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Daniel N. Shaviro

NYU School of Law, shavirod@exchange.law.nyu.edu

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The David R. Tillinghast Lecture The Rising Tax-Electivity of U.S. Corporate Residence

DANIEL SHAVIRO*

I. INTRODUCTION

In 1975, Bill Gates moved to New Mexico and founded Microsoft there. This may have been a mistake. William Woods, while head of the Bermuda Stock Exchange, claimed that Gates “would be fabulously more wealthy if he had started Microsoft in Bermuda . . . [H]is ignorance about tax cost him a fortune.”¹ As the author of the article quoting Woods, adds, “Mr. Gates has not done badly even so, but he knows better now. The new company that he recently co-founded is now incorporated in Bermuda.”²

Notwithstanding any boosterism or hyperbole that one might detect in this statement, Woods had an undeniable point. Gates’ new company, as a foreign corporation for U.S. federal income tax purposes, is taxable in the United States only on what the U.S. rules classify as domestic source income. Microsoft, by contrast, as a U.S. corporation and thus, under the rules, a resident taxpayer just like any individual who is an U.S. citizen, potentially is taxable in the United States on all of its worldwide income. This may be inconvenient for a company like Microsoft, not just because it earns vast profits abroad, but also because its resident status impedes tax planning that otherwise might have been available to minimize its domestic source income, as defined by the U.S. rules.

Once a company is incorporated in the United States, however, escaping its status as a U.S. resident is difficult. It may require genuinely being purchased by new owners, such as a private equity fund or else a distinct foreign company with its own shareholders and manag-

* Wayne Perry Professor of Taxation, NYU Law School. This Article was the basis for the fifteenth annual David R. Tillinghast Lecture on International Taxation, delivered at NYU Law School on September 21, 2010. I am grateful to the D’Agostino-Greenberg Fund for financial support.

¹ Matthew Bishop, Gimme Shelter, *The Economist*, Jan. 29, 2000, at S15.

² *Id.*

ers.³ “Real” expatriations of this kind do happen,⁴ and U.S. international tax law effectively encourages them by making them a magic bullet for eliminating domestic resident status, but the associated ownership disruption may go well beyond what a large, successful company such as Microsoft is willing to contemplate just for the tax benefits.

Bill Gates is not the only entrepreneur to learn in recent years that up-front U.S. incorporation of a contemplated multinational enterprise may neither be wise from a tax standpoint nor necessary from a business standpoint. Increasingly, Americans forming new companies with global business potential, as well as foreigners who want to reach investors in U.S. capital markets, have found that they do not need to pay the tax price of incorporating at home.⁵ Foreign incorporation—often in jurisdictions such as Bermuda and the Cayman Islands that lack significant domestic income tax systems—has become more common, and I have heard U.S. tax lawyers joke that recommending (or even not objecting to) U.S. incorporation of an intended global business verges on being malpractice *per se*.

Increasingly, moreover, other countries—not just those like Bermuda and the Cayman Islands that cater to foreign investors, but even major industrial powers like England, France, Germany, and Japan⁶—do not comparably attempt to tax resident companies on their worldwide business income. Instead, they have primarily territorial tax systems (also known as exemption systems), in which resident companies’ foreign source active business income generally is exempt from domestic taxation. This effectively increases the relative tax price of U.S. incorporation for a projected global business.

The fact that U.S. incorporation of new global businesses is moving towards being just an undesirable election—whereas terminating U.S. residence for existing companies is far more difficult—is at once well-known in the international tax policy literature, and yet, to a surprising degree, ignored. Each half of the picture has an important implication. Rising electivity for new companies is potentially a game-changer. The long and frequently vociferous debate about whether the United States should seek to strengthen its worldwide taxation of

³ See IRC § 7874.

⁴ An example is the 1998 acquisition of the U.S. automaker Chrysler by Daimler, a German company. The combined enterprise, known as DaimlerChrysler, was a German resident. See Lee A. Sheppard, Last Corporate Taxpayer Out the Door, Please Turn Out the Lights, 82 Tax Notes 941 (Feb. 15, 1999).

⁵ See Mihir A. Desai & Dhammika Dharmapala, Do Strong Fences Make Strong Neighbors?, 63 Nat’l Tax J. 723, 724-25 (2010).

⁶ See, e.g., Tom Neubig & Barbara M. Angus, Japan’s Move to Territorial Contrasts with U.S. Tax Policy, 54 Tax Notes Int’l 252 (Apr. 27, 2009) (describing all four countries as either having a territorial tax system or moving toward one).

resident companies, or instead follow the rest of the world by moving towards exemption, would become a historical curio over time if there were no significant nontax reasons for incorporating in the United States. A mere election to pay more tax, by gratuitously subjecting oneself to the U.S. worldwide system (such as it is), would make too little sense even to matter—though, by the same token, this would rebut claims by exemption’s proponents that this system was actually harming the U.S. economy.⁷ Moreover, while electivity is likely to remain incomplete, the underlying factors thus limiting electivity need analysis, as they help determine the actual consequences of a worldwide residence-based tax.

The second half of the picture is trapped equity in existing U.S. corporations that operate global businesses. So long as these companies continue to be major economic players, the choice between a more worldwide and a more territorial system remains important because of its effects on them. Insofar as only they are affected, however, the debate is, in a sense, just about transition, or whether and how to apply new law (if and when enacted) to old capital that was invested under prior law.⁸

To help show the difference between transition and prospectively applicable tax policy, consider the issues raised by a “classical” corporate income tax system (like that in the United States) that potentially double taxes equity-financed investment, by imposing tax first at the corporate level and then at the shareholder level.⁹ Many commentators favor adopting some variant of corporate integration, under which the double tax would be eliminated, creating greater tax neutrality both between corporate and noncorporate entities and between debt and equity financing.¹⁰ However, the arguments for creating a more neutral corporate tax regime that applies to behavior after the new system’s enactment do not tell one whether the double tax should be eliminated as to shareholders who invested under old law with the expectation that corporate dividends generally would be taxable. Ap-

⁷ John Samuels, Vice President & Senior Counsel of Tax Pol’y, Gen. Elec., True North: Charting a Course for U.S. International Tax Policy in the Global Economy, David R. Tillinghast Lecture, NYU Law School (Sept. 25, 2007).

⁸ See generally Daniel N. Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (2000) (discussing retroactive and other transition effects, providing an economic framework for considering transition issues, and providing an economic theory of politics to illuminate the forces that influence substantive political outcomes).

⁹ See generally Daniel N. Shaviro, *Decoding the U.S. Corporate Tax 18-23* (2009) (discussing the reasons the U.S. corporate tax treats debt and equity differently, and the reason for imposing double taxation on equity-financed investment).

¹⁰ See, e.g., U.S. Treasury Dep’t, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once 1-2* (1992).

plying the new law in this sense retroactively—that is, to exempt from tax post-enactment dividends that relate to pre-enactment equity and earnings—might effectively hand the shareholders who had invested under old law what some view as an unfair windfall gain.¹¹

Shifting from a worldwide to a territorial system would raise transition issues very similar to adopting corporate integration domestically. Nonetheless, in recent years, when countries such as the United Kingdom and Japan have announced such shifts,¹² transition analysis has been all too absent. Resident companies have simply been permitted to reap the transition gain from eliminating the potential domestic tax liability on existing foreign earnings, even though the companies may have become domestic residents and invested abroad long before adoption of the shift seemed at all likely.

In the United States, if rising electivity (or any other consideration) induces a shift towards exemption, transition issues should not be similarly ignored given the potential stakes. At present, U.S. multinationals have more than \$10 trillion invested abroad, including at least \$1 trillion of foreign earnings.¹³ A reasonable transition tax conceivably might raise as much as \$200 billion. This is not a trivial amount. Moreover, even beyond any revenue implications of allowing the transition gain, an anticipated change in the law can have important effects on companies' incentives in the period before actual adoption. Thus, the transition issues merit serious attention, however one ultimately resolves them.

The rest of this Article proceeds as follows. Part II discusses what I mean by electivity. Part III examines why one might want to consider taxing U.S. companies on their worldwide income if corporate residence could not be affected by taxpayer choices. Part IV examines what we know about the actual degree of electivity of corporate residence. Part V examines the transition issues that would be raised if exemption of foreign source income were to be adopted for new equity. Part VI offers a brief conclusion.

¹¹ See, e.g., ALI, Federal Income Tax Project, Subchapter C (Supplemental Study), Reporter's Study Draft 92-93 (1989).

¹² HM Treasury, Budget 2009, 2009, H.C. 407, at 83, available at http://www.hm-treasury.gov.uk/bud_bud09_index.htm; Jonathan Stuart-Smith, Yang-Ho Kim & Nicholas Walters, Japan: Ruling Party Releases 2009 Tax Reform Proposals, 53 *Tax Notes Int'l* 50, 50-51 (Jan. 5, 2009).

¹³ See Daniel N. Shaviro, Moving to a Territorial System and Reforming the Corporate Tax, in *Toward Tax Reform: Recommendations for President Obama's Task Force 78*, 78 (Tax Analysts, 2009) [hereinafter *Moving*]; Daniel N. Shaviro, The Obama Administration's Tax Reform Proposals Concerning Controlled Foreign Corporations, 4 *Brit. Tax Rev.* 331, 339 (2009) [hereinafter *Proposals*].

II. *Defining Electivity*

Since this Article focuses on whether corporate residence electivity is rising, and what consequences would follow from this, I begin by explaining what electivity means here. An initial concept—not, however, what I ultimately have in mind—is formal or explicit electivity. Suppose, for example, that, even for existing companies, treatment as a resident U.S. corporation was explicitly elective. In this scenario, the Code might define a resident U.S. corporation as any corporation (or similar legal entity) that filed a statement with the Service stating that it wished to be so classified.

While such a rule would make U.S. corporate residence status formally elective, we would need to know more before concluding that such status in fact was entirely elective as a substantive matter. Suppose that a company's tax return filing choice had important nontax effects on its operations—for example, by affecting its appeal to consumers or investors, or its ability to participate effectively in the Washington political process. Then the company would be strongly discouraged from electing the U.S. tax status it preferred without considering the possible nontax implications. In general, the greater the nontax thumb on the scales, the less tax considerations would be able to determine the company's bottom-line choice. Substantive tax-electivity therefore would gradually decline as the choice's nontax significance increased.

In practice, formal tax-electivity is relatively rare in U.S. tax law—although, where found, it tends to create real electivity in substance. The most pertinent example for international tax policy is the so-called “check-the-box” election, which permits U.S. multinationals explicitly to elect whether certain foreign legal entities that they own will be treated for U.S. tax purposes as legally distinct corporations, or instead as “disregarded entities” (that is, mere operating branches of the U.S. parent).¹⁴ This proved to be an important instrument for international tax planning by U.S. companies, which now find it easier to create “hybrid” legal entities, or entities that, for tax purposes, other countries recognize but the United States ignores. The hybrid entities created by taking advantage of the check-the-box rules could permit, for example, a U.S. company with a German subsidiary to save German taxes by shifting taxable income from Germany to, say, the Cayman Islands, without thereby creating current U.S. tax liability under subpart F of the U.S. international tax rules, as generally would

¹⁴ Reg. § 301.7701-3.

happen if U.S. tax law recognized both the German and the Caymans entities.¹⁵

Formal electivity is not needed, however, to create substantive electivity. In illustration, consider the general rule that gain or loss from an asset's change in value is not taken into account for tax purposes until it is realized, such as through a sale or exchange of the asset. If realization were entirely elective in substance—as surely it would be if it were formally elective—taxpayers almost always would elect to realize losses from depreciated assets, except where loss limitations would apply,¹⁶ while not realizing gains from appreciated assets.¹⁷ (Thus, imagine a hypothetical income tax return schedule in which the taxpayer is asked to list all the deemed asset realizations for the year that she wishes to report.)

Instead, however, U.S. income tax law makes the scope of asset realization, as a formal matter, entirely non-elective. Given what one has actually done with respect to a particular asset during the year, there either is or is not a taxable realization of gain or loss (as the case may be). One generally has no formal choice, leaving aside the question of how one chooses to report legally ambiguous circumstances that may never end up being fully reviewed by the IRS or a court.

Yet even without formal electivity, there can be varying degrees of substantive electivity, depending both on the applicable rules and on taxpayers' opportunity sets. Thus, consider a taxpayer holding an appreciated asset, such as stock in a publicly traded company, which her tax advisor says she should retain until death (at which point it will get a tax-free basis step-up¹⁸). Why might she nonetheless sell it, despite the adverse tax consequences, assuming for now that buy or hold are the only alternatives? There are many possibilities. For example, she might need the cash and find the sale more convenient than taking out a loan. Or she might feel the company's stock is overvalued and likely to decline in price. Or she might dislike her risk exposure to this company's stock price performance and want to rebalance her portfolio.

¹⁵ See Shaviro, *Proposals*, note 13, at 332. In general, subpart F accelerates U.S. taxation of foreign earnings by U.S. companies' foreign subsidiaries, which otherwise is deferred until realization by the U.S. parent (such as through the receipt of a dividend), by creating deemed dividends. Subpart F generally applies when a foreign subsidiary either has passive income, such as interest or dividends on portfolio financial assets, or does specified things that are suggestive of overseas tax planning (such as shifting taxable income from high-tax to low-tax countries). See Daniel N. Shaviro, *Fixing the U.S. International Tax Rules* (forthcoming 2011).

¹⁶ See, e.g., IRC § 1211 (generally limiting allowable capital losses to the amount of capital gains, plus \$3,000 for individual taxpayers).

¹⁷ When applicable tax rates are about to increase, however, taxpayers in some cases might accelerate elective gain realizations.

¹⁸ IRC § 1014.

The more important and further from equipoise that these considerations tend to be, the more often she will end up, in practice, not doing the tax-preferred thing. When tax considerations tell her to hold (or, in the case of a loss asset, to sell), one could think of her as having an effective election to attain the tax-preferred result, but at the cost of incurring an exercise price: the disvalue to her of doing what, tax considerations aside, was the wrong thing. Thus, substantive electivity is potentially costly. And the higher the exercise cost, the less substantively elective the tax consequences actually are. (At an infinite exercise price, the election does not effectively even exist.)

The effective exercise price of the sell-or-hold option does not, however, depend on just the taxpayer's particular preferences regarding whichever of the underlying factors potentially constrains her tax optimization. It also depends on the other means available to her for achieving her nontax goals and on how the tax law would treat her use of those other means. For example, can she readily use the stock to secure a loan, and do so without triggering a tax realization? What about buying put options to sell the stock, cushioning her downside risk, or selling call options that permit her to monetize and transfer the appreciation potential? Both the completeness of financial markets and the tax law's treatment of effective substitutes for an outright sale will help determine the degree of substantive or effective electivity of gain and/or loss realization in practice.

