repealing these incentives for non-corporate business taxpayers, which may not be politically feasible.¹⁷⁵

Incorporated firms with primarily domestic business stand to gain if the corporate tax rate is lowered, but they stand to lose to the extent business tax preferences will be repealed to pay for such a rate cut. Incorporated firms with global businesses stand to gain if the corporate tax rate is lowered, albeit somewhat less than domestic firms, given that the offshore business of MNCs is often already taxed at low rates. Therefore, global MNCs simultaneously seek to maintain a low overall tax rate through the enactment of a favorable territoriality regime.¹⁷⁶ Finally, unincorporated businesses will not benefit from a corporate rate cut, but will suffer if business tax incentives are repealed to pay for such a rate cut.¹⁷⁷

Revenue-neutral adoption of territoriality thus raises the possibility that global multinationals will benefit from a more favorable tax regime going forward relative to the pre-enactment rules, while incorporated and unincorporated domestic businesses will face less-advantageous rules after the reform compared to the pre-enactment rules. There are, of course, a large number of small moving pieces in this analysis. Territoriality adoption itself could increase or decrease the effective tax burden on global multinationals, depending, for example, on the rules allocating income and deduction items between U.S. and non-U.S. source categories, as well as business and non-business categories.¹⁷⁸ Nevertheless, territoriality reform may

would also hurt unincorporated businesses); Jane G. Gravelle, *Practical Tax Reform for a More Efficient Income Tax*, 30 VA. TAX REV. 389, 402–06 (2010) (listing and evaluating different base-broadening options, including deferral repeal); see also *International Tax Reform*, *supra* note 112, at 9–10 (2011) (arguing that existing revenue raisers in Camp plan would not provide sufficient room to reduce the corporate tax rate).

175. See Stephen E. Shay, *Daunting Fiscal and Political Challenges for US International Tax Reform*, 66 BULL. INT’L TAX’N 229, 232 (2012) (“To date, there is no clear path to a politically realistic revenue neutral tax reform, not to mention a reform that would contribute to deficit reduction. Even though there appear to be shared objectives in relation to business tax reform, its intersection with the tax on individual business owners and investors makes it difficult to achieve independently.”).

176. See Martin A. Sullivan, *Tax Reform Goals Differ for Corporate Coalitions*, 134 TAX NOTES 1481, 1481, 1484 (2012) (comparing interests of domestically focused companies such as Ford, Macy’s, and UPS, which focus on rate reduction and the protection of tax breaks such as LIFO accounting or accelerated depreciation, depending on the firm’s industry; and global companies such as Cisco, Google, and Pfizer, which prioritize territoriality and the continued low taxation of non-U.S. income).

177. See Shay, *supra* note 175, at 232.

178. See, e.g., Graetz & Oosterhuis, *supra* note 14, at 774–76 (listing design options for defining business income).

present equity reasons to impose a corporate offshore profits transition tax on global businesses to help offset the benefits of the territoriality reform to those businesses.

The third equity question concerns relative winners and losers among the global multinationals who would be expected to pay the transition tax. The adoption of the underlying steady-state territoriality reform itself will produce winners and losers among such global MNCs.¹⁷⁹ With respect to the appropriate tax rate for the transition tax, one question is whether the tax rate should vary according to the marginal tax rate applicable to different firms. A related question is whether foreign tax credits should be allowed.

The firms with lower domestic tax rates will expect lower tax upon repatriation than those with higher domestic tax rates. Firms with higher foreign tax rates will also expect lower tax upon repatriation, because they will expect higher sheltering from foreign tax credits.¹⁸⁰ Should these variations be equitably accounted for, and if so, how? Moreover, how can they be measured and weighed against the administrability detriments that will certainly result from the additional complexity required to differentiate among groups? This question is considered below.

D. Administrability/Equity Tradeoffs

As described above, the reduced tax imposed on extraordinary dividends under the 2004 tax holiday rule was imposed after those dividends were run through the income tax base of a taxpaying corporation.¹⁸¹ A corporate offshore profits transition tax would be simpler if it were imposed on a measure of offshore, untaxed earnings without running the tax base through the taxpaying firm's income tax return. For example, declining to run the transition tax through the income tax base would avoid presenting corporations with incentives to use tax planning to lower their income tax rate in the year in which the COPE transition tax was imposed.

The transition tax would also be simpler if it imposed a flat rate of tax on offshore earnings without allowance for a foreign tax credit. The administrability advantage is enhanced because firms have little reason to keep track of their pre-1987 foreign taxes paid under the

179. See Jennifer Gravelle, *Who Will Benefit from a Territorial Tax? Characteristics of Multinational Firms*, Presentation at National Tax Association Annual Meeting (Nov. 16, 2012).

180. See generally Altshuler & Grubert, *supra* note 134 (describing "excess credit" firms).

181. See *supra* notes 163–68 and accompanying text (describing I.R.C. § 965 (2006)).

relevant deemed dividend rules. Most firms presumably would have to engage in a forensic accounting exercise in order to determine these pre-1987 foreign taxes.¹⁸²

Imposing a corporate offshore profits transition tax that did not vary based on firms' different marginal tax rates and foreign tax credit positions could have important equitable effects, in particular with respect to the equitable positions of some groups of multinational corporations compared to other groups. But these may be best dealt with in the political process and best mediated by interest group lobbying.

