THE YALE LAW JOURNAL FORUM

OCTOBER 25, 2018

Critiquing (and Repairing) the New International Tax Regime

Rebecca M. Kysar

ABSTRACT. In this Essay, I address three serious problems created—or left unaddressed—by the new U.S. international tax regime. First, the new international rules aimed at intangible income incentivize offshoring and do not sufficiently deter profit shifting. Second, the new patent box regime is unlikely to increase innovation, can be easily gamed, and will create difficulties for the United States at the World Trade Organization. Third, the new inbound regime has too generous of thresholds and can be readily circumvented. There are ways, however, to improve upon many of these shortcomings through modest and achievable legislative changes, eventually paving the way for more ambitious reform. These recommendations, which I explore in detail below, include moving to a per-country minimum tax, eliminating the patent box, and strengthening the new inbound regime. Even if Congress were to enact these possible legislative fixes, however, it would be a grave mistake for the United States to become complacent in the international tax area. In addition to the issues mentioned above, the challenges of the modern global economy will continue to demand dramatic revisions to the tax system.

INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA)[1] significantly changed the way the United States taxes multinational corporations on their cross-border income. The legislation, however, both failed to solve old problems in the international system and opened the door to new ones. Furthermore, the legislation will deplete government resources, holding the United States back in the twentieth century rather than propelling it to be a competitive force and source of general wellbeing for its citizens in the current one.

1. Although the 2017 tax legislation did not ultimately bear this title, the works in this Collection use the Act's original, popular name for ease of reference and consistency.

One of the most disappointing aspects of the legislation is its immense cost. The TCJA's tax cuts will shrink revenues over the next decade by $1.9 trillion.[2] The actual decrease in revenue is likely to be much greater if the law's expiring provisions, or a portion of them, are made permanent.[3] Additionally, the new legislation has created numerous tax planning opportunities that will result in a loss of further revenue. The need for international tax reform was the impetus for the legislation, but it became the proverbial tail wagging the dog. In an attempt to deal with base erosion and profit shifting strategies of multinational corporations, the United States instead created a true mess of business taxation generally. The new "pass-through" deduction, which was intended to create parity with the new lower rate available on corporate income, inefficiently and arbitrarily punishes workers and certain industries and allows for significant tax planning opportunities. Individuals may also now be able to use corporations as tax shelters to avoid the top rate, thereby undermining the individual income tax system.

Given the enormous losses of revenue and the gamesmanship the legislation will generate, it is fair to ask a lot of the new international regime. Yet the international provisions too fall short, mostly due to avoidable policy choices. Judged against possible alternative policies that Congress could have enacted, the new international provisions are quite problematic. There is a possibility that the new legislation will serve as a bridge to true reform in the international tax area; however, there is also reason to worry that 2017 was a squandered opportunity for international tax policy.

In this Essay, I address three serious problems created—or left unaddressed—by the new regime. First, the new international rules aimed at intangible income incentivize offshoring and do not sufficiently deter profit shifting.[4] Second, the new patent box regime will cause problems; it is unlikely to increase

2. *The Budget and Economic Outlook: 2018 to 2028*, CONG. BUDGET OFF. 106 (Apr. 2018), https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53651-outlook.pdf [https://perma.cc/RK3N-TXCF].

3. The Congressional Budget Office (CBO) estimates that the permanent extension of all expiring tax provisions would further reduce revenues by $1.2 trillion over the next decade. *Id.* at 90. Moreover, Congress tends to contort the budget process so that temporary legislation is not subject to its usual rules and may attempt to make such tax cuts permanent without paying for them. *See, e.g.*, Consolidated Appropriations Act 2016, Pub. L. No. 114-113, § 1001, 129 Stat. 3034-35 (exempting the costs of making the tax "extenders" permanent from PAYGO); David Kamin & Rebecca Kysar, *Temporary Tax Laws and the Budget Baseline*, 157 TAX NOTES 125 (2017) (discussing this phenomenon in the context of the Bush tax cuts); Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1030-41 (2011) (critiquing the sunsets of the Bush tax cuts on the same grounds).

4. Profit shifting can be accomplished on paper by, for instance, companies not charging arm's length prices to their subsidiaries. In contrast, offshoring involves the shifting of economic activity and real assets, although it may also affect reported profits.

innovation, can be easily gamed, and will create difficulties for the United States at the World Trade Organization (WTO). Third, the new inbound regime has too generous of thresholds and can be readily circumvented. There are ways, however, to improve upon many of these shortcomings through modest and achievable legislative changes, eventually paving the way for more ambitious reform. These recommendations, which I explore in detail below, include moving to a per-country minimum tax, eliminating the patent box, and strengthening the new inbound regime.