Returning to the issue of U.S. corporate residence, as a formal matter it is not at all elective. A corporation is a U.S. resident if and only if it is "created or organized in the United States or under the law of the United States or of any State."¹⁹ Thus, substantive electivity depends on whatever nontax consequences attach to having a U.S., as opposed to a foreign, place of incorporation.

While I defer further addressing the electivity of U.S. incorporation until Section IV, two preliminary points are worth making here. First, a useful rubric in thinking about the issue, suggested by Mitchell Kane and Edward Rock, is to think about the "tax surplus" as opposed to the "corporate surplus" (that is, the factors affecting value, taxes aside) that would result from alternative residence choices.²⁰ In my terminology, tax electivity would be complete if the corporate surplus

¹⁹ IRC § 7701(a)(4). The anti-inversion rules can cause a foreign-incorporated company to be treated as a U.S. resident, but only because of the U.S. resident status (based on U.S. incorporation) of its predecessor company. IRC § 7874(b).

²⁰ Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 Mich. L. Rev. 1229, 1239-40 (2008). Because of their interest in the issue of international charter competition, Kane and Rock restrict the term "corporate surplus" to governance-related factors resulting from the choice of substantive corporate law. I use the term more broadly, given my interest here in factors affecting electivity generally.

from choosing U.S. residence were always zero, rather than being positive or negative.

Second, one should keep in mind four distinct settings in which the degree of electivity of U.S. corporate residence may matter. The first involves new U.S. incorporation of a start-up business. Here, obviously, in principle one can do whatever one likes, but actual electivity depends on the U.S. versus foreign alternatives' nontax consequences.

A second scenario involves existing foreign companies that have reason to consider becoming U.S. companies. This scenario is apparently a very real one, hallucinatory though it might seem to tax officers in U.S. companies who desperately wish they could expatriate.²¹ (Lewis Steinberg has dubbed this mutual desire to change places the "reverse endowment effect."²²) A well-known recent example involved Rudolph Murdoch's News Corporation, an Australian company that reincorporated in Delaware in 2004.²³

A third setting for electivity involves existing U.S. companies that may want to expatriate. The recently enacted anti-inversion rules, which attach adverse tax consequences (including continued U.S. resident status) to transactions that might otherwise have permitted low-cost effective expatriation by existing companies,²⁴ play an important role in limiting effective electivity for such companies.

The fourth setting for electivity is the least obvious, yet arguably the most important. It involves tax law's impact on the making of new investments by existing U.S. and foreign firms that themselves have fixed places of residence. To illustrate, suppose either a U.S. firm or a foreign firm could make a new investment in a given capital-importing country. China, for example, was recently reported to be considering a \$60 billion to \$100 billion upgrade to its electricity infrastructure, prompting expected competition for the business between General Electric (GE), a U.S. corporation, and Siemens, a German corporation, among other non-Chinese prospective entrants.²⁵ Suppose that China picks the company that offers it the best bid, and that each company's bid reflects its own need to offer the requisite after-tax return to the investors who ultimately would supply the financing in integrated world capital markets. The winning bid presumably depends

²¹ Lewis R. Steinberg, Reverse Endowment Effect, Remarks at a panel discussion at the 11th Annual Tax Policy & Practice Symposium (Feb. 24, 2010), in 88 *Taxes* 79, 79 (June 2010).

²² *Id.*

²³ See Press Release, News Corp., News Corp. Plans to Reincorporate in the United States (Apr. 6, 2004), available at http://www.newscorp.com/news/news_207.html.

²⁴ IRC § 7874.

²⁵ See Kelly McGuire, China Moves to Build Smart Grid, GE, Siemens Feel Competition (May 24, 2010), <http://smart-grid.tmcnet.com/topics/smart-grid/articles/86212-china-moves-build-smart-grid-ge-siemens-feel.htm>.

on the interaction between corporate surplus (that is, relative expected pre-domestic tax returns)²⁶ and tax surplus (that is, relative domestic tax burdens). One could fruitfully think of this as if the investors were electing between the use of GE and Siemens to make the investment, even if the only party consciously making a choice—the Chinese government—is looking only at the bids, and thus does not itself care about the winning supplier’s place of corporate residence.

While the word “electivity” may initially seem a misnomer as applied in such a setting, its use is appropriate (and the semantic infelicity, if any, can be overlooked) for two reasons. First, no less than when people who are founding new businesses decide where to incorporate, outcomes presumably depend on the relationship between tax surplus and corporate surplus. Second, the effects on the reach of worldwide residence-based corporate taxation, and on its capacity to achieve whatever underlying policy goals it may serve, may be the same whether opting out takes the form of differential incorporation rates or differential new equity issuance rates.

III. WHY IMPOSE (OR NOT) A WORLDWIDE TAX ON U.S. RESIDENT COMPANIES IF CORPORATE RESIDENCE ELECTIVITY IS LIMITED?

A. *Analyzing the Issues Raised by Worldwide Taxation*

Whether or not rising electivity dooms worldwide residence-based corporate taxation, it is important to know why this conceivably might be grounds for regret. What purposes might such a tax serve if the residence attributed to particular corporate equity were a fixed attribute, immune from taxpayer control? The answer matters both to the assessment of partial electivity and to tax policy generally insofar as the worldwide corporate tax might be playing an integral role in achieving broader aims.

To anyone acquainted with the international tax policy literature, the question of whether one ought to levy a worldwide residence-based tax is familiar and long controversial. Indeed, it has been the dominant question explored and debated in the literature for more than fifty years.²⁷ Typically, however, the debate amounts to little

²⁶ I assume that either investor would pay Chinese tax at the same rate, thus leaving only residence-based taxation as a potential source of disparity.

²⁷ The seminal work in establishing the modern international tax policy literature is Peggy B. Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (1963), but the taxation of outbound investment had begun to attract academic attention by the late 1950’s. See, e.g., Stanley S. Surrey, *Current Issues in the Taxation of Corporate*

more than what I call “alphabet soup”²⁸ or the battle of the acronyms. First one chooses a particular margin at which the standard principle of tax neutrality is asserted to be desirable. Then one determines what sort of international tax regime this requires.

Capital export neutrality (CEN), for example, calls for inducing a given investor, residing in a particular country, to invest wherever she would earn the highest pre-tax return (treating all countries’ taxes the same). This requires that all investments by this person, wherever made, face the same combined worldwide tax rate. By contrast, capital import neutrality (CIN) calls for providing that a given investment will face the same combined worldwide tax burden no matter who makes it. CEN is satisfied by a worldwide residence-based tax system with unlimited foreign tax credits to neutralize the relative incentive effects of source countries’ varying tax rates, whereas CIN is satisfied by a territorial system in which everyone treats foreign source income as exempt. Decide which margin is more important, the standard analysis goes, and you will know whether you should favor a worldwide or territorial system.

Of late, one more acronym has been added to the alphabet soup. Capital ownership neutrality (CON) is satisfied if the tax rate on income from a business asset does not depend on which company owns it.²⁹ Though CON can in principle be satisfied in multiple ways, in practice it is thought to call for moving towards territorial taxation, in part because that approach is increasingly prevalent outside the United States.

I have elsewhere argued that a “battle of the acronyms” approach to international tax policy is fundamentally inadequate.³⁰ For present purposes, however, it is enough to note two main objections. First, all three of the above norms are based on maximizing global, rather than national, welfare. Thus, for example, they treat it as normatively irrelevant which country collects a given dollar of tax revenue, or which country attracts a given dollar of scarce investment capital. As a guide to national policy, such global altruism may be morally admirable, but it is more than we might really expect. Nations, no less than individuals, typically act, at least within broad limits, to advance their own

Foreign Investment, 56 Colum. L. Rev. 815 (1956); Stanley S. Surrey, The United States Taxation of Foreign Income, 1 J. Law & Econ. 72 (1958).

²⁸ See, e.g., Daniel Shaviro, Comments for Panel on International Corporate Taxation: Are We Headed in the Right Direction? 4 (last visited Apr. 4, 2011), http://www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website__faculty__faculty_profiles__dshaviro/documents/documents/ecm_pro_067387.pdf.

²⁹ See Mihir A. Desai & James R. Hines Jr., Evaluating International Tax Reform, 56 Nat’l Tax J. 487, 488 (2003).

³⁰ See Daniel N. Shaviro, Rethinking Foreign Tax Creditability, 63 Nat’l Tax J. 709, 710 (2010).

interests rather than those of everyone in the world. Moreover, commentators on international tax policy who purport to favor advancing global welfare appear actually to have something more limited in mind: the use of cooperative or reciprocal rather than unilateral strategies to promote national welfare. Global welfare analysis is relevant to how one can improve national welfare by cooperating with other countries, but the two approaches are not identical given the need, in the latter setting, critically to analyze the full range of possible strategic interactions.³¹

Second, exclusive reliance on welfare norms would involve ignoring distributional objectives in tax policy. If efficiency (whether national or global) were all that mattered, one could simply impose lump sum taxes, such as uniform head taxes, that do not depend on taxpayer behavior or outcomes and thus do not affect marginal incentives. To be sure, the pursuit of distributional objectives in international tax policy is complicated by the fact that corporations, rather than individuals, are the main taxpayers to which tax rules for cross-border business activity actually apply in practice. Distribution policy cannot sensibly relate to corporations as such, given that they are merely abstract legal entities rather than sentient beings. But the importance of distribution to tax policy means that one must keep in mind the relationship between the corporate and shareholder levels, notwithstanding that shareholders generally are not directly taxed until they realize gain or loss (such as by transferring their shares or receiving corporate distributions).

As discussed later,³² the traditional analysis of efficiency, no less than that of distribution, has been thrown off by a frequent failure to appreciate the full significance of mainly taxing income from international business activity at the entity level, rather than directly to the owners. Until the rise of CON, with its focus on corporations' potential productivity differences with respect to the same asset, corporations verged on being missing actors in the theoretical literature on international tax policy, in the sense that the analysis seemingly could and would have been exactly the same if individuals were being taxed directly. This has begun to change for the better with the rise of CON, but there is still further to go in understanding the significance of the relationship between the entity and shareholder levels.

To show how this matters, I begin the next Section by examining what the case for worldwide residence-based taxation would look like if individuals were directly taxed on their investments through corporations in cross-border business activity, and corporations were not

³¹ Id. at 711-13.

³² See Section III.C.

themselves taxpayers. That is, keeping in mind the actual state of the world in which corporations are the main economic actors in this realm, what would the analysis look like if flow-through or generally partnership-style taxation was both feasible and prevalent? The following Section then discusses what happens when we modify the picture to reflect the reality of mainly entity-based business income taxation.

B. Evaluating Worldwide Residence-Based Taxation of Individuals

1. The Hypothetical Approach

As noted above, to clarify the significance of mainly entity-level business income taxation, it is useful to start by asking how the analysis would look if individuals shareholders were taxed directly on corporate income, under a well-functioning partnership-style flow-through model, in lieu of both the entity and shareholder levels of the existing corporate income tax. Foreign tax credits would flow through as well. Under this hypothetical approach, suppose that GE and Siemens have both (1) a mix of U.S. and German shareholders, and (2) a mix of U.S., German, and Caymans taxable income—the last of which is taxed only very lightly (if at all) at source, and is likely an artifact of imperfect tax rules for determining the source of income (rather than reflecting significant production activity in the Caymans). Since corporations are assumed not to be themselves taxpayers here, it makes no difference whether a given tax dollar, assigned to a U.S. or German individual under the flow-through rules, was earned by GE or by Siemens. Instead, all we have are U.S. and German shareholders who are regarded by all relevant tax systems as having earned income in the United States, in Germany, and in the Caymans.

In this scenario, taking source-based taxation by Germany (but not the Caymans) as given, in what situations would the United States have reason to want to impose income taxes on a residence as well as a source basis? (I assume that source-based taxes are imposed on foreigners, whether or not this is wise national policy.) This question is best addressed by distinguishing between distributional and efficiency issues.

2. Distributional Issues if Individuals Were Taxed Directly

In analyzing the distributional motive for U.S. worldwide residence-based taxation, the key starting point is that the United States generally imposes income taxation on resident individuals. Income taxes have the unfortunate feature, from an efficiency standpoint, of dis-

couraging work and saving. They are nonetheless widely used for distributional reasons, on the view that income provides a suitable metric for distinguishing between better-off and worse-off individuals, so that the former can be assigned a greater share of the overall tax burden.³³ Accurate measurement of income therefore serves the purpose of properly allocating tax burdens between individuals in light of their relative well-being as indicated by the chosen metric.

As it happens, income is only one of two main measures used to accomplish this distributional aim. The other is consumption, which many countries (but not the United States) use alongside income taxation at the national level via value-added taxes (VATs), but which, in the United States, is only used by state and local governments via retail sales taxes (RSTs). Proponents of fundamental tax reform in the United States often urge replacing the income tax with a consumption tax that (like most existing income taxes but unlike VATs and RSTs) would be collected through periodic individual tax returns that permitted the application of graduated marginal rates based on one's broader circumstances (such as family structure and one's overall consumption for the year).³⁴ The prospect that this will happen appears remote, however.³⁵

The fact that income taxation, rather than any such alternative, continues to play a major role in national distribution policy is crucial to the case for worldwide residence-based taxation of individuals. The foreign source income issue closely resembles that which would arise if, in the purely domestic setting, corporate income were taxed neither at the entity level nor at the shareholder level. Such a gap in the tax base—causing taxable income to be computed without regard to amounts earned through corporations—would leave the remaining income tax system's measure of relative well-being fundamentally askew. For example, if all income could be redirected to arise for tax purposes through corporations, the income tax might become effectively a dead letter. If people with particular distinctive tastes and abilities were less able than others thus to redirect their income to

³³ The rationale for income taxation is often called "ability to pay." As I have discussed elsewhere, in my view the focus might better be placed on the disutility of paying, which one might assume to be lower, all else equal, for high-income than low-income individuals. A broader view still would see income as a proxy for earning ability, and the income tax as insurance against ability risk along with the risks associated with possessing under-diversified human capital. See, e.g., Daniel Shaviro, *Endowment and Inequality*, in *Tax Justice: The Ongoing Debate* 123, 125-32 (Joseph J. Thorndike & Dennis J. Ventry eds., 2002).

³⁴ See, e.g., Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 *Tax Notes* 91, 96-97 (Apr. 5, 2004).