So long as special interest groups can influence legislation—and reliable accounts provide every indication that they can,¹⁸³ at least in the absence of an unusually strong media firestorm of opposition to the special interests¹⁸⁴—they can be relied upon to defend themselves through interest group lobbying.¹⁸⁵ Tax policymakers might propose a

182. Typically, foreign tax credits relating to income taxes paid by non-U.S. corporate subsidiaries are available for credit against U.S. income tax only where there is a dividend distribution from the subsidiary to a U.S. parent corporation. *See* I.R.C. § 902(a) (2006). The relationship between the dividend distribution and the total earnings of the non-U.S. subsidiary determines the proportion of non-U.S. income taxes paid by the non-U.S. subsidiary that are deemed paid by the U.S. parent upon distribution. *See id.* However, these “pooling” rules only apply to post-1986 earnings and taxes. *See id.* Pre-1987 earnings and taxes are subject to a different regime. *See id.* § 902(c)(6); *see also* BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION* ¶ 72.9.3 (3d ed. 2005) (describing last-in, first-out rule applicable to pre-1987 earnings). If a lower-tier corporation is the source of the earnings and related creditable foreign taxes, “tiering-up” rules apply to determine what taxes are brought up between levels as distributions make their way up the chain. *See* I.R.C. § 902(b) (2006). Finally, at the U.S. parent level, basketing rules attempt to prevent cross-crediting, or, for example, the use of higher income taxes attributable to dividends drawn from active business non-U.S. income to reduce the U.S. tax due on dividends drawn from lower-taxed passive non-U.S. income. *See id.* § 902.

183. *See* Michael Doran, *Legislative Compromise and Tax Transition Policy*, 74 U. CHI. L. REV. 545, 587–89 (2007) (noting that deal brokering over transition policy is inextricably linked to the steady-state policy and to the chances of overcoming the legislative status quo bias).

184. *See, e.g.,* Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 25 (1990) (emphasizing media role in encouraging a turning point toward successful base-broadening reform in the 1986 Act).

185. This is especially important because of the complexities of corporate firms' interests. For example, the brief equity discussion here does not consider the possibility that accounting considerations will significantly affect how firms react to reform proposals. *See, e.g.,* James M. Poterba, Nirupama S. Rao & Jeri K. Seidman, *Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Changes*, 64 NAT'L TAX J. 27, 50–51 (2011) (noting that a corporate rate reduction results in a decrease in financial accounting net income for firms with deferred tax assets and an increase in net income for firms with deferred tax liabilities).

flat transition tax that does not differentiate among firms with different effective tax rates or foreign tax credit positions, anticipating that interest group lobbying will sort out significant inequities.¹⁸⁶

As an example, assume an energy firm pays high rates of foreign tax,¹⁸⁷ and an internet firm pays low rates of foreign tax.¹⁸⁸ Further, assume a flat-rate transition tax not allowing any reduction for foreign tax credits, and that the amount of the transition tax exceeds the present value of the tax that each firm would eventually pay upon repatriation of untaxed offshore earnings.

The energy firm might object that the tax exceeds that firm's corresponding estimate of the present value of its future tax on accumulated offshore earnings, due to foreign tax credits. If there is sufficient political pressure to remedy this inequity, several tools are available in the political process to help do so. Possibilities include income tax benefits available to energy firms, such as oil and gas depletion allowances.¹⁸⁹

The internet firm in the example might also object that the tax exceeds the firm's estimate of the present value of the eventual tax on offshore earnings due to the firm's plan not to repatriate any substantial earnings. The equities of this situation are somewhat different. For example, transition tax supporters might point to the ongoing discussion of transition tax policy in the event of territoriality adoption, including the Camp proposal, as evidence of the clearly incorrect nature of an estimate of zero tax on offshore earnings in the event of such a reform. The equities of the pre-enactment system that permitted the software firm to accumulate so much cash overseas free of U.S. tax might be discussed, together with related public relations and accounting implications. Perhaps a different deal would be struck.

The above approach of leaving equities to the process of interest group lobbying pushes complexity away from the transition tax and into other areas of a reform package. Whether this tradeoff makes sense depends, in part, on the incremental complexity and cost in the balance of a legislative package that would result from interest group

186. A caveat relates to the possibility of firms' inability to effectively lobby individually. If different effective tax rate and foreign tax credit profiles do not break down along group lines formed for other purposes, the ability of a lobbying process to resolve inequities may be reduced.

187. See Grubert & Altshuler, *supra* note 4, at 348 (identifying petroleum firms as entities with generally high rates of foreign tax).

188. See Grubert, *supra* note 139, at 259 (explaining that research and development-based intangibles are correlated with lower foreign tax rates).

189. See, e.g., I.R.C. § 611 (2006) (providing energy-related depletion rules).

lobbying mounted in objection to any perceived inequity in the flat and no-foreign-tax-credit nature of the corporate offshore profits transition tax proposed here. The incremental complexity in turn depends in part on whether the balance of the reform package is likely to be complicated in any case. Different effects of territoriality adoption on different firms suggest that other complexities resulting from interest group lobbying are indeed likely. Different impacts of accompanying revenue raisers should similarly result in complexities. The Camp discussion draft, for example, has a large number of specialized provisions that would have different impacts on different corporations.¹⁹⁰

III. TRANSITION TAX BASE

A. *Tax Measure Versus Financial Accounting Measure*

There are two potential sources of information that might support a corporate offshore profits transition tax base. One is a tax measure: the untaxed offshore earnings and profits of non-U.S. subsidiaries recorded for U.S. federal income tax purposes,¹⁹¹ particularly for the purpose of calculating foreign taxes deemed paid by a U.S. corporation when it receives a dividend distribution from a foreign subsidiary.¹⁹² The other is a financial accounting measure: the unremitted earnings of foreign subsidiaries, including those designated as PRE,¹⁹³ as determined under financial accounting rules.¹⁹⁴

190. See GRAVELLE, *supra* note 22, at 25–27 (describing Camp proposal).

191. See Treas. Reg. § 1.964-1 (as amended in 2009) (providing rules for determining the earnings and profits of a foreign corporation and using a financial accounting profit and loss statement as a starting point).

192. See Treas. Reg. § 1.902-1(a)(9) (as amended in 2009) (defining “post-1986 undistributed earnings” as earnings and profits).

193. The standard for permitting a firm to avoid recording a deferred tax liability by categorizing earnings as “permanently reinvested earnings” is known as the “Indefinite Reversal Exception” and is set forth by FASB ASC 740-30-25-17. See Blouin, Krull & Robinson, *supra* note 151, at 2–4.