Together, these problems underscore that we must continue to improve the tax rules governing cross-border activity. Even if Congress were to enact these possible legislative fixes, it would be a grave mistake for the United States to become complacent in the international tax area. In addition to the issues mentioned above, the challenges of the modern global economy will continue to demand dramatic revisions to the tax system. The new regime falls short of effective international tax reform. Rather than aligning taxation with U.S. economic needs and social objectives, the new regime doubles down on archaic concepts of source and residency that have become malleable and disconnected from economic reality. The regime unwisely retains the place of incorporation as the sole determinant of corporate residency and subscribes to the fiction that the production of income can be sourced to a specific locale. These determinations should be updated or replaced, and new supplemental sources of revenue should be explored seriously. A longer-term objective should be to reach consensus on how to tax businesses selling into a domestic customer base from abroad.

I. BACKGROUND

The former U.S. international tax system has been described as a worldwide system of taxation because it subjected foreign earnings to U.S. taxation, whereas a territorial system of taxation exempts such earnings altogether. In reality, active earnings of foreign subsidiaries could be deferred, even indefinitely. The disparate treatment between foreign and domestic earnings meant that the old system was somewhere between worldwide and territorial.

The new regime has been described as a territorial system because a basic feature of the regime is that a broad swath of foreign profits are effectively exempt from U.S. corporate tax, since domestic corporate shareholders can deduct the foreign-sourced portion of dividends received from foreign subsidiaries in which they own at least 10% of the stock.[5] Here again, however, labels like "territorial" fall short, since smaller corporate shareholders and individuals are still subject to taxation on their foreign income. Furthermore, the new minimum tax

5. I.R.C. § 245A (2018).

regime, along with the older subpart F rules,[6] also means that the foreign income of 10% shareholders in controlled foreign corporations, or "CFCs," is possibly subject to some U.S. taxation.[7]

The TCJA retained worldwide-type features because the legislation's drafters recognized that a move to a pure territorial system would worsen profit shifting incentives by exempting foreign source income altogether rather than just allowing it to be deferred, as under the old system. The hybrid nature of both the old and new systems represents an attempt to balance investment location concerns, on the one hand, with concerns about the protection of the revenue base, on the other.[8]

Importantly, however, the international provisions are estimated to lose money going forward instead of bringing in revenue.[9] Many of the revenues from the international provisions are front-loaded into the ten-year budget window because of the transition tax on the deemed repatriation of old earnings. This is a one-time event that will not generate revenues in the future. Moreover, the official Congressional Budget Office (CBO) estimate assumes that several

---

6. The new minimum tax, or GILTI, regime effectively establishes a minimum tax of 10.5% on certain foreign source income. *Id.* § 951A. The old subpart F regime taxed certain foreign source income of large shareholders in controlled corporations (CFCs) on a current basis. *Id.* § 951. Although no longer needed as an antideferral mechanism, it remains in place, alongside the new minimum tax regime, in order to combat the profit shifting incentives created by territoriality.

7. *See* MARK P. KEIGHTLEY & JEFFREY M. STUPAK, CONG. RESEARCH SERV., R44013, CORPORATE TAX BASE EROSION AND PROFIT SHIFTING (BEPS): AN EXAMINATION OF THE DATA 17 (2015) (discussing the futility of the worldwide and territorial labels); Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System*, 160 TAX NOTES 57 (2018) (presenting similar concerns about the problems with territorial and worldwide labeling).

8. Michael J. Graetz has described the new system as follows:

> Congress confronted daunting challenges when deciding what rules would replace our failed foreign-tax-credit-with-deferral regime. There were essentially two options: (1) strengthen the source-base taxation of U.S. business activities and allow foreign business earnings of U.S. multinationals to go un-taxed; or (2) tax the worldwide business income of U.S. multinationals on a current basis when earned with a credit for all or part of the foreign income taxes imposed on that income. Faced with the choice between these two very different regimes for taxing the foreign income of the U.S. multinationals, Congress chose both.

Michael J. Graetz, *Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J.F. 315, 328 (2018).