³⁵ See Daniel Shaviro, *Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product?*, in *Fundamental Tax Reform: Issues, Choices, and Implications* 75, 77-86 (John W. Diamond & George R. Zodrow eds., 2008).

corporations, those individuals would be relatively overtaxed. If some industries or professions were less able than others to use the corporate form, they would be relatively overtaxed, creating inefficiency wholly apart from merely discouraging work and saving in general. Thus, the enterprise of taxing income strongly encourages ensuring that the tax extends to corporate income, whether at the entity level as in actual practice, or via flow-through taxation of shareholders as I assume in this Section.³⁶ No such problem would arise under a consumption tax, however, given that taxpayers would be able to exclude savings even if not in corporate solution.³⁷

A similar analysis applies to foreign source income. Given the taxation of income earned at home, permitting the exclusion of that which had been earned abroad would compromise using the income measure to assess residents' relative well-being for purposes of allocating tax burdens between them. Indeed, the only significant difference between the issues raised by excluding corporate income, on the one hand, and foreign source income, on the other, is that in the latter setting one must consider whether it matters that the source country may be levying a tax.

In this regard, consider the example above where U.S. and German individuals enjoy earnings that may arise in the United States, in Germany, or in the Cayman Islands. U.S. individuals' Caymans income is enjoyed tax-free unless the United States steps in by imposing worldwide taxation. For German income, however, one has to consider the significance of its being subject to a German source-based tax that is broadly similar to that which the United States would levy on a worldwide basis.

The common view is that German source-based taxation is an acceptable substitute for U.S. worldwide taxation.³⁸ Given, however, the important difference from a unilateral U.S. national welfare standpoint between money paid to ourselves (via the U.S. Treasury) and money paid to someone else (such as people in Germany),³⁹ this is

³⁶ Eliminating the entity-level corporate income tax while taxing shareholders (as under current law) on the occurrence of realization events, such as receiving a dividend or selling the stock, would still fall short of the mark, as it effectively turn corporate investments into unlimited tax-free savings accounts without (as under some consumption tax models) making such savings accounts generally available.

³⁷ This assumes the use of a "consumed income tax" that applies to individuals in much the same way as a conventional income tax, but with an unlimited deduction for savings (and inclusion of borrowing). See Shaviro, note 34, at 96. Other consumption tax models, such as the X-Tax, treat corporations as taxpayers, but without fundamentally changing the economics. See *id.* at 93-95.

³⁸ See, e.g., Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, What's Source Got To Do With It? Source Rules and U.S. International Taxation, David R. Tillinghast Lecture (Nov. 13, 2001), in 56 Tax L. Rev. 81, 146-47.

³⁹ See Shaviro, note 31, at 711.

clearly wrong absent a couple of crucial intermediate steps in the reasoning. And while taking those steps may be justified, causing the common view to be correct after all, it is important to keep in mind just what they are, in order to clarify one's thinking.

Suppose the United States, while exclusively concerned with promoting its own national welfare, had unilaterally decided not to tax foreigners on their U.S. source income. Then the notion that paying German income taxes is even relevant to the determination of how U.S. income tax burdens should be divided between Americans would be farfetched. Paying German income taxes does nothing to lessen the remaining tax burden that other Americans must bear. German income taxes, no less than salaries paid to German workers or fuel costs paid to German energy suppliers, are simply a cost of doing business from the U.S. national standpoint. The reason why we regard domestic taxes socially as a transfer rather than a cost—which is that the money goes to other Americans via the U.S. Treasury—simply does not apply to taxes that are paid to a foreign government.⁴⁰ The fact that Germany, unlike the Cayman Islands, is charging U.S. investors income tax at U.S.-like rates would therefore simply be irrelevant to the analysis of rational U.S. motivations (within a national welfare framework) for taxing foreign source income, unless there were more to the story.

What more there is relates back to the assumption that the United States is imposing source-based taxation of U.S. income earned by German residents. Perhaps, as Mihir Desai and Dhammika Dharmapala have posited with respect to investors' portfolio income,⁴¹ it turns out that every dollar invested by an American abroad is replaced by an inflowing foreign dollar—say, from a German as these are the only other investors in my simplified illustration. Then the United States ends up with the same overall tax revenues, and the outbound U.S. investor ends up with the same after-all-taxes income, as if she had invested an extra dollar in the United States and the German investor therefore had not.

Alternatively, suppose we are less confident about the offsetting capital flows but view the United States and Germany as potentially or actually cooperating in coordinating their income tax systems. Surely there would be no problem if both reciprocally agreed to waive their source-based taxes on the others' residents, while each applied worldwide taxation to their own. (Even if omitting to tax Germans on

⁴⁰ Id.

⁴¹ See Mihir A. Desai & Dhammika Dharmapala, *Investor Taxation in Open Economies* (Aug. 2009) (unpublished manuscript), available at <http://areas.kenan-flagler.unc.edu/Accounting/TaxCenter/taxsym2010/Documents/Dharmapala-Desai.pdf>.

their U.S. source income is contrary to unilateral U.S. national self-interest, the detriment is presumably offset by the benefit of Germany's agreeing to waive its source-based tax on income earned there by Americans.) Coordinating in the opposite way, by each waiving its tax on its residents' foreign source income while levying a source-based tax on foreigners, comes out exactly the same in aggregate if the income amounts and applicable tax rates are identical. Once again, therefore, even though paying German income taxes rather than other expenses is (considered in isolation) simply irrelevant to the determination of how U.S. tax burdens should be allocated based on income, the distributional motivation for worldwide taxation may disappear, with respect to income earned in comparably high-tax countries, where interactions with U.S. source-based taxation of foreigners permit us, in effect, to achieve the desired end result by proxy without actually imposing the worldwide tax.

In sum, distributional considerations strongly favor taxing resident individuals on their worldwide income. But this is conditioned on having an income tax that one wants to keep reasonably comprehensive and effective. And the worldwide tax can be waived with respect to foreign source income earned in comparably high-tax countries if reciprocal source-based taxation of inbound investment (mutually given priority over worldwide taxation) can sufficiently achieve desired distributional aims.

3. Efficiency Issues if Individuals Were Taxed Directly

From an efficiency standpoint, the case for worldwide taxation of individuals long appeared to be, if anything, even stronger than the distributional case.⁴² In deciding how to tax outbound investment, a key problem is that, as noted above, domestic taxes paid, though simply a cost like any other from the taxpayer's perspective, are socially a transfer, since someone else gets the money. Thus, when one's taxpayers are deciding where to invest, one might want them to evaluate the alternatives based on expected pre-domestic-tax returns. Given, however, that home country investments do in fact face these taxes, the only way to avoid tax-induced bias in favor of outbound investment is to charge one's taxpayers the same tax (or rate of tax) no matter where they invest.

Seemingly—though not actually—this establishes an airtight efficiency case for worldwide taxation of domestic residents. At least at

⁴² Again, the literature did not explicitly focus on worldwide taxation of individuals, as opposed to that of business entities, but rather did this implicitly by ignoring the question of how entity-level taxation might change the analysis from that which would be appropriate if individuals were being taxed directly.

first glance, it would appear clearly to follow that, if the home country is acting unilaterally, not only should foreign source income be taxed, but foreign taxes should merely be deductible—an approach that was taken by Peggy Richman Musgrave in her path-breaking early-1960's work, and subsequently dubbed “national neutrality” or NN.⁴³ To be sure, as in the distributional analysis, this may change where countries that are levying source taxes can choose to coordinate their systems. Thus, consider two countries with sufficiently similar tax systems and offsetting investment flows (such as the United States and Germany, but not the Caymans, in the earlier example). Reciprocal U.S.-German foreign tax creditability may leave both countries better off than if each followed NN, since they avoid collectively tax-discouraging cross-border investment. Moreover, with sufficiently similar tax systems and matching investment flows, it little matters whether the United States and Germany coordinate via foreign tax creditability, or instead via exemption.

Still, absent such coordination, the implication in favor of worldwide taxation (and NN) seems unavoidable, given the unmistakable correctness of the underlying claim that domestic taxes are privately a cost yet socially a transfer. Accordingly, at least to the uninitiated, it may come as a surprise to learn that, in recent years, the NN claim has largely been refuted in the international tax policy literature—albeit in the specific context (which I ignore in this Section) of entity-level corporate taxation. What is more, the refutation might continue to hold (although this is uncertain) even if individuals were taxed directly on the business income that they earn through corporations. To explain why, it is worth taking a step back.

An initial point is that, from an efficiency standpoint, incentives do not matter for their own sake—consequences do. The incentive under a source-based but not worldwide tax to invest abroad, rather than in the United States, potentially matters because it can lead to a reduction in U.S. investment that reflects U.S. investors' misvaluing (from a social standpoint) the domestic tax revenues as worth zero. But if giving U.S. investors this incentive ended up having no effect on U.S. investment levels and tax revenues, no harm would have been done.

To show why this is possible, suppose hypothetically that the United States could and did make everyone in the world—not just U.S. residents—pay a worldwide tax to the U.S. government based on the U.S. rate. That is, suppose the United States required foreign investors, who at present face U.S. tax solely when they invest here, to pay it no matter *where* they invested. Such a system, of course, would be

⁴³ Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* 134 (1969).

utterly untenable as a matter of international law, comity, and actual U.S. power. Leaving all that aside, however (and assuming overall global investment is fixed), it surely would result in higher aggregate U.S. investment and tax revenues than the alternative scenario where everyone (whether a U.S. resident or not) could avoid the U.S. tax by investing elsewhere. In effect, the United States would have entirely eliminated global tax competition, so far as its own source-based income tax was concerned, by making the tax invariant to location.

With this being unfeasible, however, imposing a worldwide tax just on resident investors results in tax neutrality (as defined from the U.S.-centric NN standpoint) only for a subset of the relevant actors. This, in turn, means that U.S. and foreign taxpayers will differ in their relative valuations of U.S. as opposed to foreign assets, even assuming identical expected pretax returns. A possible consequence is that imposing the worldwide tax on residents merely leads to asset swaps between them and foreign investors relative to the case of pure territoriality. In other words, imposing worldwide taxation on U.S. investors might end up merely having clientele effects, and thus altering who owned which assets, but not where any asset was located.

If the worldwide tax only has clientele effects, it has at best no efficiency benefits from a U.S. standpoint. In other respects, moreover, the clientele effects might be affirmatively undesirable. Suppose, for example, that U.S. individuals' reduced foreign asset holdings, by reason of their facing a U.S. tax on the income from such assets that other investors could avoid, meant that they ended up being less globally diversified against U.S.-specific macroeconomic risk.⁴⁴

The questions of whether (and to what extent) U.S. investment and tax revenues would decline under a worldwide tax on U.S. investors, and how the benefits to U.S. individuals of global diversification would be affected, are empirical and cannot be answered in the abstract. Obviously, however, they also cannot be answered empirically given that the underlying premise (flow-through of all corporate income to the shareholders for tax purposes) is itself a hypothetical one. Therefore, we do not know whether, if individuals were taxed directly on all corporate income, there would be efficiency reasons for the United States to impose worldwide taxation on U.S. individuals.

Absent entity-level corporate taxation, therefore, the case for the worldwide tax would mainly have to rest on distributional grounds, though with the proviso that a definitive efficiency analysis might conceivably add further support. As shown next, however, the analysis changes significantly once we add in (and evaluate the full implica-

⁴⁴ See Desai & Dharmapala, note 41, at 20-21.

tions of) the real-world fact that business income from cross-border investment is mainly taxed at the corporate entity level.

C. Applying the Analysis to Corporations

The fact that multinational business income is mainly taxed at the corporate level weakens both the distributional and the efficiency arguments for worldwide residence-based taxation. Distributionally, it undermines the worldwide tax's aim of shoring up the income tax on resident individuals—indeed, potentially making this unachievable over the long run. From an efficiency standpoint, it turns a merely speculative line of argument for worldwide taxation into something far more dubious.

1. Entity-Level Corporate Taxation and Distribution Issues

There is no direct distributional reason for imposing worldwide taxation on resident U.S. corporations. After all, corporations are not sentient beings, and cannot feel benefits or burdens. Thus, they are not directly of normative interest. Relevant distributional goals can only relate to people. Accordingly, to evaluate the significance of imposing worldwide taxation at the entity rather than the shareholder level, one must think about how it relates to taxing individuals. And given the residence-based character of individual income taxes (and national-level distribution policy generally), the key distinction one should make, for this purpose, lies between U.S. individuals and foreign individuals who are shareholders in particular companies.

a. U.S. Individuals

Suppose initially that U.S. individuals only invested in U.S. companies, and even when creating new companies insisted on U.S. incorporation. In that case, the only difference that entity-level corporate taxation would make, so far as defending the income tax story is concerned, is that it would change the specific tax returns on which U.S. individuals' foreign source income appeared.

If U.S. corporate income tax rates were significantly lower than those applying to high-income individuals, this potentially would make a large difference.⁴⁵ As I have discussed elsewhere, this may

⁴⁵ See Edward A. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 *Nw. J. L. & Soc. Pol'y* 41 (2010) (addressing the issues raised if the corporate rate is significantly below the top individual rate).

indeed happen in the near to medium-term future.⁴⁶ Top rates for U.S. individuals may be headed up at some point given long-term budgetary pressures, and there has been much talk in recent years of lowering the U.S. corporate rate in response to the pressures of international tax competition.⁴⁷ At present, however, with a top marginal rate of 35% for both individuals and corporations,⁴⁸ the fact that U.S. individuals' foreign source income, when earned through resident corporations, is taxed on corporate rather than individual returns does little by itself to undermine the feasibility of worldwide taxation.⁴⁹

Now suppose at the opposite extreme that investing through U.S. rather than foreign corporations made no non-tax difference and hence was entirely elective. In that scenario, leaving aside the transition issue with respect to existing U.S. companies, the corporate-level residence-based worldwide tax would accomplish nothing. U.S. individuals' foreign source income would be effectively excludable, through the mechanism of earning it through foreign (rather than U.S.) entities. And whether or not this seriously compromised the individual income tax as an institution—which would depend on the broader significance of this effective exclusion for foreign source income—a worldwide residence-based corporate income tax simply would not be able to do anything about it.

Accordingly, the question of interest lies in the degree of present and expected future electivity, and on what factors might make the corporate residence choice less than fully elective. These will determine both the extent to which worldwide residence-based corporate taxation can aid the individual income tax, and the nature of the associated efficiency costs of tax-discouraging home incorporation.

b. Foreign Individuals

With cross-border share ownership, imposing worldwide taxation on U.S. companies may also affect foreign individuals who would potentially own stock in U.S. companies or even choose U.S. incorporation for their global businesses. Under a national welfare framework, where only resident individuals' welfare matters, this is not actually a distribution issue but rather one of efficiency (defined as increasing

⁴⁶ Daniel N. Shaviro, Letter to the Editor, Why the BEIT Proposal Shouldn't Be Discounted, 118 Tax Notes 1048 (Mar. 3, 2008).

⁴⁷ See Shaviro, note 9, at 167-69.

⁴⁸ IRC § 1, 11.