194. “Unremitted earnings” are one element of the book-tax basis difference of the stock of non-U.S. subsidiaries owned by U.S. parent corporations. See ABAHOONIE & ALFONSO, *supra* note 152, at 6. Some unremitted earnings produce a deferred tax liability. Others do not because they have been designated under the Indefinite Reversal Exception. See, e.g., Apple Inc., Annual Report (Form 10-K) 63 (Oct. 26, 2011), available at <http://investor.apple.com/secfiling.cfm?filingID=1193125-11-282113&CIK=320193> (listing \$8.9 billion deferred tax liability resulting from unremitted earnings and a designation of PRE under the Indefinite Reversal Exception in 2011 resulting in a decrease in expected tax of \$3.9 billion in 2011).

This Part will discuss efficiency, administrability, and equity tax base considerations. It will focus first on the tax earnings and profits measure and then on the financial accounting unremitted earnings measure. The tax earnings and profits base is the most natural choice for a transition tax base since it most closely adheres to the underlying goal of imposing a lump-sum tax intended to match the eventual income tax that would be due on a firm's untaxed offshore earnings.¹⁹⁵ However, the tax earnings and profits base suffers from at least two compliance challenges: difficulty of determining pre-1987 earnings and vulnerability to reductions in the earnings and profits base from tax planning.

These compliance challenges raise efficiency, administrability, and horizontal equity issues. The deadweight loss of taxpayer compliance and planning efforts produces the efficiency concern. The challenge of policing tax planning generates the administrability concern. A related horizontal equity problem may arise assuming that taxpayers differ in their exposure to high compliance costs and/or in their willingness to engage in aggressive tax planning, given the likelihood that aggressive tax planning will not be discovered and/or appropriately redressed.¹⁹⁶ To address each of these issues, the financial accounting measure of unremitted earnings could be used both to provide an easier method of calculating the transition tax base based on pre-1987 earnings and to reduce the impact of tax planning on the transition tax base.

B. The Tax Measure: Earnings and Profits

Untaxed offshore earnings and profits, as calculated for U.S. federal income tax purposes, provide one source of information that could support a corporate offshore profits transition tax base. This tax measure is typically split into post-1986 undistributed earnings and pre-1987 accumulated profits.¹⁹⁷ This is because of an ordering rule that requires the taxpayers to first use the post-1986 amount and then the pre-1987 amount to support the calculation of deemed paid

195. See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 430 (2009) ("The purposes that underlie requiring companies to compute taxable income and financial accounting income are quite distinct.").

196. Cf. Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Modest Fault-Based Penalties*, 64 TAX L. REV. 453, 472 (2011) (noting different impact of uncertainty and certain sanction rules on risk-averse versus risk-neutral taxpayers).

197. See Form 1118, *Foreign Tax Credit—Corporations* (2011), available at <http://www.irs.gov/pub/irs-pdf/f1118.pdf>.

foreign income taxes brought up when a non-U.S. corporation pays a dividend to a U.S. corporation.¹⁹⁸

Most firms should have relatively easy access to a post-1986 earnings and profits calculation since they need it to determine the deemed foreign taxes paid upon the distribution of earnings. However, there is little reason for most firms to calculate their pre-1987 foreign earnings and profits. This is because the pre-1987 figure is needed for deemed foreign tax credit calculations only after the firm has distributed all of its post-1986 foreign earnings and profits. Due in part to MNCs' incentive to retain earnings overseas and avoid the U.S. tax typically due on repatriation,¹⁹⁹ it is likely that most firms have found it unnecessary to determine their pre-1987 foreign earnings and profits.

The earnings and profits figure reflects a deduction for foreign taxes paid.²⁰⁰ It thus permits taxpayers to reduce their tax as a result of foreign taxes, though its deduction mechanism is less generous than a tax credit mechanism, since a deduction reduces taxable income, rather than tax, on a dollar-for-dollar basis. Permitting a deduction for foreign taxes rests on the theory of taxable income measurement: foreign taxes are a legitimate income-generation expense.²⁰¹ Some commentators strongly argue in support

198. See I.R.C. § 902(a), (c)(6) (2006) (referring to post-1986 earnings and providing that dividends shall first be made out of post-1986 earnings and then out of pre-1987 earnings, the latter of which are subject to rules in effect before the 1986 statutory change).

199. See *supra* Part II.A.

200. See Treas. Reg. § 1.902-1(a)(9)(iii) (as amended in 2009) (providing for reduction of earnings and profits for foreign taxes paid "regardless of whether the taxes are creditable").

201. Another question is whether the transition tax itself should be deductible from firms' federal income tax base. It should not be. The reason is that the transition tax is intended to match a federal income tax liability, and federal income taxes are not deductible against a federal income tax base. See I.R.C. § 164 (2006) (allowing deduction for listed taxes, not including federal income taxes). Deductibility would be circular. In other words, a lower rate is possible if the tax is not deductible. However, deductibility would also provide an "upside-down subsidy" to firms with higher marginal tax rates. See, e.g., Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 24 (2006) (describing the upside-down subsidy phenomenon under which deductions provide higher dollar benefits to higher-income taxpayers). There is no reason to think that taxpayers' expectations about the present value of the eventual tax liability on their offshore untaxed earnings are negatively correlated with their current marginal tax rate, and, therefore, there is no equitable reason to impose a lower tax on firms with higher current marginal tax rates by permitting a deduction for the transition tax.

of allowing only a deduction, and not a credit, for foreign taxes paid.²⁰²

When a U.S. corporation receives a dividend from a foreign subsidiary, the U.S. corporation is also deemed to pay a portion of the foreign income taxes paid by the foreign subsidiary for U.S. foreign tax credit. Otherwise, the earnings underlying the dividend would be taxed twice. The amount of foreign income taxes deemed paid along with a dividend generally equals the dividend multiplied by a fraction, the numerator of which equals post-1986 foreign income taxes and the denominator of which equals post-1986 foreign earnings.²⁰³ This has produced an incentive for U.S.-parented MNCs to engage in tax planning in order to increase the foreign income taxes that are deemed paid by a U.S. parent when it receives a dividend from a non-U.S. subsidiary. Reducing post-1986 foreign earnings, the denominator of the fraction, accomplishes the goal of increasing foreign taxes deemed paid. Planning strategies include efforts to maximize tax depreciation deductions in non-U.S. subsidiaries by stepping up the basis of assets in non-U.S. subsidiaries for U.S. purposes, but not for non-U.S. purposes.²⁰⁴