9. *Estimated Budget Effects of the Conference Agreement for H.R. 1, "The Tax Cuts and Jobs Act,"* JOINT COMMITTEE ON TAX'N, (2017), https://www.jct.gov/publications.html?func=startdown&id=5053 [https://perma.cc/8TGM-539T]. In total, the estimate for the new international regime has a $324.4 billion cost over the ten-year budget window period. If one ignores the one-time repatriation tax, which is estimated to bring in $338.8 billion in that time frame, then the international provisions will lose revenue going forward.

far-off tax increases will go into effect, an unlikely event. Further, the CBO estimate does not take into account the possibility that some investors may, even in light of new incentives, be reluctant to invest in the United States because of possible challenges under trade and tax treaties and the political instability of the law.[10] Finally, if the new U.S. taxing environment spurs other countries to engage in tax competition, as one would expect, this might reduce the anticipated growth effects of the legislation by decreasing the investment flowing into the United States.

As a general overview, the purposes of the TCJA's international reforms are to: (1) exempt foreign income of certain U.S. corporations from taxation in the United States (the quasi-territorial, or participation exemption, system); (2) backstop this new participation exemption system with a 10.5% "minimum tax" on certain foreign-source income (the "Global Intangible Low-Taxed Income," or "GILTI," regime); (3) provide a special low rate on export income (the "Foreign Derived Intangible Income," or "FDII," regime); and (4) target profit-stripping by foreign firms operating in the United States (the "Base Erosion Anti-Abuse Tax," or "BEAT," regime). In the remainder of this Essay, I discuss problems presented by the latter three of these new regimes.[11]

II. THE GILTI REGIME

A. *New Offshoring and Shifting Incentives*

The existence of a partial territorial system coupled with a minimum tax could be an improvement over the prior system, which often resulted in a zero rate of taxation on foreign earnings because of deferral and other tax planning maneuvers. It is also preferable to a pure territorial system because of protections it places on the revenue base. Nonetheless, although a minimum tax can work conceptually, the current GILTI incarnation problematically incentivizes firms to offshore assets and profit shift—as I, and others, pointed out early in the legislative process.[12]

---

10. *See* Rebecca M. Kysar & Linda Sugin, Opinion, *The Built-In Instability of the G.O.P.'s Tax Bill*, N.Y. TIMES (Dec. 19, 2017), https://www.nytimes.com/2017/12/19/opinion/republican-tax-bill-unstable.html [https://perma.cc/U7ZV-T4ZH].

11. I have chosen not to focus here on the participation exemption system, in and of itself, although I do discuss the policy issues that partial territoriality implicates by means of the other three regimes. I do not object to partial territoriality in principle but think that the *degree* of territoriality Congress chose can and should be adjusted by altering aspects of the other three regimes.

12. Rebecca M. Kysar, Opinion, *The G.O.P's 20th-Century Tax Plan*, N.Y. TIMES (Nov. 15, 2017), https://www.nytimes.com/2017/11/15/opinion/republican-tax-plan-economy.html [https://

First, the minimum tax regime allows a 50% deduction of GILTI. At the 21% corporate rate, this amounts to a 10.5% rate on GILTI.[13] Given the wide differential between the domestic rate and the minimum tax rate, there remains substantial motivation to shift profits.

The new tax legislation also presents more subtle incentives to locate investment and assets abroad. There is an exemption from the GILTI tax in the form of a deemed 10% return on tangible assets held by a CFC, as measured by tax basis. If U.S. firms have or locate tangible assets overseas,[14] then they can reduce their GILTI tax commensurately. This is because the more a U.S. shareholder increases tangible assets held by the CFC, the smaller the amount of income subject to the GILTI regime.[15]

Take for instance, a firm that invests $100 million in a plant abroad through a CFC that will generate $10 million of income. None of that $10 million of income will be subject to U.S. tax because the firm gets to reduce its GILTI by the deemed 10% return on the CFC's assets.[16] In effect, the $10 million of income is reduced by 10% of $100 million, or $10 million, so that it is all tax-free. To compare, consider the tax consequences of the same firm investing in a $100 million

perma.cc/K4HS-2SP5]. Others have discussed the offshoring incentives created by the legislation; *see* Gene B. Sperling, *How the Tax Plan Will Send Jobs Overseas*, ATLANTIC (Dec. 8, 2017), https://www.theatlantic.com/business/archive/2017/12/tax-jobs-overseas/547916 [https://perma.cc/7MVD-3JRT]; Steven M. Rosenthal, *Current Tax Reform Bills Could Encourage US Jobs, Factories and Profits to Shift Overseas*, TAXVOX (Nov. 28, 2017), http://www.taxpolicycenter.org/taxvox/current-tax-reform-bills-could-encourage-us-jobs-factories-and-profits-shift-overseas [https://perma.cc/JS3D-BGBF]; Kimberly Clausing, *How the GOP's Tax Plan Puts Other Countries Before America*, FORTUNE (Nov. 20, 2017), http://fortune.com/2017/11/20/gop-tax-plan-donald-trump-america-first [https://perma.cc/47ED-QFXD].