⁴⁹ The fact that U.S. corporations generally are allowed deferral for the income of their foreign subsidiaries (a tax benefit not available to U.S. individuals who directly own overseas businesses) does more to undermine worldwide residence-based taxation of U.S. individuals, but this is a function of the existing tax base rather than of inherent underlying constraints.

the size of the pie for all domestic individuals). Nonetheless, this is a convenient point in the discussion at which to consider it.

With foreign individuals' welfare being irrelevant to the analysis, the question is simply one of attempting to impose tax burdens on them, so as to enrich Americans at their expense. If U.S. corporate residence is entirely elective and has no value to foreign investors, then conditioning adverse tax consequences on it (such as worldwide rather than purely territorial U.S. income taxation) cannot succeed in imposing burdens on foreigners. But suppose instead that, at least in some settings, foreign investors do indeed value U.S. incorporation and are willing to pay for it. In that case, U.S. national welfare would suggest charging what the market will bear.

Under existing U.S. income tax and corporate law, being a U.S. company generally means having incorporated in one of the fifty states (or the District of Columbia). States presumably already have incentives to charge market value to outside investors, although these might be defined in terms of state rather than national residence. Nonetheless, with the states being in competition with each other to attract incorporations, it is possible that the fees they impose on foreign investors are too low from a national welfare standpoint. The U.S. corporate income tax, by effectively cartelizing the states through a tax charge that applies no matter where among them one incorporates, potentially can overcome this problem and charge foreign investors more than any state would individually find feasible.

Therefore, there is a potential rationale for charging foreign investors for the value, if any, of being incorporated in the United States. Some sort of a tax that is conditioned on U.S. corporate residence—as is a worldwide U.S. corporate tax—might clearly be worth considering. There might also be good practical reasons for imposing at the entity level a tax that was aimed at foreign shareholders. Only, it is hard to see why the tax would take this particular form. Why would the optimal fee structure, reflecting what foreigners are willing to pay for U.S. corporate resident status, involve collecting a residual U.S. tax on the foreign income generated by U.S. entities' overseas activities?

2. *Entity-Level Corporate Taxation and Efficiency Issues*

As shown above, the fact that source-based U.S. income taxes are a cost from the taxpayer's standpoint, but not that of U.S. residents collectively, creates an incentive problem, from the U.S. national welfare standpoint, that could only be eliminated (taking the source-based tax as given) by imposing worldwide taxation on everyone in the world. This not being feasible, the United States inevitably faces the pressure

of tax competition. If United States individuals were taxed directly on all business income that they earned abroad (including through corporations), the incentive problem would be eliminated as to them, but the question of whether this would actually improve U.S. fortunes relative to tax competition, or instead merely lead to clientele effects with U.S. individuals owning domestic rather than foreign assets, remains unresolved.

Switching to residence-based corporate taxation and allowing for cross-border shareholding, however, the problem gets dramatically worse. For individuals, two simplifying assumptions permit me to say, with only limited potential for significant inaccuracy, that clientele effects are the only mechanism by which the worldwide residence-based tax might fail to boost U.S. domestic investment and tax revenues. The first is that U.S. residence is a relatively fixed attribute; people will not in significant numbers expatriate (or decline to immigrate) in response to our imposing a worldwide tax. The second is that each U.S. investor presumably faces a budget constraint, and thus can only fund foreign asset holdings at the expense of holding domestic assets.

Shifting to residence-based corporate taxation, portfolio effects remain a concern, but the weakening of those two assumptions means they are no longer the only plausible mechanism by which worldwide taxation could entirely fail to boost domestic investment and revenues. First, even if existing U.S. companies cannot expatriate, electivity as to corporate residence may apply with respect to new corporate equity. This is a matter not just of new incorporations outside the United States, but also of which existing companies issue new equity to fund particular investments. Second, for reasonably successful and well-established existing U.S. companies, their access to world capital markets may mean that they do not face budget constraints in the same sense as individual investors. To a considerable extent, such companies can fund all meritorious projects under normal capital market conditions.⁵⁰ This may mean, for example, that a U.S. company deciding to invest abroad need not do so at the expense of investing in the United States. Indeed, foreign investment may even be a complement, rather than a substitute, for U.S. investment, as in cases where cheaper mass production opportunities abroad make associated U.S. production more appealing. Or the two sets of investment opportunities may be unrelated, with each to be pursued or not based purely on a separate decision.

Given that all three relationships between domestic and foreign investment—substitution, unrelatedness, and complementarity—are

⁵⁰ See, e.g., Mihir A. Desai, *Taxing Multinationals: Securing Jobs or the New Protectionism?*, 55 *Tax Notes Int'l* 61, 67-69 (July 6, 2009).

theoretically plausible and that each surely holds in some cases, the question of how worldwide taxation affects domestic investment and tax revenues in the aggregate needs empirical evaluation. In general, firm-level studies range from finding outright complementarity of outbound and domestic activity to finding very small downward domestic effects on investment and/or employment.⁵¹ These mixed results are generally consistent with contemporaneous work finding that the firm-level effect should depend on the motive for investing abroad and underlying firm characteristics. Thus, for example, Walid Hejazi and Peter Pauly suggest that outbound investment motivated by seeking access to foreign markets should be expected to increase complementary domestic activity, whereas seeking cheaper productive inputs could go either way, as it implies substitution but also may open new opportunities for globally integrated production.⁵² Likewise, Ann Harrison and Margaret McMillan find complementarity among firms with vertically integrated global production networks and thus affiliates in different countries performing distinctive tasks, but substitution among firms that do the same thing in parallel in multiple places.⁵³ Helen Simpson finds a similar divide between companies in high-skill and low-skill industries.⁵⁴

While the firm-level evidence is thus mixed, several studies that look at economy-wide or industry-level data support complementar-

⁵¹ See, e.g., Claudia M. Buch, Jörn Kleinert, Alexander Lipponer & Farid Toubal, Determinants and Effects of Foreign Direct Investment: Evidence from German Firm-Level Data, 20 *Econ. Pol'y* 51, 96-98 (2005) (finding evidence suggestive of complementarity, using German data); Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Domestic Effects of the Foreign Activities of US Multinationals, 1 *Am. Econ. J.: Econ. Pol'y* 181 (2009) (finding complementarity, using U.S. data); Ann E. Harrison & Margaret S. McMillan, Outsourcing Jobs? Multinationals and US Employment (NBER, Working Paper No. 12372, 2006), available at <http://www.nber.org/papers/W12372.pdf> (finding offsetting effects but a small overall manufacturing employment decline, using U.S. data); Jörn Kleinert & Farid Toubal, The Impact of Locating Production Abroad on Activities at Home: Evidence from German Firm-Level Data (June 11, 2008) (unpublished manuscript), available at <http://ces.univ-paris1.fr/membre/toubal/papers/WA/res.pdf>. (finding no significant net effect, using German data); Helen Simpson, How Do Firms' Outward FDI Strategies Relate to Their Activity at Home? Empirical Evidence for the UK (Oxford Univ. Ctr. for Bus. Tax'n, Working Paper No. 10/09, 2010), available at http://www.sbs.ox.ac.uk/centres/tax/documents/working_papers/wp1009.pdf (finding mixed results, with high-skill industries showing more complementarity than low-skill industries, using U.K. data).

⁵² Walid Hejazi & Peter Pauly, Motivations for FDI and Domestic Capital Formation, 34 *J. Int'l Bus. Stud.* 282, 284 (2003). In this regard, firm-level complementarity arguably is more broadly supported by evidence in Buch, et al., note 51, that outbound investment by the firms studied was more motivated by seeking access to foreign markets than by seeking cheaper inputs.

⁵³ Harrison & McMillan, note 51. Although the authors find a small aggregate firm-level decline in U.S. employment from U.S. multinationals' outbound investment, one could perhaps count their work as supporting the complementarity story over the long run if one believes that rising vertical integration is the wave of the future.

⁵⁴ Simpson, note 51.

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ity.⁵⁵ Overall, Mihir Desai has reasonable grounds for arguing that “it is hard to find systematic evidence of significant negative effects of the overseas activities of firms on domestic investment or employment” and that “the emerging consensus is that the average effect is positive, although it may mask some underlying heterogeneity.”⁵⁶

There is still an alternative ground, however, on which one could make an efficiency argument for worldwide taxation of U.S. firms—at least, that is, at a rate greater than zero (as under exemption), even if not at the full rate that applies to domestic source income. Suppose that the United States has decided to raise a given amount of tax revenue from corporate and other business income taxes. In general, the deadweight loss resulting from a given tax rises in a more than linear fashion as the tax rate increases.⁵⁷ Against this background, suppose one starts with exemption (that is, with a zero rate for U.S. companies’ foreign source income), along with a positive rate for all U.S. source income. It is plausible that a revenue-neutral package that involved at least modestly raising the tax rate on U.S. companies’ foreign source income, in exchange for lowering the source-based domestic rate, would reduce overall U.S. deadweight loss.

There may also be efficiency arguments against imposing a positive rate of U.S. tax on U.S. companies’ foreign source income. For example, it may reduce the extent to which resident individuals achieve global diversification, if they are leery of stock in foreign companies but not that of resident multinationals with foreign investments. Or it may undermine corporate governance goals by discouraging domestic incorporation. Still, the efficiency case for outright exemption of U.S. companies’ foreign source income may be weakened significantly if one broadens the alternatives such that the tax rate for foreign source income does not have to be either zero or the full domestic rate.

⁵⁵ See Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Foreign Direct Investment and the Domestic Capital Stock*, 95 *Am. Econ. Rev. (Papers & Proc.)* 33 (2005) (finding time-series evidence that foreign and domestic investment are positively correlated in the United States); Isabel Faeth, *Consequences of FDI in Australia—Causal Links Between FDI, Domestic Investment, Economic Growth, and Trade* (Univ. of Melbourne Dep’t of Econ., Working Paper No. 977, 2006), available at <http://www.economics.unimelb.edu.au/downloads/wpapers-06/977.pdf> (using Australian data). Recent industry-level studies of the effect of outbound investment by resident multinationals on domestic activity include Hejazi & Pauly, note 52 (finding support for complementarity in Canadian data), and Christian Arndt, Claudia M. Buch & Monika Schnitzer, *FDI and Domestic Investment: An Industry-Level View* (Ctr. for Econ. & Policy Research, Working Paper No. DP6464, 2007), available at <http://www.cepr.org/pubs/dps/DP6464.asp> (finding similar results using German data).

⁵⁶ Desai, note 50, at 68.

⁵⁷ See, e.g., Jonathan Gruber, *Public Finance and Public Policy* 594 (3d ed. 2011) (demonstrating that deadweight loss rises with the square of the tax rate).

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D. A Practical Aside

So far, this Part has discussed why in general one might favor worldwide residence-based corporate taxation. International tax experts, however, often see a narrower practical motivation that is rooted in the broader structure of the existing U.S. rules. The worldwide tax, some argue, is needed to defend source-based corporate income taxation, by limiting U.S. multinationals' tax planning opportunities to re-label their domestic earnings as foreign source income.⁵⁸ Just to give one example, consider opportunities to use inter-group leverage. U.S. companies that otherwise might use loans from foreign subsidiaries to the domestic parent, as a device for generating interest deductions that reduce U.S. income, often have no reason to do so, given that the subpart F rules make the interest income side of the ledger currently taxable in the United States.

As things stand, worldwide taxation of U.S. companies clearly does perform a significant role in reducing these companies' ability to minimize source-based U.S. taxation. Evidence of its importance lies in the role that the aim of escaping the subpart F rules appears to have played in motivating actual and attempted expatriations before the anti-inversion rules were enacted.⁵⁹ Thus, shifting to a territorial system without changing the source rules would amount to altering the prevailing status quo with respect to U.S. source-based taxation.

Retaining the worldwide tax in order to back up the tax on U.S. source income is not a very compelling long-term strategy, however. To begin with, rising electivity of corporate residence could increasingly undermine it over time. But even if U.S. companies remain as prevalent in domestic investment as they are today, there is no good reason for, in effect, applying the source rules differently to foreign as opposed to U.S. multinationals, by relying on elements of worldwide taxation that the foreign companies do not face. A better solution, whether the United States shifts from a worldwide to a territorial system or not, is to address the source rules, as they apply to multinational companies and groups, on a residence-neutral basis. This would require looking at the entire worldwide group to which a given company that is active in the United States belongs—including corporate parents and “siblings,” rather than being limited to group members that lie directly below the companies that are directly subject to U.S. tax.

⁵⁸ Edward D. Kleinbard, *Stateless Income*, Fla. Tax Rev. (forthcoming 2011).

⁵⁹ See, e.g., Mihir A. Desai & James R. Hines Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 Nat'l Tax J. 409, 421 (2002).

E. Summing Up

Rising electivity of corporate residence potentially makes worldwide residence-based corporate taxation unfeasible. One cannot reasonably hope to accomplish much by using an instrument that taxpayers can simply elect to avoid. To assess whether rising electivity would pose serious problems, however, one must ask what purposes a worldwide residence-based corporate tax potentially serves.

One reason for possibly wanting to perpetuate the worldwide residence-based corporate tax is distributional. While it is a given (unless other rules change) that U.S. individuals can effectively avoid U.S. income taxation or its equivalent by investing in low-tax countries using foreign entities, a worldwide tax can prevent them from doing so via U.S. entities. This is potentially important insofar as they are willing to invest abroad, but not to do so through foreign entities.

A second possible argument relates to foreign shareholders in U.S. companies. If they are willing to pay to invest in such companies, one might want to charge them at the national level (to avoid interstate competition) for the privilege of doing so. While it is hard to see why the optimal fee design would involve charging a residual tax on the U.S. entities' foreign source income, conceivably that has the potential to be better than nothing, if superior fee designs are politically or administratively unavailable.

The main traditional efficiency argument for continued worldwide residence-based corporate taxation, based on the point that domestic source-based taxes are a cost to taxpayers but socially are a transfer, stands on weaker ground. The underlying claim about the incentive problem that such taxes create (from a unilateral national welfare standpoint) is clearly correct. Thus, preventing tax competition by making all taxpayers in the world—not just one's residents—pay tax at the domestic rate, even if they invested abroad, in principle would be desirable. Yet, if only one's own residents can be taxed on a worldwide basis, and if for active business investment this mainly depends on corporate residence, then the prescription may be largely ineffective even though the diagnosis is correct.

The weakness of the traditional efficiency argument for worldwide residence-based corporate taxation does not, however, establish that exemption's zero rate is optimal, even ignoring distributional considerations. Again, a positive (even if low) rate that financed a reduction in the domestic corporate rate might conceivably reduce deadweight loss. An important question, however, is whether and how rising electivity of corporate residence would affect the analysis. Unfortunately, as discussed next, such electivity is hard to assess currently, much less

project into the future. Yet the effort to assess it clearly is worth making.