Additional tax planning strategies might also arise if a corporate offshore profits transition tax used a tax earnings and profits base. If firms had an opportunity to plan before the transition tax base measurement date, they might erode the transition tax base, for example by recognizing tax losses in their non-U.S. subsidiaries. Even after the tax base measurement date, they might carry back losses that would adjust the transition tax base, if the transition tax legislation did not bar this strategy. Firms might distribute earnings in advance of the tax base measurement date or even sell subsidiaries

202. See Clausung & Shaviro, *supra* note 137, at 431–32 (2011) (criticizing foreign tax creditability as “over-generous” and its underlying “worldwide efficiency criteria” as lacking “conditionality”); Musgrave, *supra* note 23, at 178 (“[U]nder what may be called a ‘national’ view of taxpayer equity the foreign tax is treated as a deduction from foreign source income (in effect, a cost of doing business), and the residence country’s corporate tax is applied to foreign earnings net of foreign tax.”).

203. See I.R.C. § 902(a) (2006) (providing formula).

204. See, e.g., Harry J. Hicks, III, *Selected Section 338 Issues on International Acquisitions and Dispositions by U.S. Multinationals*, in 11 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2001, at 1295, 1297 (noting that a U.S. buyer of a firm would be advised to “always consider making a section 338 election” with respect to the acquisition of a foreign target, in part to increase the basis of the target’s assets, thus increasing future depreciation deductions and decreasing future target earnings in order to “supercharge” foreign tax credits).

with high accumulated earnings and replace the subsidiaries with contract arrangements.²⁰⁵

The efficiency framework advanced in Part II emphasized the importance of seeking a transition tax burden that matched taxpayers' estimate of the present value of future tax on offshore earnings. The use of a tax earnings and profits base in general tends to further this efficiency goal. Nevertheless, there are also efficiency drawbacks to the use of a tax earnings and profits base. First, the lack of information about pre-1987 earnings and profits requires the inefficient use of taxpayer resources to perform forensic earnings and profits studies. Second, a tax base drawn from the tax measure of earnings and profits incents taxpayers to make inefficient choices, such as incurring tax planning costs or making business decisions that would be inadvisable in the absence of the transition tax.²⁰⁶

Both the lack of information about pre-1987 earnings and profits and the availability of tax planning strategies cause parallel administrability problems. There is an information asymmetry problem with respect to the calculation of pre-1987 earnings and profits: taxpayers will have all the information, and the government will lack the audit resources necessary to ensure that their calculations make sense.²⁰⁷ Similarly, tax base erosion strategies may be challenging to identify, may not provide the government with a sufficient chance of litigation success and would consume significant resources to litigate in any case. Finally, different compliance costs and different tolerance of aggressive tax planning among affected taxpayers can also present a horizontal equity concern, since more aggressive taxpayers could obtain a better tax result through planning.²⁰⁸

205. Cf. Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 236–37 (2008) (noting that existing tax law encourages the use of “third party commissionaires and contractors” and that a formulary apportionment system might encourage the further expansion of such strategies).

206. See, e.g., Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 INT’L MONETARY FUND STAFF PAPERS 172, 172 (1996) (arguing that taxation can cause “deadweight losses—from substitution, evasion and avoidance activities—and direct, administrative and compliance, costs”).

207. Cf. Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 121 (2008) (noting that because of a lack of guidance and administrative controls, the determination of intangibles pricing for transfer pricing purposes is “completely exposed to abuse by taxpayers and their advisors”).

208. Cf. Gergen, *supra* note 196, at 472 (noting different impact of uncertainty and certain sanction rules on risk-averse versus risk-neutral taxpayers).

C. *The Financial Accounting Measure: Unremitted Earnings*

The financial accounting tax base candidate for a corporate offshore profits transition tax is the measure of a firm's unremitted earnings held in non-U.S. subsidiaries. This differs from the PRE figure that is sometimes cited as an available estimate of offshore earnings or cash²⁰⁹ and was used as a benchmark in the 2004 repatriation holiday.²¹⁰ A corporate offshore profits transition tax should seek to reach all unremitted non-U.S. earnings. However, PRE represents only a portion of unremitted earnings, those for which the company has represented, and its auditors have accepted, that "repatriation will be . . . postponed indefinitely."²¹¹ A widely cited estimate of total PRE is \$1.3 trillion.²¹²

Imposing a tax on a financial accounting measure of unremitted earnings has administrability and efficiency advantages. A tax base linked to earnings recorded for financial accounting purposes avoids the information problems and tax planning costs that otherwise

209. See, e.g., Victor Fleischer, *Overseas Cash and the Tax Games Multinationals Play*, N.Y. TIMES DEALBOOK (Oct. 3, 2012, 1:48 PM), <http://dealbook.nytimes.com/2012/10/03/overseas-cash-and-the-tax-games-multinationals-play/> (referencing PRE as a measure of cash held overseas).

210. Section 965 of the Internal Revenue Code used PRE as a benchmark when it provided that the amount of tax-favored dividends could not exceed "the amount shown on the applicable financial statement as earnings permanently reinvested outside the United States." I.R.C. § 965(b) (2006) (providing for a repatriation amount limit of the greater of \$500 million or PRE).