13. I.R.C. § 250(a)(1) (2018). For tax years beginning after 2025, the 50% deduction is reduced to 37.5%, and thus the effective rate on GILTI goes up to 13.125% in those years. *Id.* § 250(a)(3).

14. The CFC could in theory invest in tangible assets in the United States and have these count for the deemed return, but this investment would be subject to current U.S. tax under I.R.C. § 956.

15. Note that I am not claiming that the offshoring incentives of the new tax law are worse overall than under the prior regime, which due to the high corporate tax rate created a large disparity between investing in the United States versus abroad. This disparity has been minimized through the lowering of the corporate rate to 21%. *See* Martin A. Sullivan, *Economic Analysis: Where Will the Factories Go? A Preliminary Assessment*, 158 TAX NOTES 570 (2018). Instead, I am pointing out the unfortunate offshoring incentives created by GILTI that could have been avoided through alternative policies, which I discuss below. I am also emphasizing that, on the margins, it often still is a better bet tax-wise to locate plants offshore, rather than in the United States.

16. In addition to the GILTI exemption, the firm will get depreciation deductions on the assets under I.R.C. § 168(g).

plant in the United States that will generate $10 million of income. It would pay U.S. tax of $2,100,000 (21% of $10 million).[17]

Where there happens to be nonexempt return to tangible assets (return in excess of 10%), this is taxed by the minimum tax regime but at a lower rate than the rate on domestic income.[18] To build on the above example, assume that the $100 million foreign plant generates not $10 million, but $20 million of income. The firm will still get to exempt $10 million of the income through the deemed 10% return, but the other $10 million will be subject to the GILTI regime and given a 50% deduction (i.e., taxed at a 10.5% effective rate). This would produce U.S. tax of $1,050,000 (10.5% of $10 million), as compared to a U.S. tax burden of $4,200,000 (21% of $20 million) on a similar U.S.-based investment.[19]

Investors will, of course, take local foreign taxes into account, and higher taxes abroad will likely sway the decision of where to locate investment. The offshoring incentives of GILTI might then primarily be a problem when low-tax countries are a viable alternative. Although many tax havens have limitations regarding labor supply or lack the protections of the U.S. legal system, among other factors, some low-tax countries, like Ireland and Singapore, are hospitable options for investment.[20]

The structure of GILTI is even more problematic when considering foreign tax credits. The new legislation allows foreign taxes to be blended between low-tax and high-tax countries before offsetting GILTI from those countries (thus constituting a "global" minimum tax), rather than allowing foreign taxes to offset only the GILTI from the country in which they are paid (a "per-country" minimum tax). This structure encourages firms to locate investment in low-tax countries and combine them with income and taxes from high-tax countries, possibly to avoid GILTI liability altogether.[21]

---

17. Note that the rate on the income from the U.S. plant would be lower if such income exceeded a hurdle of a 10% return on the tangible assets and was export income, which is effectively taxed at a 13.125% rate in the new tax legislation. I.R.C. § 250. This is the FDII regime, which I discuss below. *See infra* Part III.

18. Note that the nonexempt return amount will vary depending on tangible asset intensity. We can thus expect certain industries, like services and technology, to be harmed from this aspect of the formula, whereas we can expect other sectors, like non-U.S. manufacturing, to benefit.

19. If this was export income, the U.S. tax on the U.S.-based investment would be $3,412,500 ($1,312,500 on the $10 million exceeding the exempt return, and $2,100,000 on the other $10 million). Again, I discuss the FDII regime in more detail below. *See infra* Part III.

20. Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System, Part 2*, 160 TAX NOTES 171, 182 (2018).