IV. EVALUATING THE ELECTIVITY OF U.S. CORPORATE RESIDENCE

The tax-electivity of U.S. corporate residence depends not only on available technologies and the relevant actors' preferences, but also on how we define resident companies. Thus, shedding U.S. corporate residence became more difficult with the enactment of the anti-inversion rules. Not acquiring it to begin with could also be impeded, by defining U.S. residence more expansively, or along dimensions that matter more to the relevant actors than does the existing place-of-incorporation rule. Nonetheless, in view of the possible stickiness of current law, and the fact that we know more about the effects of today's rules than of those we might adopt in the future, in most of this Part I assume the retention of current law, and only at the end explore possible changes that might reduce corporate residence electivity.

A. *Empirical Issues in Gauging Electivity*

In gauging the electivity of U.S. corporate residence, the key issue is whether its nontax advantages to those who would choose it if they were tax-indifferent are low enough that any significant associated tax cost would lead to opting out. Unfortunately, this is hard to measure directly, especially given that it is only for companies engaged in global economic activity that U.S. incorporation is potentially tax-disadvantageous. For those operating exclusively in the United States, the fact that it has more of a worldwide regime than most countries is irrelevant, and domestic incorporation may continue to make perfect sense.

As Desai and Dharmapala have recently noted, even just for new incorporations, a "full empirical assessment [of electivity] would require worldwide data on incorporations, and an empirical strategy that credibly identifies the relevant counterfactual—i.e. incorporations that would have occurred in the United States, but occurred in other countries for tax reasons."⁶⁰ Both the data and the strategy are hard to come by. For example, even for public offerings, it is unclear what available data sources could be used to distinguish between prospective multinationals and other companies, or to identify the cases in which the organizers are U.S. individuals. Data about incorporations around the world (including in tax haven countries) including the universe of closely held companies, may also be hard, if not impos-

⁶⁰ Desai & Dharmapala, note 5, at 726.

sible, to assemble. Apparently for these reasons, to date there has been relatively little empirical work bearing on electivity, although I can personally testify that a number of international tax economists are aware of the issue's importance and would like to study it.

This does not mean, however, we know nothing. Thus, for each of the main settings where (as discussed in Part II) effective electivity may play out, I next discuss what is currently known or can reasonably be discerned. In doing so, I draw not only on existing empirical work where available, but also on my own knowledge about current tax practice, including that gained from recent discussions with leading practitioners.

B. New Start-Ups

New start-ups, in particular by U.S. individuals, are a key area in which electivity must be limited if worldwide residence-based taxation of U.S. corporations is to achieve its main purposes. In particular, if a central aim is to back up the individual income tax by ensuring that a future Bill Gates ends up being effectively taxed (at the entity level) on his worldwide rather than just his U.S. profits, it is important that his successors frequently continue to follow his lead by incorporating their main businesses in the United States. Should we expect this when global capital markets are increasingly integrated and foreign incorporation has the potential to become increasingly familiar, accepted, and cheap?

In support of the view that electivity is rising, Desai and Dharmapala examine a comprehensive data set of initial public offerings (IPOs) listed on the New York Stock Exchange and NASDAQ during the period from 1988 through 2009.⁶¹ This data set has the substantial advantage of listing firms' place of incorporation. They find that, whereas no firms were being incorporated in what they define as tax haven jurisdictions early in the period, tax haven incorporations rose to 10% of U.S. incorporations in the period 2005-2009 (and peaked at 30% in 2008).⁶² Anecdotally, moreover, Desai notes that firms increasingly are separating their legal home (that is, where they are incorporated) from their homes for managerial talent and their financial homes (that is, where they mainly raise capital).⁶³ This clearly would tend to raise the electivity of where one incorporates, by reducing its dependence on where its managers live or it raises capital.

⁶¹ Id.

⁶² Id. at 728.

⁶³ Mihir A. Desai, *The Decentering of the Global Firm*, 32 *World Econ.* 1272, 1276 (2009).

At least so far as current practice in new incorporations is concerned, however, tax practitioners with whom I have discussed electivity offer a more complicated picture. In particular, each of three main situations merits separate discussion.

The Typical Start-Up. Often start-ups are based on business ideas that are not inherently global in intended scope. When U.S. individuals are behind such a start-up, their initial plan is simply to launch a U.S. business. Global aspirations would only come into focus later, if the firm hits enough of a “home run” to suggest expanding it abroad.

In such situations, U.S. incorporation has continued to predominate, for reasons that include the following:

- Not everyone is thinking that far ahead. While such lack of foresight, if it were the only explanation, might suggest the possibility of irrational failures to optimize, this might not be unprecedented. Joseph Bankman has written about start-ups during the 1990’s Internet boom that arguably left money on the table by failing to use tax structures that could have permitted them to monetize the tax value of losses early in the business cycle.⁶⁴ One need not posit this, however, given the remaining factors that may encourage domestic incorporation.

- Start-ups often need to be highly cost-conscious in the early stages, when they may need to make large capital outlays, are not yet generating revenue, and cannot be certain that they ever will. Incorporating abroad, rather than in one’s home state or a familiar domestic locale such as Delaware, may raise costs initially—for example, by making routine managerial and governance transactions costlier to execute (such as due to the need to recruit more remote and specialized outside legal advisors).

- For an initially domestic start-up that is indeed thinking ahead, the relevant U.S. income tax analysis is not limited to the admitted desirability of avoiding future U.S. taxation of foreign profits. Incorporating a foreign parent of the domestic operating company in a tax haven gives rise to concern about potential U.S. withholding tax liability if the need to access or extract cash requires the making of upstream dividend payments. Use of a U.S. tax treaty partner to avoid the withholding tax may raise problems under the limitation of benefits (LOB) rules that such treaties typically deploy in order to impede such “treaty-shopping.”⁶⁵ LOB rules typically require more of a real

⁶⁴ Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 *UCLA L. Rev.* 1737, 1738 (1994).

⁶⁵ U.S. Model Income Tax Convention, art. 22, Nov. 15, 2006, 1 *Tax Treaties* (CCH) ¶ 209.22.

presence in the treaty partner than mere incorporation provides, and thus may make use of the treaty too costly or inconvenient.

Currently, the residence-based worldwide U.S. corporate tax is not actually all that onerous, given the opportunities firms have to exploit deferral, gain effective access to overseas profits without a taxable repatriation,⁶⁶ and use foreign tax credits to limit or eliminate the domestic tax bite when repatriations occur. The incentive to exercise foresight by incorporating abroad to pave the way for a hypothetical future expansion abroad of a new domestic business that hits a “home run” would be greater if the United States worldwide tax were more onerous. Thus, the fact that new start-ups so frequently do not incorporate abroad given the current rules (and expectations about them in the future) does not tell us how much latitude the United States might have to toughen its international tax regime without significantly affecting current practice.

Niche Start-Ups in Particular Industries. For some types of business, the practice of incorporating in the United States just because it is convenient does not apply. In a few areas—for example, defense contracting or operating an airline inside the United States—domestic corporate residence is legally or politically necessary or at least advantageous. There also are areas in which foreign incorporation has become the norm. Companies engaged in reinsurance, for example, commonly incorporate in Bermuda.⁶⁷ And funds that engage in strategic investment and trading, typically on behalf of high-net-worth individuals, frequently choose tax haven incorporation in one place or another.⁶⁸ One important motivation they have is that, under § 864(b)(2), they can run active trading desks through a U.S. office, using U.S. individuals who are deemed crucial to the expected profitability of the enterprise, without thereby generating income of a U.S. trade or business. Accordingly, their tax motivation for incorporating abroad is not limited to the prospect of further expansion.

Prospective Multinationals that Are Indeed Thinking Ahead Strategically. Finally, some start-ups involving U.S. individuals plan for an expected future as multinational businesses, and therefore base incorporation decisions on assessing the relevant tax and other considerations. During the planning process, U.S. tax lawyers, if consulted,

⁶⁶ See generally Rosanne Altshuler & Harry Grubert, Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy, 87 J. Pub. Econ. 73 (2002) (describing strategies for tax-free repatriation).

⁶⁷ On the use of Bermuda-based companies for reinsurance, see, e.g., Daniel M. Crane & Linnsey K. Workman, Bermuda Triangle: Tax Havens, Treaties, and U.S. P&C Insurance Competitiveness, 94 Tax Notes 73 (Jan. 7, 2002).

⁶⁸ See, e.g., Lee A. Sheppard, Tax Haven Apples and Oranges, 124 Tax Notes 16 (July 6, 2009) (noting that hedge funds commonly organize in tax havens, such as the Caymans).

commonly make the point that domestic incorporation is potentially disadvantageous from a tax standpoint, given in particular that it will require either paying future U.S. taxes on foreign source income, or engaging in careful and potentially cumbersome planning to avoid this result. They do not always win this argument, however, as U.S. incorporation may also be perceived as having nontax advantages, such as that it shows one's willingness to be fully subject to the U.S. corporate governance and securities law regimes, and eases trading on U.S. capital markets.⁶⁹ Apparently, these concerns are not always considered fully addressed by the fact that (as I discuss below⁷⁰) foreign firms can enable U.S. trading of their shares, and signal their willingness to face U.S. securities laws, by using U.S. depositary receipts (ADRs) or other cross-listing mechanisms.

While this suggests the United States retains (at least for now) some market power to impose worldwide taxation on start-ups of prospective multinationals that are explicitly evaluating the question of where best to incorporate, one should not exaggerate how great this power is. Again, the current U.S. worldwide regime is not all that onerous. What is more, start-ups in this category frequently engage in careful planning to make sure that valuable intellectual property is assigned to foreign affiliates before it demonstrably has significant value, thus limiting the U.S. source income that will result from profitably exploiting the intellectual property. This tax planning would not work, of course, if the United States had a sufficiently aggressive regime for currently taxing resident multinationals' foreign source income. But if the United States had such a regime, making the tax price of domestic incorporation much higher in such cases, it is plausible that the U.S. tax lawyers would start winning far more of their arguments about where best to incorporate.

C. Foreign Individuals Who Value U.S. Incorporation

The previous Section emphasized start-ups by U.S. individuals, on the view that they are the most likely either to value incorporating here or to treat it as the default option. Foreign individuals, however, also may have reason to favor U.S. incorporation, even given that they can access U.S. capital markets simply through cross-listing. One reason is that using, say, Delaware corporate law may create corporate surplus because it is perceived as high-quality,⁷¹ leading to the hope

⁶⁹ Differences between bankruptcy laws in the United States and abroad may also affect the analysis of where to incorporate.

⁷⁰ See Section IV.C.

⁷¹ Kane & Rock, note 20, at 1267-68.

among a firm's organizers that "it brands them legally, reputationally and otherwise as a real company with high standards."⁷²

According to Steinberg, however, this is not the only reason why investment bankers "see lots of [existing] non-U.S. companies that today are small but would like to become multinationals,"⁷³ and that are eager to reincorporate in the United States as an important step in that direction. Such companies also may respond to evidence suggesting that U.S. companies may tend to trade at higher price-earnings ratios than their foreign peers, notwithstanding the powerful economic forces in global capital markets that push towards convergence.⁷⁴ Steinberg attributes this asserted effect of U.S. incorporation on share value to the existence of "a variety of different investors for whom U.S. incorporation is every bit as important as U.S. listing."⁷⁵ Often, these are U.S. investors with home equity bias that may reflect legal constraints, in the case of various institutional investors, such as U.S. pension funds and certain insurance companies, the desire to avoid currency issues, and the perceived value of being able to join U.S.-only indices such as the S&P 500.⁷⁶ And even where U.S. incorporation would not boost share value, new companies' founders in countries such as Israel and India often appear to view U.S. incorporation as a prestige factor.⁷⁷

While this conceivably could support charging foreigners a fee for U.S. incorporation (whether or not by means of taxing foreign source income), Steinberg cautions against assuming too readily that it will continue. He notes, for example, that legal restrictions against holdings of foreign stock by U.S. institutional investors have been easing, and that private equity sponsors and hedge funds are exerting pressure towards global price-value convergence.⁷⁸ To similar effect, consider recent evidence that, when the Sarbanes-Oxley Act of 2002⁷⁹ raised the securities law compliance costs associated with U.S. incorporation, companies organized by foreign individuals responded by shifting what might otherwise have been U.S. IPOs to non-U.S. locales such as London.⁸⁰

⁷² Steinberg, note 21, at 79.

⁷³ *Id.*

⁷⁴ *Id.* at 80.

⁷⁵ *Id.* at 81.

⁷⁶ *Id.*

⁷⁷ *Id.* at 82.

⁷⁸ *Id.* at 81-82.

⁷⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

⁸⁰ See, e.g., Larry E. Ribstein & Erin Ann O'Hara, Corporations and the Market for Law, 2008 U. Ill. L. Rev. 661, 711 (apparently due to Sarbanes-Oxley, "while in 1999 and 2000, foreign IPOs on U.S. exchanges raised ten times the amount raised in London, in 2005 London exchanges raised over \$4 billion more than U.S. exchanges").

D. Expatriation by Existing U.S. Companies

Due to the anti-inversion rules that Congress enacted in 2004,⁸¹ along with recent Treasury modifications to the initial proposed regulations that tightened the rules' application,⁸² existing U.S. companies are now to a considerable degree stuck with their status as U.S. residents. Transactions in which at least 60% of the company's stock remains in the same hands as previously, and in which its new legal home is not a country in which it afterwards is conducting "substantial business activities," effectively are caught by the statute.⁸³ Practitioners generally report that these rules are indeed extremely difficult to circumvent.⁸⁴ Thus, while genuine merger and acquisition (M&A) activity involving U.S. companies and their foreign peers can succeed in eliminating U.S. corporate residence at the top of the formerly U.S.-led group, expatriation is no longer feasible just as a tax planning play.⁸⁵

Opting out of U.S. corporate residence is therefore costly unless one actually wants to engage in meaningful cross-border M&A. However, while this suggests that most existing U.S. multinationals are unlikely to disappear anytime soon, it does not indicate anything approaching complete nonelectivity. For example, it can lead both to cross-border M&A that otherwise would not have occurred, and to a change in which company ends up on top in the aftermath of such a transaction.

With respect to whether U.S. residence-based corporate taxation is significantly encouraging cross-border M&A that otherwise would not have occurred, anecdotal evidence is to my knowledge scant, and direct statistical tests hard to come by. Desai and Dharmapala, however, find it suggestive that, during the period from 1988 to 2009, the percentage (for all U.S. M&A deals) in which the acquirer was a foreign company located either in a tax haven or an exemption country more than doubled.⁸⁶ Moreover, looking just at transactions with a

⁸¹ IRC § 7874; American jobs Creation Act of 2004, Pub. L. No. 108-357, tit. VIII, § 801(a), 118 Stat. 1562.