211. Julie H. Collins, John R. M. Hand & Douglas A. Shackelford, *Valuing Deferral: The Effect of Permanently Reinvested Foreign Earnings on Stock Prices*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 143, 143–44 (James R. Hines Jr. ed., 2001). This rule is presently defined in FASB ASC-740. See Ernst & Young LLP, *Portfolio Description Sheet, Accounting for Income Taxes—FASB ASC 740, Tax & Acct.* Center (BNA), <http://taxandaccounting.bna.com/btac/lpages/lpages.adp?pg=acctports> (last visited Jan. 4, 2013) (subscription required) ("Accounting Standards Codification Topic 740 (ASC 740) codifies the guidance related to accounting for income taxes that was previously included in . . . APB 23."). The financial statement incentive for the identification of PRE is that the deferred tax liability that would result on the payment of dividends to the U.S. need not be recognized for accounting purposes. See ABAHOONIE & ALFONSO, *supra* note 152, at 1. Accordingly, PRE tends to be higher when offshore earnings would incur a significant tax upon repatriation, for example, because the earnings had been subject to low non-U.S. income taxes before repatriation or because the earnings would be subject to high non-U.S. withholding taxes upon repatriation. See Blouin, Krull & Robinson, *supra* note 151, at 20 & n.27, 35 (reporting results suggesting that 95% of PRE is located in affiliates with tax due upon repatriation, including withholding tax, and 74% of PRE is located in lower-tax affiliates). Other factors can, however, also prompt PRE designations, including earnings management, see Krull, *supra* note 143, at 746, 765, and practical linkages between PRE designations for low-tax affiliates and PRE designations for higher-tax affiliates. See Blouin, Krull & Robinson, *supra* note 151, at 12–13.

212. See ZION, VARSHNEY & BURNAP, *supra* note 1, at 1.

present efficiency, administrability, and horizontal equity problems. This is because the measure of unremitted earnings provides a third-party-verified figure which companies generally have been incented to maximize rather than minimize.²¹³ The use of a financial accounting measure of unremitted earnings as a transition tax base would permit the calculation of the corporate offshore profits transition tax based on a firm's most recent financial statements and/or supporting working papers. Later adjustments to transition tax liability would be based solely on financial accounting restatements.

However, using a financial accounting measure of unremitted earnings would also pose efficiency costs because it would be inconsistent with taxpayers' expectations and might influence taxpayers to anticipate other instances of conformity. Conformity does not attract a consensus. This is in part because the accounting rules push against "overstatement of income," while the tax rules push against "understatement of income," and both goals cannot always be pursued simultaneously.²¹⁴ For example, accounting rules might aim to ensure that firms recognize losses for accounting purposes, while tax laws might aim to ensure that firms recognize gains for tax purposes.²¹⁵

In addition, tax accounting is more open to government politics than financial accounting, since decisions are made by Congress rather than by an independent standards board.²¹⁶ Tax accounting must answer to fiscal and policy goals, while financial accounting focuses on information accuracy and disclosure. For example, tax typically uses a faster rate of depreciation than accounting.²¹⁷ The substitution of a financial accounting base would disturb the tax base equilibrium, and if that equilibrium contributes to equity, changing

213. See Shaviro, *supra* note 195, at 429 (noting the possibility of "[s]etting the goals of reducing and increasing 'income' against each other"); see also Gil B. Manzoni, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 181–82 (2002) ("[T]he incentives of preparers likely differ with respect to financial reporting and tax reporting. Specifically, managers of firms may have incentives to make choices that increase income reported to shareholders while at the same time making choices that minimize reported taxable income."); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 119–22, 145 (2005) (discussing financial and tax accounting in the United States).

214. See, e.g., Manzoni & Plesko, *supra* note 213, at 181–82 (noting different incentives and objectives in tax and financial accounting).

215. See Shaviro, *supra* note 195, at 446.

216. See *id.* at 465–72 (comparing political environments relating to the setting of tax accounting and financial accounting rules).

217. See, e.g., Manzoni & Plesko, *supra* note 213, at 181 (noting different depreciation approaches).

the base reduces equity. A reference in the 2004 tax holiday law to PRE as a limit on the maximum amount that could be repatriated²¹⁸ was a relatively rare instance of the explicit use of financial accounting figures in tax statutes.

The equity issue most directly raised by the tax base question is deciding the relative winners and losers among the global multinationals expected to pay a corporate offshore profits transition tax.²¹⁹ Stated differently, compared to the tax base of earnings and profits, how would an unremitted earnings financial accounting measure for the tax base of a transition tax change the treatment of different MNCs relative to each other? A full consideration of this question is beyond the scope of this Article. However, diverse results should be expected. For example, one important component of book-tax differences derives from temporary differences such as those relating to depreciation schedules;²²⁰ these will be more important for firms with significant capital investment. Another component of book-tax differences results from the use of employee stock options as compensatory devices;²²¹ this, too, should differ from firm to firm.

There might be an equity reason to use the narrower measure of PRE, rather than the broader measure of unremitted earnings, as a tax base if firms' PRE bore a predictable relationship to earnings and profits across firms depending on the extent to which unremitted earnings bore foreign taxes. For example, assume that high-taxed non-U.S. earnings were never designated PRE and low-taxed non-U.S. earnings were always designated PRE. If this were so, applying a corporate offshore profits transition tax to a PRE base might be a good proxy for imposing the transition tax only to the extent that firms would not be able to claim a foreign tax credit to reduce U.S. tax due on the underlying income.

It appears, however, that firms' PRE does not bear a predictable relationship to the financial accounting measure of total unremitted earnings, let alone the tax measure of earnings and profits. Jennifer Blouin, Linda Krull, and Leslie Robinson report that about 75% of

218. I.R.C. § 965(b) (2006).

219. This is the third of three equity concerns raised above in Part II.C, identifying: (1) the question of the equitable role of the corporate tax in general; (2) the question of relative winners and losers in the event of a revenue-neutral business tax reform effort; and (3) the question of relative winners and losers among the global multinationals who would be expected to pay the transition tax.

220. See SCHOLES ET AL., *supra* note 118, at 186 (noting tax and financial accounting tension relating to "income shifting across time").