21. For instance, say a corporation earns $1,000,000 of income in Country A, which imposes a 21% rate of taxation. For simplicity's sake, let us ignore the deemed return by assuming there are no assets abroad. Now say the corporation is choosing where to locate an additional $2,000,000 in profits (and any associated activity), facing a choice between the United States

Note that, through this blending technique, a firm can also shield profits in tax havens by choosing to invest in high-tax countries.[22] A firm may even prefer to invest in countries with *higher* tax rates than the United States since income and taxes from such countries can be used to blend down the U.S. minimum tax

and a tax haven. There would be a $210,000 Country A tax and a tentative U.S. GILTI tax on this Country A income of $105,000 ($1,000,000 x 10.5%). But the 80% U.S. credit for the $210,000 Country A tax would reduce the U.S. tax to zero and $63,000 of excess foreign tax credits would remain unused ($105,000 - [$210,000 x .8] = -$63,000) and are lost forever under the GILTI rules. If an additional $2,000,000 were earned in the United States, the 21% U.S. tax thereon would be $420,000 and the $63,000 of excess credit for Country A tax could not be used to reduce this liability. Thus, the corporation's total tax liability (both U.S. and foreign) would be $630,000 ($210,000 Country A tax + zero post-credit U.S. tax on the first $1,000,000 of Country A income + $420,000 U.S. tax on the additional $2,000,000 of U.S. income).

Suppose instead that the corporation earned the additional $2,000,000 in a tax haven, Country B, which imposes no local taxes. Looking at this investment on a standalone basis, the total foreign taxes imposed would be $210,000 with no foreign tax credit offset. If GILTI were applied on a per country basis, this would mean the company was paying $210,000 of foreign taxes on Country A income and $210,000 of U.S. taxes on Country B income, with total taxes of $420,000. Under current law, however, the global minimum tax allows firms to blend low-income and high-income taxes together, thereby reducing their GILTI liability. Thus, in this example under the current GILTI regime, the total foreign taxes imposed would be $210,000 (imposed by Country A), 80% of which ($168,000) is creditable against the 10.5% tax on the $3,000,000 of total Country A and Country B income. This produces a $147,000 U.S. tax liability ([10.5% x $3,000,000] - 168,000]). Why is the tax bill lower as compared to the per country approach? Because the $63,000 excess credits from Country A partially offset the $210,000 U.S. tax on Country B income. This reduces the total tax liability (U.S. and foreign) to $357,000, compared to $420,000 if we had a per-country minimum tax and $630,000 if the investment were made in the United States.

22. In response to a question from Senator Johnny Isakson of the Senate Committee on Finance, Kim Clausing explained this dynamic in the following manner:

> If you earn income in Bermuda, say, where the tax rate is zero, that per country minimum tax would tax the Bermuda income right away . . . . If you have a global minimum tax you could use taxes paid in Germany to offset the Bermuda income and then you have an incentive to move income to both Bermuda and Germany.

Hearing on International Tax Reform Before the S. Comm. On Fin., 115th Cong. 1-6 (2017) (statement of Kimberly A. Clausing, Thormund A. Miller and Walter Mintz Professor of Economics, Reed College); *see also Senate Convenes International Tax Reform Hearing*, DELOITTE TAX@HAND (Oct. 6, 2017), https://www.taxathand.com/article/7596/United-States/2017/Senate-convenes-international-tax-reform-hearing [https://perma.cc/NSC6-CU9W]. Edward Kleinbard, former chief of staff for the U.S. Congress Joint Committee on Taxation, has similarly warned, "[c]ompanies will double down on tax-planning technologies to create a stream of zero-tax income that brings their average down to that minimum rate." Lynnley Browning, *One Sentence in the GOP Tax Plan Has Multibillion-Dollar Implications*, BLOOMBERG (Oct. 2, 2018, 4:00 AM), https://www.bloomberg.com/news/articles/2017-10-02/trump-plan-aims-new-foreign-tax-at-apple-other-multinationals.

to zero. If a firm has profits in tax havens, then the effective U.S. tax rate of investing in a high-tax country, say Sweden, which has a 22% statutory corporate rate, might only be 4.4% since most of those taxes can be used to blend down GILTI completely.[23] This puts the United States at a competitive disadvantage, making it more likely that jobs and investment go to countries like Sweden.

Finally, as a general matter, the structure of the minimum tax allows multinationals to blend their high profits from intangibles with their low profits from tangibles, thereby falling below the deemed 10% rate of return on tangible investments, and escaping the GILTI regime. This ability to blend high-return with low-return income will further encourage offshoring and profit shifting.[24]

In summary, the deemed rate of return and global minimum features of the GILTI regime run contrary to Congress's pronounced intention to keep investment in the United States.