⁸² Notice 2009-78, 2009-2 C.B. 452; Prop. Reg. § 1.7874-2T.

⁸³ IRC § 7874(a)(2)(B).

⁸⁴ See, e.g., Steinberg, note 21, at 79 (noting that tax practitioners consider successful inversions "difficult," whereas "we investment bankers like to say, because we're very upbeat . . . [that] it's 'very challenging'. . . [by which they mean] are you out of your mind. If we were so smart, we'd be taking every company offshore.").

⁸⁵ For evidence that expatriation is relatively common in companies with headquarters rather than incorporation rules for determining corporate residence, see Johannes Voget, *Relocation of Headquarters and International Taxation*, J. Pub. Econ. (forthcoming 2011) (finding that about 6% of multinationals moved their headquarters between countries between 1997 and 2007, and that increasing the repatriation tax or introducing controlled foreign corporations legislation tended to increase relocations out of a given country).

⁸⁶ Desai & Dharmapala, note 5, at 730-31 figs.2 & 3.

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foreign acquirer, the percentage in which that company resided in a tax haven country roughly tripled.⁸⁷

With respect to which company ends up on top in a genuine strategic merger between U.S. and foreign peers, practitioners report that “social” considerations, such as which company’s managers end up with more clout, can matter along with the tax analysis. Nonetheless, there is statistical evidence supporting the unsurprising conclusion that taxes do indeed matter. Harry Huizinga and Johannes Voget estimate that, if the United States had been an exemption country in 2004, the proportion of cross-border deals in their sample that resulted in a U.S. parent would have been 57.6%, rather than 53.1%, “correspond[ing] to an 8.6 billion dollar increase in the difference between outward and inward takeovers for the United States.”⁸⁸

The bottom line appears to be as follows. On the one hand, worldwide taxation does in some cases lead to exits that otherwise would not occur, and this problem could grow worse in the future, due either to expanding global M&A (such as by reason of declining home equity bias and transaction costs) or to any relative increase in the onerousness of the U.S. worldwide tax regime, compared to those existing in other countries. On the other hand, however, existing U.S. companies are indeed to a significant degree trapped here, and the United States surely has greater leeway to apply worldwide taxation to them than to tomorrow’s start-ups.

E. Effects on New Investment by Existing Companies

Perhaps the most important, though least visible, mechanism by which electivity could undermine achievement of the aims of worldwide residence-based corporate taxation concerns the making of new investments by existing companies. Foreign direct investment (FDI) from around the world, much of it made by existing multinational corporations, typically exceeds \$1 trillion annually.⁸⁹ FDI outflows just from the United States averaged about \$200 billion annually between 2000 and 2007.⁹⁰ If U.S. international tax rules significantly reduce the extent to which FDI (whether ultimately funded by U.S. or foreign individuals) is made through U.S. companies, then electivity is playing

⁸⁷ Id.

⁸⁸ Harry P. Huizinga & Johannes Voget, *International Taxation and the Direction and Volume of Cross-Border M&As*, 64 J. Fin. 1217, 1218-19 (2009). The high percentage of post-transaction U.S. parents even under existing law presumably reflects the greater size of the U.S. company in many cases.

⁸⁹ U.N. Conference on Trade & Dev., *World Investment Report 2010* 167, at tbl.1 (2010).

⁹⁰ See Bureau of Economic Analysis, U.S. Dep’t of Commerce, *U.S. Direct Investment Abroad*, <http://www.bea.gov/international/di1usdbal.htm> (last visited Mar. 27, 2011).

a significant role—no less than when new companies decide to incorporate abroad, and potentially on a larger canvas.

Unfortunately, this issue, to my knowledge, has not been studied empirically as yet, presumably reflecting the difficulty of the task. As in the case of measuring how worldwide tax regimes affect new incorporations, one would need both adequate data about new investment by companies from around the world, and an “empirical strategy that credibly identifies the relevant counterfactual”—that is, investments that would have been made by U.S. companies, but instead were made by foreign companies by reason of the differences in domestic tax regime.⁹¹

Anecdotal evidence on this question also may be harder to come by than it is with respect to new incorporations. U.S. tax lawyers who work for particular clients may not get to observe the determinants of whether a U.S. or foreign company ends up exploiting a given investment opportunity. They also may tend not to work on foreign investments by foreign companies, which typically would pose no U.S. tax issues. Perhaps officers at U.S. companies, when they complain about how U.S. tax burdens affect their ability to compete with foreign rivals, are relying on personal experience. But complaints about one’s taxes and one’s competitors are hardly unusual in the business world, and may be tintured with self-interest when made in the context of international tax policy debate.

Theoretically speaking, the case that worldwide taxation should affect which firms end up making particular investments is straightforward. Suppose first that two alternative companies, like GE and Siemens in the earlier example involving China’s electrical grid, are identical, except that one resides in a worldwide country while the other is in a territorial country. The company in the worldwide country will earn less at the corporate level after considering all taxes, presumably making it a less appealing vehicle for equity investors. Or one could think of it as being able to make a more favorable offer to local resource owners while being equally appealing to equity investors.

If we add in the idea that particular companies often have unique attributes, making them better or worse performers on a particular project, then the question is how the tax difference compares to that in expected pretax profitability. One would still expect, however, that companies residing in territorial countries would end up with a greater share of the overall projects than if all companies were taxed the same.

⁹¹ Desai & Dharmapala, note 5, at 726.

Is this an overly rational and ordered way of looking at global capital markets, in which chaos and unpredictability, managerial autonomy, and ignorant herd behavior by investors may often prevail? Certainly one would prefer empirical verification, especially given that worldwide regimes, like that in the United States, generally are not in fact all that onerous. The reasoning is hard to dismiss altogether, however. Moreover, one might expect taxes to matter increasingly over time in ever more integrated global capital markets with gradually declining home equity bias by investors.

A prominent recent argument to the effect that U.S. worldwide taxation, by shifting investment to foreign firms, thereby seriously undermines U.S. national welfare, proceeds as follows.⁹² U.S. companies, mainly owned by U.S. individuals, are intensively competing in global markets with foreign firms, each seeking rents, or extra-normal returns. U.S. worldwide taxation threatens to cause resident firms, and therefore resident individuals, to lose out to the foreigners in pursuing these rents. It therefore threatens to make U.S. residents significantly poorer over time than if our tax rules for resident multinationals were similar to those in other countries.

I find this analysis questionable. On the one hand, there is tension between the claims of intense competition and of rents being available. One would expect competitive pressures to drive down available returns to the normal global rate. On the other hand, if U.S. firms' distinctive characteristics would permit them to earn rents despite the presence of foreign competitors, one would think that taxing them would be feasible up to a point without discouraging them from making the investments.

Thus, I would view somewhat more circumspectly the grounds for concern about worldwide taxation shifting overseas investment from U.S. firms to foreign firms. In addition to causing global economic inefficiency (though at what cost to Americans is unclear) if the "wrong" firm makes a given investment for tax reasons, the shifting narrows the effective reach of U.S. worldwide residence-based corporate taxation. It thus reduces such taxation's capacity to advance its aims (as described in Part III) with respect to both resident and foreign individuals. Once again, this is simply the electivity problem, the actual empirical significance of which admittedly remains hard to determine.

⁹² This account is based on my recollection of Samuels, note 7.

F. Responding to Rising Electivity

Rising electivity of the worldwide residence-based U.S. corporate tax is both plausible and, to a modest degree, demonstrable. For example, the evidence of growing use of tax havens for both IPOs and cross-border M&A is at least suggestive. Yet complete electivity appears to remain far off.

Thus, rising residence electivity would not by itself, at least in the short run, make retaining current law unfeasible if one thought it otherwise well-conceived. It may, however, reasonably motivate either of two alternative directions of change. The first would be to change the U.S. residence rules so that being a U.S. company is harder and costlier to avoid. The second would be to shift to a territorial system, on the view that worldwide taxation's merits are slender to begin with, and thus do not need much undermining from rising residence electivity to be rightly viewed as a lost cause. Each merits brief discussion.

1. Option One: Enacting Tougher Corporate Residence Rules

Suppose we were to conclude that U.S. incorporation is too slender a reed on which to rest U.S. corporate resident status and consequent worldwide taxation. One then might want to consider adopting additional or alternative residence tests that would either supplement or replace the place-of-incorporation test.

Obviously, such a rule change could not address any tendency of non-U.S. companies to grow faster than U.S. companies by reason of the value to prospective investors of avoiding the worldwide tax. But if one wanted to make U.S. residence harder to avoid for particular companies, possible alternatives would include the following:

Place of Central Management and Control Test. A number of countries base corporate residence on some version of an inquiry into the location of a given company's headquarters, or its place of central management and control.⁹³ Using a headquarters test instead of a place-of-incorporation test would reduce electivity if U.S. managers who operate multinationals are sufficiently important to their businesses and reluctant to move (and if the test works well enough in practice at detecting "true" headquarters). And electivity could hardly help but decline if U.S. companies were defined as those that either incorporated here or have U.S. headquarters.

⁹³ See, e.g., Kane & Rock, note 20, at 1235; David R. Tillinghast, A Matter of Definition: "Foreign" and "Domestic" Taxpayers, 2 Int'l Tax & Bus. Law. 239, 261 (1984); William M. Funk, On and Over the Horizon: Emerging Issues in U.S. Taxation of Investments, 10 Hous. Bus. & Tax J. 1, 24-32 (2010).

How well a headquarters test would work is unclear, however. There presumably are talented potential managers living in countries around the world, along with plenty of nice places where U.S.-born managers can enjoyably live. Moreover, some argue that corporate headquarters have positive spillover effects on the countries where they are located.⁹⁴ This would tend to support, if anything, subsidizing domestic corporate headquarters, rather than tax-penalizing them by making them a ground for imposing worldwide taxation.

If used as an exclusive rather than a supplementary basis for establishing corporate residence, a headquarters rule might have a key disadvantage relative to the place-of-incorporation approach. Headquarters can always be changed. Moreover, countries (such as the United Kingdom⁹⁵) that rely on headquarters to establish residence evidently accept that, if one genuinely moves them abroad, one can cease to be a corporate resident—without either the overheated rhetoric about “treason” or the enactment of legislation akin to the U.S. anti-inversion rules. Corporate expatriation, for purposes of the residence rules, therefore tends to be easier in headquarters jurisdictions than in the United States. This importantly affects the political dynamics of international taxation, and may help explain the U.K. government’s practice in recent years of consulting closely with resident multinationals regarding what rules for outbound investment they would consider acceptable.⁹⁶

U.S. Listing Test. A second possibility would be to treat as U.S. resident corporations all publicly traded companies that list their stock on prominent U.S. securities markets, such as the New York Stock Exchange (NYSE), or that otherwise take sufficient steps to make their stock readily tradable in the United States.⁹⁷ This potentially could make avoiding U.S. residence relatively painful and costly to companies that want direct access to the U.S. stock market.

This approach, while worth considering if one is sufficiently eager to defend (or even expand) the reach of the U.S. worldwide tax, has sev-

⁹⁴ Gary Clyde Hufbauer & Ariel Assa, *U.S. Taxation of Foreign Income* 115-16 (2007).

⁹⁵ Funk, note 93, at 24.

⁹⁶ HM Treasury, *Corporate Tax Reform: Delivering a More Competitive System* 26-27 (2010), available at http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf.

⁹⁷ Drafters of such a rule might base it on part on § 7704(b), which defines a publicly traded partnership, taxable as a corporation, as “any partnership if—(1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).” An analogous corporate residence rule presumably would limit its scope to established securities markets and secondary markets in the United States. In addition, since corporate stock is more routinely tradable than partnership interests, conceivably the residence rule might require not just the existence of some U.S. trading but that the company took steps to facilitate it.

eral potential downsides. One is that the United States may not want to discourage giving domestic individuals ready access to the stock of companies that are incorporated abroad. Or there could be concern about disadvantaging established securities markets, such as the NYSE, by attaching adverse tax consequences to their use. The rule would also have a strong tendency to make companies that are either incorporated or managed abroad dual residents of both the United States and other countries, raising tax planning complications. This, in turn, might invite the criticism that the rule was over-aggressive, in the sense of extending U.S. corporate residence to cases where the U.S. link is not necessarily the strongest by any claimed metric. This conceivably might affect broader cooperation.

U.S. Ownership Test. A third possibility is to treat companies as U.S. residents if a sufficient percentage of their stock, say 50%, is ultimately owned by U.S. individuals. However, the bright line, either/or nature of this test is hard to reconcile with the fact that publicly traded companies' stock may frequently change hands and be owned through intermediate entities such as corporations.

Current U.S. international tax law does indeed, in certain situations, examine the ownership percentage of a given company by U.S. persons (including corporations). The subpart F rules, for example, apply with respect to controlled foreign corporations (CFCs), which are defined as those at least 50% owned by U.S. shareholders (that is, U.S. persons, but only counting those who own at least 10% of the stock).⁹⁸ These rules, however, take on the much easier task of looking inside commonly controlled corporate groups, the lower-tier members of which are not publicly traded. And while conceivably these rules could be changed to define CFCs as U.S. persons, this would amount in practice to repealing deferral (by making all of a CFC's income currently taxable in the United States). Thus, it really has more to do with how U.S. multinational groups are taxed than with determining which multinationals fall under the U.S. worldwide umbrella.

2. *Option Two: Shifting to a Territorial System*

Rising electivity clearly weakens the case for worldwide residence-based corporate taxation, even if it is by no means dispositive. Thus, the more skeptical one was to begin with about the underlying rationales for worldwide residence-based corporate taxation, the more likely one is to view rising electivity as supporting the bottom-line

⁹⁸ IRC §§ 951(b), 957(a). The recently repealed personal foreign holding company rules of §§ 551-559 made a similar inquiry.

conclusion that the United States should now move decisively towards a more territorial system.

Though this Article makes no effort definitively to settle the worldwide versus territorial debate, perhaps I should briefly note why I would favor shifting to a territorial system under appropriate circumstances (such as accompanying changes to the source rules)—perhaps even without the rising electivity problem, but all the more so in light of it. The line of argument is very much second-best, however—or perhaps seventieth-best, rather than resting on any claim that exemption represents an optimum or ideal.

Since the United States still has some market power with respect to corporate residence, the worldwide tax is not entirely ineffectual. It may both reduce income tax avoidance by U.S. individuals who prefer to invest abroad through domestic entities (including their own start-ups), and have some capacity to extract resources from foreigners who value investing in U.S. firms. Thus, assuming that we keep the income tax and rule out other means of charging foreigners, one could argue that the tax rate for foreign source income should be greater than zero—albeit, tending to be lowered by rising electivity.