221. See Manzon & Plesko, *supra* note 213, at 190–92 (describing impact of nonstatutory stock options on tax accounting and financial accounting).

the PRE they study is located in affiliates with corporate tax rates less than or equal to 30%, but only about 20% is located in the so-called “big 7” tax havens.²²² The largest percentages of PRE are located in relatively high-tax trading partners, with between 11% and 17% in each of the UK, Canada, and Germany.²²³ Ratios of PRE to assets vary significantly by sector.²²⁴ In addition, firms may have different policies for designating PRE, consistent with the hypothesis that investors may value PRE differently depending on how the PRE are invested²²⁵ and also consistent with findings of significant diversity in earnings management practices more generally.²²⁶ Some, for example, may set aside all they can out of a pool of low-taxed foreign earnings; others will set aside far less than they perhaps could. Apple is an example of a company that sets aside a fairly low proportion of its non-U.S. earnings as PRE.²²⁷

D. How the Financial Accounting Measure of Unremitted Earnings Can Backstop the Tax Measure of Earnings and Profits

As described above, using a financial accounting measure like unremitted earnings as a tax base might violate taxpayer expectations, cause taxpayers to anticipate greater conformity between financial accounting and tax accounting on other items in the future, and disturb whatever equity is currently built into the use of income tax accounting in order to measure tax liability. However, using a financial accounting measure also provides some efficiency and

222. See Blouin, Krull & Robinson, *supra* note 151, at 18 n.25, 19, 35.

223. See *id.* at 42.

224. “Wholesale trade” companies, for example, which include intermediaries for the sale of goods, have PRE on average equal to between 25 and 30% of assets and their total PRE represents about 20% of the total. *Id.* at 43. Electronic manufacturers have PRE on average equal to about 15% of assets and their total PRE represents less than 10% of the total. Of course, these figures depend in part on the denominator of “assets”; perhaps wholesale trade concerns have lower capital needs than electronic manufacturers. See *id.* at 43.

225. See Bryant-Kutcher, Eiler & Guenther, *supra* note 132, at 701 (describing results indicating that PRE attract lower valuations if invested in financial assets).

226. See, e.g., Poterba, Rao & Seidman, *supra* note 185, at 50–51 (reporting significant diversity in firms’ reporting of deferred tax assets and deferred tax liabilities).

227. Apple apparently does not designate large portions of its unremitted earnings that it could designate as PRE. See Peter Svensson, *How Apple’s Phantom Taxes Hide Billions in Profit*, USA TODAY, Jul. 23, 2012, <http://www.usatoday.com/tech/news/story/2012-07-23/apple-phantom-taxes/56441134/1>; see also Daniel Shaviro, *Is Apple Deliberately Understating Its Earnings?*, START MAKING SENSE BLOG (Jul. 24, 2012), <http://danschaviro.blogspot.com/2012/07/deliberately-understating-earnings.html> (discussing the idea that Apple is “lobbying for the enactment of an exemption system that . . . would give them a positive reported earnings shock of many billions of dollars, in addition to giving them full U.S. access to the overseas fund without a tax hit”).

administrability benefits. In particular, unremitted earnings might help address the efficiency, administrability, and horizontal equity problems posed by unknown pre-1987 earnings and by tax planning opportunities to erode an earnings and profits transition tax base.²²⁸

Financial accounting incentives already discourage at least one approach to planning to reduce a corporate offshore profits transition tax because they deter repatriation in at least some circumstances.²²⁹ In particular, a firm's repatriation of earnings previously designated as PRE requires a firm to change the designation of the earnings, thus reneging on previous representations regarding intended repatriation plans.²³⁰ Work on repatriation in response to the 2004 holiday shows that financial accounting disincentives appear to have discouraged repatriation in some cases.²³¹

More explicit use of the financial accounting measure of unremitted earnings to backstop the tax measure of earnings and profits is also possible. For example, the corporate offshore profits transition tax could include a provision that required or permitted companies to use their pre-1987 financial accounting unremitted earnings as a measure of their pre-1987 earnings and profits. This could be styled as an election, as a required data point in the determination of pre-1987 earnings and profits, or as a required disclosure. There are benefits and detriments to the different approaches to such a reference to unremitted earnings.²³²

The corporate offshore profits transition tax could also require reconciliation between a company's financial accounting measure of unremitted earnings and its tax measure of earnings and profits. Such reconciliation would resemble the existing Schedule M-3 (to C corporations' income tax return filed on Form 1120), which requires large corporate taxpayers to reconcile their book and tax income.²³³

228. See *supra* Part III.B (describing tax base erosion planning opportunities).

229. See generally Jennifer Blouin, Linda Krull & Leslie Robinson, *Is U.S. Multinational Dividend Repatriation Policy Influenced By Reporting Incentives?*, 87 ACCT. REV. 1463 (2012).

230. See *id.* at 1467, 1487.

231. See *id.* at 1487.

232. See, e.g., Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21 (2010) (discussing advantages and disadvantages of providing taxpayers with explicit elections).

233. Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, available at <http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf>; see also Shaviro, *supra* note 195, at 477–79 (describing how to “[t]ake advantage of Schedule M-3 in designing the taxable income adjustment”).

As with Schedule M-3, significant discrepancies might trigger more careful audit examination.²³⁴

A final possibility is to provide for the transition tax to tax unremitted earnings to the extent the difference between the accounting measure and the tax measure exceeded a certain level. The objections to book-tax base conformity described above may be less pressing in the case of the corporate offshore profits transition tax, as it would only require one-time, snapshot conformity, which seems less likely to cause alarm among accounting standard-setters as a result of the different politics and objectives of tax income measurement. However, a full analysis of this option is beyond the scope of this Article.

IV. A TRANSITION TAX FOR AN ACCOMPANYING WORLDWIDE CONSOLIDATION REFORM

Most of this Article considers the appropriate form for a corporate offshore profits transition tax in connection with a steady-state territorial tax reform. Although a steady-state worldwide consolidation reform is not the focus of current political debate, it is a possibility.²³⁵ Worldwide consolidation would involve the current taxation of all income earned by non-U.S. subsidiaries of U.S. parent corporations.²³⁶ It could tax non-U.S. business income at the maximum U.S. statutory rate or at a lower rate.²³⁷ This Part briefly applies the efficiency and equity elements of this Article's framework to transition tax policy in connection with a worldwide consolidation steady-state reform.

A. *Efficiency*

As the discussion of efficiency in Part II initially noted, one view suggests that an efficient transition tax policy should give retroactive

234. See Shaviro, *supra* note 195, at 477 ("To date, the main purpose served by Schedule M-3 has been to provide the IRS with a vital roadmap for tax audits, by helping to identify the most potentially questionable areas on corporate tax returns.").