B. Reform Possibilities

The CBO estimates that nearly 80% of existing profit shifting will continue under the new regime.[25] It is in the United States' interest to tolerate some degree of profit shifting. For instance, profit shifting allows multinationals to save foreign taxes, which might benefit the United States if shareholders are domestic. And multinationals are more mobile than individuals, so we may be worried about them leaving the United States if they are taxed too heavily.[26] Yet, given CBO's figures, it does not seem like Congress landed on the most desirable amount of profit shifting. This is especially the case because the recent legislation's effect on profit shifting is likely even smaller than the CBO's estimate, since the CBO does not take into account investor reactions to the instability of the FDII regime in response to potential WTO challenges,[27] investor reactions to the political instability of the legislation in general, and the potential for tax competition from other countries. Many profit-shifting opportunities exist, as demonstrated by recent reported tax rates after enactment of the TCJA.[28] The

---

23. This is because 80% of the foreign taxes paid to Sweden can be credited against the U.S. minimum tax liability on the tax haven profits, so that the firm is effectively only paying 20% of the 22% Swedish rate, or 4.4%.

24. Sperling, *supra* note 12.

25. *The Budget and Economic Outlook: 2018 to 2028*, CONG. BUDGET OFF. 124, 127 (Apr. 2018), https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf [https://perma.cc/X9GZ-XHLA].

26. Shaviro, *supra* note 7.

27. *See infra* Part III.

28. AbbVie Inc., a biopharmaceutical company, however, recently reported a tax rate of 9%, decreased from around 22% in years before the legislation. Michael Erman & Tom Bergin, *How*

balance of payments data following the legislation also supports the view that companies' current incentives to book profits abroad are similar to their incentives before the new law.[29]

There are several options, however, to remove or reduce GILTI's profit shifting and offshoring incentives. The most effective way to reduce profit shifting is to move to a per-country minimum tax rather than one applied on a global basis, thereby reducing opportunities to blend foreign tax credits.[30] Critics of a per-country approach argue that it would be too complex to administer,[31] but others disagree.[32] The primary targets of GILTI are sophisticated multinational corporations that can effectively deal with the challenge of computational complexity. Moreover, the blending technique itself requires significant resources and complex tax planning, and a global minimum tax would eliminate the need for such inefficient maneuvering. Additionally, a per-country approach is even more necessary if Congress maintains other offshoring incentives in the GILTI regime.[33]

U.S. Tax Reform Rewards Companies That Shift Profit to Tax Havens, REUTERS (June 18, 2018, 7:03 AM), https://www.reuters.com/article/us-usa-tax-abbvie/how-u-s-tax-reform-rewards-companies-that-shift-profit-to-tax-havens-idUSKBN1JE12Q [https://perma.cc/GH6U-RLAC]. "If the guardrails in the new territorial system were meant to prevent companies from avoiding all taxes, AbbVie's (tax rate) is a pretty clear signal that these guardrails may not be effective." *Id*. (quoting Matthew Gardner, Senior Fellow, Institute of Taxation and Economic Policy). AbbVie may be reducing their tax rate by allocating interest and compensation costs to the United States, among other tactics involving transfer pricing. *Id.*

29. Brad W. Setser, *Tax Reform in the Q1-2018 BoP Data*, COUNCIL ON FOREIGN REL. (June 29, 2018), https://www.cfr.org/blog/tax-reform-q1-2018-bop-data [https://perma.cc/PU5E-YHSM].

30. KEIGHTLY & STUPAK, *supra* note 7, at 17-18. The IMF has also taken the position that GILTI should be imposed on a per-country basis. Otherwise, "the link of this provision to worldwide profits and tangible capital will create complex and distortionary effects on firms' global investment decisions and may dilute its effectiveness in dis-incentivizing cross-border tax competition." *United States of America: Staff Concluding Statement of the 2018 Article IV Mission*, INT'L MONETARY FUND (June 14, 2018) [hereinafter *IMF Concluding Statement*], https://www.imf.org/en/News/Articles/2018/06/13/ms061418-2018-United-States-article-iv-consultation-concluding-statement [https://perma.cc/FBW4-X3C6].

31. *See* Kyle Pomerleau, *A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act*, TAX FOUND. (May 3, 2018), https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/ [https://perma.cc/3GT5-MV9Q].

32. *See* Stephen E. Shay et al., *Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base*, 17 FLA. TAX REV. 669, 706 (2015) (recommending that any minimum tax be determined on a per-country basis); *see also* J. Clifton Fleming et al., *Incorporating a Minimum Tax in a Territorial System*, 157 TAX NOTES 73, 80 (2017) (same).

33. Proponents of the global approach might argue that the per-country approach punishes multinationals that naturally conduct integrated production in high- and low-tax countries for non-tax reasons. I believe that the national welfare objective implicated in cross-crediting for

Moving to a per-country approach would decrease the offshoring incentives created by the legislation, at least for those countries with corporate tax rates at or above that of the United States.