Accordingly, in my view, exemption's appeal lies not in its arguably too-low zero rate for foreign source income of U.S. resident companies, but rather in its capacity to address a political dilemma that otherwise appears insoluble. As is well known, the existing U.S. international tax rules generate tax planning and compliance costs that are “disproportionately high relative to their role in the activities of the corporation,” and “extremely high relative to the revenue raised by the U.S. government on this income.”⁹⁹ Raising little revenue, while imposing large tax planning and compliance costs that create no productive payoff for society, virtually defines needless and harmful inefficiency.

As I discuss in other forthcoming work,¹⁰⁰ this bad tradeoff is inevitable under a system that employs deferral and the foreign tax credit. Each of these two sets of rules generates substantial inefficiency. Deferral induces U.S. companies to avoid repatriating their foreign subsidiaries' earnings other than by circuitous, and often transactionally costly, means. Foreign tax credits sharply reduce U.S. companies' cost-consciousness with respect to foreign tax liabilities, and create the need for a broad array of rules limiting their availability that generate further complexity and tax planning responses.

⁹⁹ Marsha Blumenthal & Joel Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, in *The Taxation of Multinational Corporations* 33, 48 (Joel Slemrod ed., 1996).

¹⁰⁰ Shaviro, note 15.

In principle, one could alter these tax base choices— that is, repeal deferral and make foreign taxes merely deductible—without increasing the aggregate U.S. tax burden on foreign source income. All this would require is sufficiently lowering the U.S. tax rate for foreign source income.¹⁰¹ Exemption is effectively such a system, with the additional detail that the outbound tax rate happens to be zero. Yet there is no logical requirement that the outbound tax rate be either zero or the full domestic rate. Likewise, there is no logical requirement that the tax base and tax rate choices be linked, with deferral and foreign tax credits being retained unless the outbound rate drops all the way to zero.

If the U.S. international tax regime used a low (but nonzero) tax rate for foreign source income, rather than deferral and foreign tax credits, to fine-tune the tax burden on foreign source income, it would not necessarily have an undesirable high ratio of tax planning and compliance costs to revenue raised. Such a system therefore would merit serious consideration. Unfortunately, however, its adoption appears to be highly unlikely in practice. And if territoriality offers the only politically feasible means of eliminating foreign tax credits and deferral, it might be worth adopting for that reason, despite its in no way representing the achievement of a first-best policy ideal.

This Article is not, however, the right setting in which to consider these issues fully. But suppose that exemption is indeed adopted— whether for my reasons or not, and whether rightly or not. This would make it important to consider the possible significance of the difference between existing corporate equity, which in the case of U.S. firms is relatively trapped, and new corporate equity, which has greater (even if incomplete) freedom to go elsewhere. I thus next consider how old, relatively trapped, equity should be treated if and when the United States (or any other country) shifts from a more worldwide to a more territorial system.

V. THE TRANSITION PROBLEM RAISED BY SHIFTING TO A TERRITORIAL SYSTEM

A. *Prospective Versus Retroactive Effects of a Switch to Territoriality*

The better rationales for shifting from a worldwide to a territorial system for taxing resident corporations concern incentives going forward. For example, one might want to avoid discouraging incorpora-

¹⁰¹ See Kimberly Clausing & Daniel Shaviro, A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?, 64 Tax L. Rev. (forthcoming 2011).

tion in the United States, and the use of U.S. companies as vehicles for foreign investment, given how electivity weakens the already tenuous case for worldwide residence-based corporate taxation.

Suppose, however, that the shift to a territorial system was promptly enacted and immediately made effective—say, with a January 1, 2012 start date. The new regime, while nominally prospective in that it would not apply to pre-enactment taxable years, potentially would also have retroactive effects, in the sense of changing the tax consequences of decisions made entirely in the past, before it was enacted. In particular, consider existing U.S. companies with operations abroad that they conduct through foreign subsidiaries. Due to deferral, these companies typically have existing foreign earnings that have not yet been taxed in the United States because the income has not yet been realized here through repatriation. Moreover, their past actions may have left them well-situated to continue earning foreign source income based on assets already in place.

For these companies to escape the future U.S. taxes implied by the laws on the books when they acted goes beyond simply changing their incentives prospectively. It also raises issues of transition policy, or how to address the retroactive effects of rule changes. Such transition issues are the subject of an extensive literature¹⁰² (to which I have contributed¹⁰³) that has not as yet, to my knowledge, received significant attention in discussions of international tax reform.

The transition issues that would be raised by shifting to exemption are not small potatoes. As I have noted elsewhere, U.S. multinationals have an estimated \$10 trillion in foreign assets, including \$1 trillion of as yet unrepatriated foreign earnings.¹⁰⁴ Despite foreign tax credits that would ease the tax bite on ultimate repatriation, “the present value of the expected U.S. tax on these earnings might well exceed \$100 billion.”¹⁰⁵

How should we think about these transition issues? Obviously, this depends on one’s choice of normative framework for addressing transition. I address here three distinct approaches—each of which, I argue, on balance supports not permitting U.S. multinationals to enjoy the transition gain from shifting to a territorial system.

¹⁰² See, e.g., Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47 (1977); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv. L. Rev. 509 (1986).

¹⁰³ See Daniel N. Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (2000).

¹⁰⁴ Daniel N. Shaviro, *Moving to a Territorial System and Reforming the Corporate Tax* (June 15, 2009), 2009 TNT 172-28, Sept. 9, 2009, available in LEXIS, Tax Analysts File.

¹⁰⁵ Shaviro, *Proposals*, note 13, at 339.

B. Alternative Frameworks for Addressing the Transition Gain

1. Aversion to Windfall Gain

An initial framework derives from the literature on corporate integration. Currently, the United States, like most other countries with corporate income taxes, has a “classical” system that can lead to double taxation of equity-financed corporate earnings. First, corporations themselves are subject to the income tax. They generally can deduct the interest expense on debt financing, effectively causing debt-financed investments to be taxed only once, but they cannot deduct any cost of capital with respect to equity financing. Accordingly, equity-financed corporate earnings, after having been taxed at the entity level, potentially are taxed a second time when gain is realized at the shareholder level, such as through the receipt of a dividend or the sale of one’s shares.¹⁰⁶

Tax policy writers have largely agreed for decades, albeit politically ineffectually, that this double tax is economically undesirable.¹⁰⁷ For example, it can inefficiently discourage the use of corporate entities, lead to a preference for debt over equity financing, and discourage corporate distributions to shareholders. A variety of different tax reform models, all generally referred to as methods of corporate integration, could be used to eliminate the double tax and at least ameliorate these inefficiencies.¹⁰⁸ For simplicity, however, suppose that the means chosen for corporate integration is making the receipt of dividends generally tax-exempt to shareholders. This would produce a scenario in the domestic income tax setting that closely resembles shifting to a territorial system with regard to resident multinationals.

If dividend exemption were made fully effective upon enactment, and thus applied to subsequent shareholder distributions of corporate earnings that arose during the era of the classical corporate income tax, shareholders at the time of enactment would reap an enormous transition benefit. Corporate earnings that previously were accessible to them only at the cost of paying a dividend tax (which owners presumably had known about when they initially incorporated or purchased corporate shares) would now newly be accessible on a tax-free basis. If corporate shares are priced in the market to reflect the ex-

¹⁰⁶ See generally Shaviro, note 9 (discussing the corporate double tax and related efficiency concerns). R

¹⁰⁷ See, e.g., Charles McLure, *Must Corporate Income Be Taxed Twice?* (1979); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 *Harv. L. Rev.* 717 (1981).

¹⁰⁸ See generally ALI, note 11 (discussing various integration proposals to alleviate current inefficiencies). R

pected shareholder-level tax whenever earnings were extracted, their price should increase, all else equal, as the prospect of enactment moves from long-shot to certainty. And this benefit from retroactively eliminating the double tax would convey none of corporate integration's benefits with regard to creating more neutral incentives, if we assume that investors generally expect the continuation of whatever is current law at the time (or regard favorable and adverse changes to the status quo as equally probable).

In the corporate integration literature, William Andrews prominently argued that this transition gain to shareholders, from unexpectedly enacting corporate integration, is not just peculiar or seemingly anomalous, but affirmatively unfair—an undue windfall gain that violates the tax policy norm of horizontal equity.¹⁰⁹ Andrews, upon devising a detailed corporate integration plan for the American Law Institute (ALI), therefore made a specific proposal (which I discuss below¹¹⁰) that was designed to eliminate the windfall gain, and confine the benefits of corporate integration to post-enactment new equity.¹¹¹

Not everyone agrees either with the norm of horizontal equity¹¹² or with the claim that the above shareholder gain should be viewed as a windfall. Suppose investors generally know throughout the pre-enactment period that the enactment of corporate integration is possible. Stock prices therefore reflect the marginal investor's probabilistic estimate. Since people's estimates differ, however, investors can effectively bet by taking positions in the stock market. Those who think enactment more likely than the market price effectively assumes go long by holding more corporate stock than they would have otherwise, while those with the opposite view reduce their holdings or even (if markets are complete) take a short position. If all this is happening, then resolution of the underlying uncertainty as corporate integration is either enacted in a given period or not provides no windfall at all. Everyone simply wins or loses after the fact on the bets that they deliberately placed if they were interested in taking a view.

This response to the windfall claim can itself be rebutted, however, even if one agrees with its description of how market actors are consciously behaving. Suppose we grant that it is not unfair for bettors who would have lost if they were wrong instead to win if they are right. Even so, it does not follow that we should force everyone who is potentially interested in holding (or shorting) stock to make an associated risky bet on future tax law unless they can separately manage

¹⁰⁹ *Id.* at 51-52.

¹¹⁰ See text accompanying notes 124-28.

¹¹¹ ALI, note 11, at 88-89, 92-93.

¹¹² See, e.g., Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 *Nat'l Tax J.* 139 (1989).

to hedge this bet while otherwise taking the positions they prefer. Committing in advance to ameliorate transition gain, such as through Andrews' proposed methodology if sufficiently workable, reduces the risk that investors must face simply by reason of plain vanilla stockholding. Those who want to bet on future corporate tax law changes still can, but investors' default position is made less risky by a transition policy that generally limits new policies' retroactive application.

If one accepts this view as applied to corporate integration, it straightforwardly applies as well to shifting from a worldwide to a territorial system. Shareholders in U.S. multinationals would enjoy transition gain from a shift to exemption that applied retroactively (albeit nominally prospectively) by permitting earnings from pre-enactment years to be repatriated tax-free.¹¹³ If the aim is to improve incentives on a going-forward basis, this serves no evident purpose, and one therefore might want to limit the new regime's application to post-enactment earnings.

2. *Retroactivity as Permitting the Imposition of a Lump Sum Capital Levy*

A second perspective on transition policy resembles the first one in viewing the relevant incentive effects, when tax policy changes, as generally being prospective only. It focuses, however, on issues of efficiency rather than distribution. It emphasizes that, so long as retroactive gains or losses do not affect taxpayers' expectations regarding future policy, they are effectively lump sum, no less than the imposition of a uniform head tax, and thus lack the adverse incentive effects that could lead to efficiency costs.

To illustrate, suppose the U.S. government engaged in a surprise one-time capital levy, involving the expropriation of 10% of everyone's wealth, accompanied by a credible promise never to do it again. Anticipated wealth taxes distort incentives by discouraging work and saving. In this case, however, by hypothesis no one would have been so discouraged in advance, because the levy was not anticipated. In addition, no one would be discouraged from working and saving afterwards, under the assumption that this was a one-time event only (and

¹¹³ U.S. multinationals often report for accounting purposes that foreign earnings have been permanently reinvested abroad, and hence will never face the residual U.S. tax. See, e.g., C. Fritz Foley, Jay C. Hartzell, Sheridan Titman & Gary Twite, *Why Do Firms Hold So Much Cash? A Tax-Based Explanation*, 86 *J. Fin. Econ.* 579 (2007) (U.S. multinationals that would face repatriation taxes respond by increasing their foreign cash holdings). Even in such cases, however, keeping the earnings abroad may be economically costly to them. See e.g., Rosanne Altshuler & Harry Grubert, *Repatriation Taxes, Repatriation Strategies, and Multinational Financial Policy*, 87 *J. Pub. Econ.* 73 (2003) (describing costly tax planning strategies that are used to avoid repatriation taxes).

that the promise never to do it again was entirely believed). Billions of dollars in tax revenues therefore would have been raised with zero economic distortion—and in some relationship to people's ability to pay—whereas, more usually, lump sum taxes must be ruled out for distributional reasons (as in the case of uniform head taxes), requiring that instruments causing inefficiency be used instead.

Obviously, even if surprise is achieved up-front, it normally would be fanciful to think that one can succeed in imposing a truly lump sum capital levy, merely by loudly promising never to do it again. The very fact that one did it once is likely to affect people's expectations regarding policy in the future. Suppose, however, that it is a byproduct of a policy change made for other reasons, and that people therefore accept its being a one-time phenomenon. Then the scenario may be worth considering after all.

The standard example in the tax policy literature is enacting a consumption tax, such as a national VAT in the United States, either as a replacement for the income tax or simply as an add-on to generate extra revenue. While a well-designed consumption tax, once in place, merely discourages work but not saving, upon enactment it may effectively serve as a one-time capital levy on existing saving. Suppose, for example, that a newly enacted 10% VAT increases all consumer prices by that percentage. Existing wealth therefore commensurately loses purchasing power, effectively resulting in a retroactive wealth levy as of the date of enactment.

Like the explicit 10% expropriation, this change does not affect pre-enactment incentives if it is not anticipated. Some have argued, moreover, that the accompanying broader policy change (that is, from having a VAT permanently in place) makes the claim that it will not be repeated far more credible than in the case of a pure expropriation. Thus, such leading economists as Alan Auerbach and Lawrence Kotlikoff have argued that the transition effect offers an important argument in favor of enacting a consumption tax.¹¹⁴

Suppose the United States already had a VAT, but that there were forward-looking reasons to repeal it. Doing so would hand existing wealth-holders a one-time transition gain, again without affecting their incentives if one assumes that they both do not see it coming and assume that it is a one-time event only. However, while VAT repeal would thus (by hypothesis) be just as efficiency-neutral as VAT enactment considered in isolation, it would have the effect of requiring that greater, rather than lesser, distortionary taxes be imposed in other respects. Thus, under Auerbach's and Kotlikoff's analysis, it is plausible

¹¹⁴ See Alan J. Auerbach, Lawrence J. Kotlikoff & Jonathan Skinner, *The Efficiency Gains from Dynamic Tax Reform*, 24 *Int'l Econ. Rev.* 81 (1983).

that one should favor the wealth levy from enacting a VAT, yet oppose the transfer to wealth-holders from repealing one.