235. See, e.g., The Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong. § 2 (2011) (sponsored by Senators Ron Wyden (D-Ore.) and Dan Coats (R-Ind.)) (proposing deferral repeal and the reduction of the corporate rate to 24%); WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 7, at 1-15 (proposing a "minimum" rate of tax on non-U.S. income).

236. See, e.g., Kleinbard, *supra* note 28, at 152 (describing a "worldwide global tax consolidation (or 'full inclusion') model").

237. See, e.g., Shaviro, *supra* note 3, at 417 (proposing "serious consideration" of a low but nonzero rate of tax on non-U.S. income).

effect to the accompanying steady-state reform.²³⁸ If the accompanying reform were worldwide consolidation, this would support a transition tax at the worldwide consolidation rate. For example, if the worldwide consolidation policy were accompanied by a reduction in the corporate tax rate to 24%²³⁹ and allowed a foreign tax credit, the transition tax policy might seek to impose a burden on untaxed accumulated offshore earnings equal to the burden that would have been imposed if such earnings had been taxed on a flow-through basis at 24%, subject to a foreign tax credit, all along.²⁴⁰ If the worldwide consolidation policy provided for the taxation of non-U.S. business income at 10%, with a deduction rather than a credit for foreign taxes, then the appropriate transition tax might tax untaxed accumulated offshore earnings at a rate of 10% to mimic the burden on such earnings that would have been imposed if such earnings had been taxed on a flow-through basis at a rate of 10% with a foreign tax deduction rule in effect all along.²⁴¹

Since steady-state policy is not routinely made retroactive,²⁴² taxpayers would not expect such an approach. Rather, the idea of making steady-state policy retroactive aspires to prompt taxpayers to anticipate policy change, both on a prospective and retroactive basis.²⁴³ If taxpayers changed their behavior based on anticipating retroactive policy change as well as prospective policy change, the change would have more far-reaching impact on taxpayer behavior.²⁴⁴ If the policy changes are good, encouraging taxpayers to anticipate the changes may constitute wise policy.²⁴⁵ Ben Alarie has defended the retroactive application of the Canadian general anti-avoidance rule, or GAAR, on this ground.²⁴⁶

238. See *supra* notes 93–95 and accompanying text (outlining argument for retroactive transition tax policy particularly in the case of good policy changes).

239. See, e.g., S. 727, § 2 (proposing deferral repeal and the reduction of the corporate rate to 24%).

240. For administrability and constitutional reasons, such a tax might be structured as a lump-sum, flat rate tax rather than, for example, requiring the reopening of tax years and/or the calculation of foreign tax credits. See *supra* Part II.B (discussing similar issues).

241. See *supra* notes 123–27 (describing a “new view” of dividend taxation).

242. See *supra* notes 89–90 and accompanying text.

243. See, e.g., Kaplow, *supra* note 92, at 14 (“Sometimes efficiency in the present setting requires . . . that a reform be made explicitly retroactive.”).

244. See discussion *supra* Part II.A.1.

245. See SHAVIRO, *supra* note 85, at 48–49 (explaining why retroactive rule change may be good if the policy change is good).

246. See Benjamin Alarie, *Retroactivity and the General Anti-Avoidance Rule*, in *TAX AVOIDANCE IN CANADA AFTER CANADA TRUSTCO AND MATTHEW* 197, 215–17 (David G. Duff & Harry Erlichman eds., 2007) (noting rule-of-law as well as efficiency-based

Even if taxpayers could, in the future, be prompted to form such expectations and act on them, there is little reason to think that taxpayers would expect the retroactive application of a worldwide consolidation reform since existing congressional practice does not include such retroactive transition rules.²⁴⁷ Accordingly, the retroactive application of a worldwide consolidation approach would not necessarily match taxpayer expectations.²⁴⁸ For each of these reasons, the imposition of transition tax in connection with a worldwide consolidation reform could surprise taxpayers and cause them to take actions such as increasing use of expatriation strategies to avoid being subject to future unexpected changes in U.S. tax rules.²⁴⁹ As this Article has assumed elsewhere, Congress presumably wants to avoid the risk of such a taxpayer surprise.

However, a worldwide consolidation reform without any transition tax, like a territoriality reform without any transition tax, would provide a windfall to U.S.-parented MNCs. This is because such MNCs should currently expect to bear some future U.S. income tax burden with respect to their untaxed accumulated offshore earnings. Thus, the efficiency analysis outlined above in Part II.A replicates in the worldwide consolidation context, and the goal of matching taxpayer expectations should similarly support a transition tax of 5–10% on such earnings.²⁵⁰

There is one circumstance in which the theory suggesting that transition tax policy should match steady-state policy and the theory stating that transition tax burdens should match taxpayer expectations produce similar transition tax results. This circumstance involves the enactment of a worldwide consolidation regime that imposes a 5–10% tax burden on non-U.S. business income going forward and permits only a deduction, not a credit, for foreign taxes.²⁵¹ In that case, the idea of matching transition tax policy to steady state policy would also produce the result of a 5–10% transition tax on a tax base of earnings and profits.

arguments against retroactivity and arguing that one could “reasonably expect” a retroactively applied GAAR to substantially reduce tax abuse).

247. See *supra* text accompanying notes 89–90.

248. See *supra* text accompanying notes 86–88.

249. See discussion *supra* Part II.A.3.

250. See *supra* Part II.A (linking taxpayer expectations with tax rate recommendation).

251. See, e.g., Shaviro, *supra* note 3, at 417 (proposing “serious consideration” of a low but nonzero rate of tax on non-U.S. income).

B. Equity

In this Article, consideration of equity issues has mentioned the question of the role of the corporate tax generally in vertical equity terms; the question of equity among three categories of business firms, global multinationals, domestic corporations, and unincorporated businesses; and equitable relationships among different global multinationals.²⁵² The prospect of worldwide consolidation squarely raises the second equity issue. This is because it raises the prospect that global multinationals will be losers, and domestic corporations will be winners, under a worldwide consolidation reform. For example, if the effective rate of tax on non-U.S. income is about 16% for a particular U.S.-parented MNC,²⁵³ then worldwide consolidation at a higher rate would increase the tax liability of that MNC.