Congress could also reduce the deduction for GILTI income so that the gap between the domestic corporate rate and the minimum tax rate is not so large. Decreasing the rate differential will lessen the motivation to earn income abroad. A tax burden on foreign income that is too high will cause corporations to simply locate their residence abroad, thereby escaping outbound base erosion rules. With the new lower 21% corporate rate and inbound base erosion regime, however, this is now less of a concern. Additionally, as I discuss below, the inbound rules can be strengthened.

Another way to target the offshoring incentives created by the GILTI regime could be to change the tax base, or the scope, of the regime. Congress could also eliminate the exempt return on foreign tangible assets, and instead apply the minimum tax to all foreign source (non-subpart F) income. Doing so would address one of the GILTI regime's conceptual flaws: it seeks only to reduce the incentive to offshore intangible assets while creating incentives to offshore operations.

If policymakers are wedded to the idea that a minimum tax should only target multinationals' intangible assets, Congress could rethink the deemed rate of return. The 10% rate is arbitrary, does not necessarily correlate to the market return on tangibles, and seems quite high, given that the average rate of return on low-risk or risk-free assets has been much lower, especially in recent years.[34]

non-tax purposes likely outweighs this concern. An alternative to the per-country approach, however, would be to raise the rate on GILTI.

34. Chuck Marr et al., *New Tax Law is Fundamentally Flawed and Will Require Basic Restructuring*, Ctr. on Budget & Pol'y Priorities 17 (Apr. 9, 2018), https://www.cbpp.org/sites/default/files/atoms/files/4-9-18tax.pdf [https://perma.cc/B2TY-SUJC]. In April 2018, a ten-year Treasury bond yielded about 2.8% interest. The average yield on ten-year Treasury bonds over the past twenty years is approximately 3.69%. Over thirty years, the average is approximately 4.87%, and over ten years it is approximately 2.57%. I constructed these averages from data on the Fred Economic Data website. *See 10-Year Treasury Constant Maturity Rate*, Fed. Res. Bank St. Louis (Aug. 20, 2018), https://fred.stlouisfed.org/series/WGS10YR [https://perma.cc/Z49T-NW4F]. Some might argue that an imputed rate of return should reflect a higher rate of return that is received by riskier investments. If one is attempting to be neutral and neither burden nor subsidize the risk-free return, then the risk-free rate is the correct rate to use, assuming that the risky return is uncertain ex ante. For instance, suppose the risk-free rate of return is 3% and the market-risk premium has an expected value of 4%. Assuming one cannot observe the actual return, the total expected return is 7%, but this extra 4% return is risky and should not be treated as a guaranteed fixed return. If one wants to be precise, the GILTI exemption could be adjusted retroactively to correspond to the actual performance of the market at the end of the period, but this would present design complexities. Email from Thomas J. Brennan, Stanely S. Surrey Professor of Law at Harvard Law School, to author (June 3, 2018) (on file with author) (setting forth this analysis).

Instead, the deemed normal return could be the short-term risk-free rate or such rate as adjusted by a dynamically adjusting measure of market performance.[35] Finally, another way to close the gap between foreign income and domestic income would be to keep the 10% exempt return but subject the excess to the normal corporate rate of 21%, rather than the 10.5% rate.[36]

As discussed, Congress has several levers available to decrease profit shifting and base erosion. Moving forward, Congress's priority should be to enact a per-country minimum tax, since this will be effective at combatting profit shifting while also reducing the offshoring incentives of the new law. The other suggested changes can be scaled up or down depending on where Congress's policy preferences land along the territorial-worldwide spectrum. Congress should take caution in lowering the minimum tax rate further, however, since this would impact revenues and would also lead to increased profit shifting and base erosion by widening the disparity between the domestic rate and the foreign minimum rate.

III. FDII: NEW OFFSHORING INCENTIVES, WTO ISSUES, AND GAMING OPPORTUNITIES

A. New Offshoring and Shifting Incentives

If GILTI is the stick that discourages earning income from intangibles abroad, then FDII is the carrot that encourages earning that income in the United States.[37] To this end, FDII provides a 37.5% deduction on so-called foreign-derived intangible income, which amounts to a 13.125% effective tax.[38] A domestic corporation's FDII represents its intangible income that is derived from foreign markets. Although this income slice is defined as "intangible income," the intangible aspect, as is the case with the GILTI regime, comes only

35. *See* Marr et al., *supra* note 34 (critiquing the GILTI exemption for being too high as compared to low-risk or risk-free investments); Shaviro, *supra* note 20, at 194 (suggesting dynamic rates); *see generally* Rebecca M. Kysar, *Dynamic Legislation*, 167 U. PA. L. REV. (forthcoming 2019) (discussing dynamically adjusting fiscal legislation).