Now consider applying this view to repeal versus enactment of a tax on resident companies' foreign source income, with the new regime to apply in either case to pre-enactment earnings that were repatriated after the effective date. Either way, by hypothesis the retroactive change would not directly affect incentives, given its being both unforeseen and accepted as a one-time change only. However, retroactive repeal of the tax on foreign earnings, while coming too late to remedy the past inefficiency of having induced taxpayers who expected its continuation to try to avoid it, would have the current disadvantage of costing the government revenue, and thus requiring that other distortionary taxes be imposed. Thus, once again the conclusion that follows is that the government should not hand resident multinationals a transition gain by permitting them to escape the presumably expected tax on their past earnings, as a byproduct of exemption's being enacted prospectively to affect future behavior.

3. *Incentive Effects of Anticipation*

A third perspective on transition policy, which I have emphasized in past work and regard as generally the most persuasive, treats incentive effects as crucial to evaluating retroactive changes, just as they are in the purely prospective setting.¹¹⁵ The rationale is as follows. First, policy changes (along with the transition rules they will employ) typically can be seen coming well in advance, at least probabilistically and even if they remain to a degree unpredictable. Overnight surprises are more the fare of textbook hypotheticals than of real world U.S. political decisions. Second, even to the extent that a given decision has purely retroactive application, it provides information about what sorts of decisions are likely in the future. In other words, the issue raised by the one-time expropriator who unconvincingly claims that he will never do it again is much more general. People's expectations regarding the tax system may regularly be updated to reflect new information of all kinds, including that derived from each new political decision. Thus, as an admitted oversimplification if one lacks specific evidence regarding a given case, one can reasonably posit that, for the sum total of accurate anticipation beforehand and revised expectations afterwards, transition policy can fruitfully be analyzed, no less than purely prospective policy, in terms of the incentive effects that it would have if preannounced before the effective date.

¹¹⁵ Shaviro, note 103, at 200.

How does this suggest analyzing the transition gain that shareholders of U.S. multinationals would enjoy if a shift to territoriality applied to the companies' pre-enactment foreign earnings? Two main effects can be distinguished. First, being a U.S. company while we still have a partly worldwide system is less costly than otherwise if the tax on foreign source income (and the tax planning costs of minimizing it) might end up disappearing. In other words, the prospect of transition gain reduces the current system's undesirable (or at least pointless) discouragement of using U.S. equity.

The second incentive effect of anticipating the transition gain is undesirable, however. Consider companies that currently have unrepatriated foreign earnings. If they bore the tax cost of bringing the money back home prior to the enactment of a territorial system, they are highly unlikely to be allowed to recoup the repatriation taxes at that point. Thus, the prospect that exemption will be enacted down the road increases the expected marginal tax cost of engaging in a taxable repatriation today. The prospective of transition gain thereby increases the incentive to keep funds abroad even if this requires companies to bear higher internal financing costs, to keep too much cash on hand abroad, or to engage in costly tax planning maneuvers.

How should one resolve this tradeoff between a good incentive effect from allowing transition gain and a bad one? In my view, though it is hard to be at all certain, the undesirable discouraging effect on repatriations appears likely to be the more significant of the two. As noted earlier, at least for new incorporations, a lot of the action continues to be driven by constraints on tax planning, such as start-ups' cost-sensitivity and the difficulty of anticipating the "home runs" that permit domestic firms to start going global. By contrast, established multinationals with significant foreign earnings are, by many accounts, meticulous tax planners and highly sensitive to the costs and benefits of internal fund-flow decisions. In other words, the tax sensitivity of U.S. corporate residence decisions, even if on the rise, may nevertheless still lag well behind that of repatriation choices, making the latter a more important margin at which to focus on the incentive effects of transition policy. This would tend to support denying transition gain with respect to past earnings, by limiting the tax benefit from shifting to a territorial system to earnings that arise after the effective date of the change.

C. Mechanisms for Addressing Transition Gain upon the Enactment of a Territorial System

1. Underlying Design Considerations

From all three of the perspectives on transition policy discussed above, the conclusion reasonably follows that exemption should not apply to U.S. multinationals' unrepatriated pre-enactment foreign earnings. This leads, however, to the question of what mechanism could be used thus to limit its applicability. Simply identifying particular repatriations as coming either from pre-enactment or post-enactment earnings is not necessarily the answer. Not only would this be hard to do accurately given the fungibility of money, but it would keep in place (as to old earnings) the undesirable distortions of current law, such as those associated with deferral.

The principles that I would suggest, in designing such a system, include the following:

- In terms of the relationship between the transition tax imposed and the tax burdens that U.S. multinationals would have faced over time with respect to pre-enactment foreign earnings if the worldwide system had remained in place, perfection is likely to be unattainable, given the unpredictability of when they would have repatriated their earnings and what benefit they would have received from foreign tax credits. Rough justice may be good enough, however. One does not have to get it exactly right, either for U.S. multinationals as a group or taxpayer by taxpayer, in order to minimize any impression of an attempted surprise capital levy.

- In evaluating what constitutes rough justice (or even exact tax burden neutrality), one should consider, not just the U.S. taxes that domestic multinationals would have paid if the current system had remained in place, but also the tax planning costs they would have incurred in minimizing its impact on them. After all, even under the current system, a dollar-for-dollar conversion of tax planning costs into added tax payments would have benefited the U.S. Treasury while leaving them no worse off.

- The rule should create as little administrative, compliance, and tax planning complexity as possible given other aims.

- The creation of undesirable incentives should be minimized. Here, however, there are multiple considerations. The aim of reducing the incentive either to slow or to rush repatriations, as enactment becomes more likely and the effective date approaches, might call for trying to approximate tax burden neutrality on a taxpayer-by-taxpayer basis. This might suggest charging lower rates of transition tax to multinationals that were in a position to make greater use either of defer-

ral or of foreign tax credits. However, both deferral and foreign tax credits themselves create bad incentives—in the former case, to waste resources in avoiding taxable repatriations, and in the latter case to be insufficiently cost-conscious, from a U.S. national welfare perspective, with respect to foreign tax liabilities.¹¹⁶ Addressing those bad incentives (including as the transition tax was increasingly anticipated) would suggest seeking rough justice overall, rather than taxpayer by taxpayer.

2. *A Modest Proposal, and Some Alternatives*

In light of these competing, and admittedly at times conflicting, considerations, I propose a very simple transition tax to impose when and if the United States shifts to a territorial system for taxing U.S. multinationals. First, each U.S. company with foreign business activities that would be exempted under the new rule reports the amount of its controlled foreign subsidiaries' accumulated earnings and profits (E&P), under U.S. rules, through the effective date. (U.S. taxpayers generally must keep track of this information in any event, so that they can determine whether distributions from the subsidiaries are dividends for U.S. tax purposes.) Second, they would multiply this amount by a uniform percentage, and pay that amount as a one-time transition tax. The percentage would be lower than the U.S. statutory rate for corporations (currently 35%),¹¹⁷ as part of a rough tradeoff for not allowing foreign tax credits (which are merely deductible in computing foreign E&P).

Thus, suppose a given U.S. company's foreign subsidiaries had \$500 million of E&P, and that the uniform percentage Congress chose to apply in levying the transition tax was 20%. The company would owe a transition tax of \$100 million, and exemption would otherwise apply to it in full. Congress could consider permitting companies to defer paying this tax, at a suitable market interest rate, to ease any resulting cash flow crunch.

How should the transition tax rate be determined? If one is aiming for rough justice relative to expected present value tax burdens under the worldwide system, 35%, the generally applicable U.S. corporate tax rate, is too high given expected benefits from deferral and foreign tax credits. In recent work using Treasury data, Harry Grubert and Rosanne Altshuler found that a 28% rate for foreign source income would be burden-neutral for U.S. companies in the aggregate, com-

¹¹⁶ See Shaviro, note 30, at 710.

¹¹⁷ IRC § 11.

pared to current law, if paired just with the repeal of deferral.¹¹⁸ Kimberly Clausing and I have examined what tax rate for foreign source income would be burden-neutral compared to current law (ignoring tax planning costs) if paired just with making foreign taxes merely deductible, rather than creditable.¹¹⁹ The answer depends on the assumed foreign tax. Illustratively, however, if the average foreign tax rate is 20%, the burden-neutral deductibility rate is 18.8%.¹²⁰

Given these estimates, each of which considers replacing only one of the two main tax benefits for foreign source income, a 20% transition tax rate would appear to be in the ballpark. If we assume such a rate for illustrative purposes, and apply it to an tax base of \$1 trillion in unrepatriated earnings of U.S. companies' foreign subsidiaries,¹²¹ the transition tax could result in a one-time levy in the amount of \$200 billion. Coincidentally, this happens to match the revenue that the Obama Administration sought to raise through its original 2009 international tax reform proposals, although that was a back-loaded ten-year revenue estimate, and thus having a lower present value except that it would continue to apply past the ten-year window.¹²² That proposal was widely criticized for reducing incentives for outbound investment by U.S. companies.¹²³ The transition tax, by contrast, would have no such effect, as it would accompany the adoption of a territorial system for such investment.

U.S. companies can be expected to dislike this proposal, and would surely denounce it as a confiscatory levy if it were being seriously considered. In fact, however, if the transition tax rate is set properly, it merely makes them pay upfront the present value of the taxes and tax planning costs that they otherwise would have borne in any event by reason of past decisions. And if the tax caused problems due to its effect on liquidity needs and cash flow, allowing deferral of the tax payments ought not to be a problem, so long as this is done at a market interest rate.

Suppose, however, that we concluded that the transition tax was not politically feasible. Then it would be necessary to consider alternatives, keeping in mind that, as their ongoing incentive effects increase

¹¹⁸ 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, 330 (John W. Diamond & George R. Zodrow eds., 2008).

¹¹⁹ Clausing & Shaviro, note 101.

¹²⁰ *Id.* at 7 tbl.1.

¹²¹ See Shaviro, *Proposals*, note 13, at 339.

¹²² Treasury Dep't, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* 28-57, 128 (2009).

¹²³ See, e.g., Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady & John D. Bates, *Recent International Tax Proposals Raise Technical Issues* (July 8, 2009), 2009 TNT 146-48, Aug. 3, 2009, available in LEXIS, Tax Analysts File.

or they become more complicated to administer, at some point the idea may cease to be worth pursuing.

An initial possibility might be modeled on Andrews' ALI proposal to eliminate the windfall transition gain from adopting corporate integration. Andrews proposed giving corporations a dividends-paid deduction, thus eliminating the double tax (as with debt and interest payments).¹²⁴ In light of the transition problem, however, he proposed allowing the deduction only for amounts up to what constituted a normal return on new equity, or that which had been contributed after the proposal's effective date.¹²⁵

Critics questioned the proposal's workability, pointing, for example, to the need for complicated mechanisms to impede maneuvers that otherwise could be used to "freshen up" old equity for purposes of the dividends-paid deduction, such as through stock repurchases followed by reissuance.¹²⁶ Moreover, the proposal could potentially cause post-enactment inefficiency, such as by influencing corporate distribution decisions that would not give rise to an entity-level deduction. Nonetheless, an international tax variant of the proposal would be worth considering if the one-time transition tax were ruled out as politically unfeasible.

A considerably less ambitious variant would involve retaining a positive (though perhaps reduced) tax rate for actual and deemed dividends to U.S. parents from controlled foreign subsidiaries, until an amount equal to pre-enactment foreign earnings and profits had been paid out, whereupon exemption would take full effect. This would perpetuate existing distortions in the U.S.-international tax rules, at least to a degree, but at least would reduce the transition windfall, and could potentially raise non-trivial revenue. In 2004, when Congress temporarily lowered the tax rate on foreign dividends to 5%,¹²⁷ this generated taxable repatriations of almost \$300 billion,¹²⁸ though in that case the temporary nature of the rate reduction surely played an important role.

¹²⁴ ALI, note 11, at 88-89.

¹²⁵ *Id.* at 88-89, 92-93.

¹²⁶ See, e.g., George R. Zodrow, On the "Traditional" and "New" Views of Dividend Taxation, 44 *Nat'l Tax J.* 497, 498 (1991); Shaviro, note 8, at 63.

¹²⁷ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 271, 118 Stat. 1418 (adding § 965).

¹²⁸ See Dhammika Dharmapala, C. Fritz Foley & Kristin J. Forbes, Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act, 66 *J. Fin.* (forthcoming June 2011).

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VI. CONCLUSION

In an increasingly integrated global economy, with rising cross-border stock listing and share ownership, it is plausible that U.S. corporate residence for income tax purposes, with its reliance on one's place of incorporation, will become increasingly elective for taxpayers at low cost. This trend is potentially fatal over time to worldwide residence-based corporate taxation, which will be wholly ineffective if its intended targets can simply opt out. Rising electivity is not nearly as great a problem, however, for existing U.S. corporate equity, which to a considerable degree is trapped, as it is for new equity (whether in new or existing corporations).

In the course of this project, I have gotten the sense that rising electivity is not quite as far along as I had thought at the start that it might be. However, if the case for worldwide residence-based corporate taxation is weak to begin with, then even modestly rising electivity may help tip the balance against it. Thus, evaluating where that case would stand in the absence of rising electivity plays an important role in the analysis.

The efficiency case for worldwide residence-based corporate taxation is increasingly discredited. There is, however, a distributional case, based on the point that such taxation helps defend the income tax as applied to resident individuals if, to a sufficient degree, they are willing to invest abroad but only through U.S. entities. In addition, if foreign individuals sufficiently value U.S. incorporation to be willing to pay for a fee for it (beyond that which individual states are willing to charge when they are competing with each other), it may make sense to charge them some sort of fee for using a U.S. entity, though why this should take the form of a residual tax on such entities' foreign source income is unclear. While opinions may differ, in my view these grounds are sufficiently tenuous that not much (if any) rising electivity would be needed to tip the balance against applying worldwide taxation to new corporate equity.

For existing equity, however, there are powerful transition arguments against providing a "windfall" gain by applying exemption to it even though it was contributed when the worldwide system was in place. The simplest method of avoiding the windfall, without either creating the realistic impression of an ex post capital levy or distorting post-enactment incentives, would be to levy a one-time transition tax on U.S. multinationals. The tax base for this one-time levy would consist of their foreign subsidiaries' accumulated E&P. The tax rate would aim at overall burden neutrality, relative to current law, given that neither deferral nor foreign tax credits would be allowed in computing the transition tax. It appears to be conceivable that such a tax

could raise on the order of \$200 billion, given the vast amount of U.S. companies' unrepatriated foreign earnings and existing estimates of burden-neutral rates if just deferral or just foreign tax credits were repealed on a going-forward basis. This is hardly a trivial amount, and ought not to be given away just because the prospective arguments for shifting to exemption are thought to be compelling.