This tax rate differential matters because of both its effect on taxes paid on future income²⁵⁴ and its impact on asset valuation. So long as lower rates were available to competitors, for example, under territorial systems, the differential would depress the value of such non-U.S. investments in the hands of U.S. firms.²⁵⁵ As a result, U.S. firms might sell some assets and simply bear the value decline of other investments.²⁵⁶

Implicit taxation analysis provides the key to understanding this “for sale sign” concern. The idea that after-tax returns adjust to a single equilibrium rate drives implicit taxation. A tax that applies to a certain type of asset initially decreases the asset type’s after-tax return, but under the assumption that after-tax returns converge, the price of the taxed asset will decrease until the asset produces the equilibrium after-tax return.²⁵⁷ Table 2 illustrates the predicted implicit taxation result of the decline in value in non-U.S. assets

252. See *supra* text accompanying note 55.

253. Cf. Grubert, *supra* note 139, at 281 (reporting average effective foreign tax rate of 16% for U.S. multinational companies in 2004).

254. Revenue estimates for deferral repeal are fairly modest, as low as \$13 billion per year. See Gravelle, *Practical Tax Reform*, *supra* note 174, at 402 (giving an annual revenue estimate of \$12.9 billion annually); see also GREGG & WYDEN, *supra* note 171, at 3 (estimating revenue increase resulting from both imposing per-country foreign tax credit rules and including active income in taxable subpart F income at approximately \$60 billion annually).

255. See *supra* text accompanying note 55.

256. See Shaviro, *supra* note 3, at 394 (describing clientele effects that could produce “asset swaps” between U.S. and non-U.S. investors upon the imposition of a worldwide tax).

257. See SCHOLES ET AL., *supra* note 118, at 130–31 (defining implicit taxes and their impact on asset prices).

owned by U.S.-parented MNCs upon adoption of worldwide consolidation. The assumed after-tax rate of return is 10%.

**Table 2: Implicit Taxation Results for Non-U.S. Assets
Owned by U.S. MNCs on Adoption of Worldwide Consolidation**

	Pre-tax return	Ex ante after-tax return	Ex post after-tax return before investment shifting
Non-U.S. asset valued at 1000 if held by U.S. MNC with: ex ante rate = 16% ex post rate = 25%	119	100	89
Non-U.S. asset valued at 1000 if held by non-U.S. MNC with tax rate of 20%	119	95	95

This implicit tax result, together with the burden of paying additional tax on future non-U.S. income, is likely to cause global U.S. multinationals to object to the imposition of a transition tax on offshore earnings in connection with a worldwide consolidation reform. In contrast, if global corporations will fare better in the future under a territoriality reform, they may be more inclined to accept a corporate offshore profits transition tax. If a reform is adopted that falls in between territoriality and worldwide consolidation, for example, by imposing a non-zero, but non-maximum, rate of tax,²⁵⁸ then an analysis of whether global multinationals are “winners” or “losers,” including under this sort of implicit taxation analysis, should suggest whether they should bear the burden of the transition tax from an inter-business equity and related political lobbying perspective.

CONCLUSION

What transition tax should be imposed on the \$1 trillion to \$2 trillion of pre-enactment non-U.S. earnings of U.S.-parented multinational firms if the United States eliminates its current

258. See WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 7, at 14–15 (“The President proposes . . . establishing a new minimum tax on foreign earnings.”).

approach of residual taxation upon repatriation of earnings from non-U.S. corporate subsidiaries to U.S. parent corporations? This could happen under a territorial reform plan, a worldwide consolidation reform plan, or an intermediate option. This Article has used the traditional tax policy metrics of efficiency, administrability, and equity to propose a design for such a corporate offshore profits transition tax. The proposed corporate offshore profits transition tax would equal between 5–10% of the untaxed earnings and profits of non-U.S. subsidiaries, with no reduction to account for foreign tax credits and some use of the financial accounting measure of unremitted earnings to reduce compliance and administrative costs.

With respect to the appropriate tax rate, efficiency concerns support a transition tax that matches taxpayer expectations. A transition tax that is less burdensome than taxpayers expect would cause a windfall. A transition tax that is more burdensome than taxpayers expect might produce post-enactment efforts by taxpayers to plan for or avoid future transition taxes or other unexpected taxes, including corporate taxpayers' possible increased use of expatriation strategies. This Article assumes that legislators would prefer to capture a windfall and also avoid presenting corporate taxpayers with incentives to minimize their exposure to future explicitly retroactive changes in U.S. tax law.

Expectations formed simply by discussions about transition taxes might suggest a transition tax rate in the range of 0–10.5%, while expectations formed by estimates of the present value of the eventual burden of taxation on pre-enactment offshore earnings, based on assumptions outlined above, suggest a tax of about 10%. This Article argues that foreign tax credits should not be allowed to offset transition tax liability because such an allowance would significantly reduce the administrability of the tax and increase its compliance costs. Equity problems, and in particular inequities among different global multinationals, may arise as a result of failing to account for foreign tax credits. But adequately represented corporate interests can address such inequities through the political process, including through adjustments to other provisions included in a reform package.

With respect to the appropriate tax base, this Article identifies two contenders: the tax measure of earnings and profits and the financial accounting measure of unremitted earnings. The earnings and profits tax measure is more consistent with taxpayer expectations and with equitable determinations incorporated into tax accounting rules. However, it has efficiency and administrability disadvantages

stemming from the difficulty of determining pre-1987 earnings and profits and the likely ability of taxpayers to plan to erode the earnings and profits tax base. The financial accounting measure of unremitted earnings may better support a pre-1987 earnings calculation and is less susceptible to tax planning. Financial accounting earnings measures might be used to backstop or check an earnings and profits tax base, including through the use of pre-1987 unremitted earnings as a proxy for pre-1987 earnings and profits and by requiring taxpayers to disclose a reconciliation of differences between unremitted earnings calculated under financial accounting rules and accumulated earnings and profits calculated under tax rules.