36. Reuven S. Avi-Yonah, *How Terrible is the New Tax Law? Reflections on TRA17* (U. Mich. Pub. Law & Legal Theory Research Paper No. 586; U. Mich. Law & Econs. Paper No. 18-002, 2018) 5 n.4, https://ssrn.com/abstract=3095830 [https://perma.cc/PNA2-9TH3]; *see also* Fleming et al., *supra* note 32, at 78.

37. GILTI, given its 50% deduction, could also be described as a carrot, with FDII simply being the "tastier carrot." Chris William Sanchirico, *The New U.S. Tax Preference for "Foreign-derived Intangible Income"*, 71 TAX L. REV. (forthcoming 2018), https://ssrn.com/abstract=3171091 [https://perma.cc/NE8M-JBMH].

38. For tax years beginning after 2025, the 37.5% deduction is reduced to 21.875%, and thus the effective rate on FDII goes up to 16.406% in those years. I.R.C. § 250(a)(3) (2018).

from the excess over the deemed return on tangible investment, rather than from intellectual property in the traditional sense of the word. This also distinguishes FDII from other patent box regimes, which apply to patents and copyright software, because it instead includes branding and other market-based intangibles.[39]

Like GILTI, the intangible slice of income is calculated by determining a 10% return on tangible assets (but those of the domestic corporation as opposed to the CFC). Unlike GILTI, a taxpayer wants to *reduce* this deemed return amount because doing so increases the amount available for the FDII reduction. In contrast, in the GILTI regime, the taxpayer wants to increase their deemed return amount because this reduces the amount of income subject to the minimum tax. Unfortunately, this again creates perverse incentives. Because we are dealing with domestic assets, the FDII regime pushes taxpayers towards minimizing their investment in such assets.

For instance, assume a U.S. corporation has income of $3,000,000, $2,500,000 of which is derived from sales abroad. Further assume the corporation has a basis in tangible assets of $30,000,000. To calculate FDII, the taxpayer would calculate the ratio that the corporation's exports bears to its income ($2,500,000/$3,000,000), or 83.33%. FDII is that percentage times the income after the deemed 10% return. Here since 10% return on $30,000,000 is $3,000,000, the taxpayer would take 83.33% of 0 ($3,000,000-$3,000,000). In this case, none of the income gets the benefit of the FDII reduction.

If the corporation instead had zero basis in tangible assets in the United States, it would have a higher FDII deduction. The taxpayer would calculate the above export ratio (83.33%). FDII is that percentage times the $3,000,0000 income less the deemed 10% return ($0 since there are no assets), or $2,500,000 (83.33% of $3,000,000). The taxpayer then gets to deduct 37.5% of FDII, here totaling $937,500, which, with the 21% corporate rate, amounts to a tax savings of $196,875 over our base case with U.S. tangible assets.

Also note that the FDII regime essentially applies effective rates between 21% if there is no income above the exempt return, and 13.125% if there is. The GILTI regime applies effective rates between 0% if there is no income above the exempt return, and 10.5% if there is. These rate disparities privilege GILTI in comparison to FDII and incentivize U.S. corporations to produce abroad for foreign markets instead of producing exports in the United States.[40]

39. Stephanie Soong Johnson, *EU Finance Minister Fires Warning Shot on U.S. Tax Reform*, 157 Tax Notes 1704, 1704 (2017).

40. The conference report explains that the minimum tax rate under GILTI is lower because only 80% of the foreign tax credits can offset the minimum tax rate. (13.125% equals the effective GILTI rate of 10.5% divided by 80%.) H.R. Rep. No. 115-466, at 626 n.1526 and accompanying text (2017). This justification, however, does not hold if no or low foreign taxes are paid.

B. WTO Issues

One significant problem with the FDII regime is that it threatens to reignite a three-decades long trade controversy between the United States and the European Union that was thought to have been resolved in 2004.[41] The new regime likely violates WTO obligations because it is an export subsidy on goods.[42] The more the U.S. taxpayer's income comes from exports, the more of its income gets taxed at the FDII 13.125% effective rate (after taking into account the 37.5% deduction), which is a subsidy in comparison to the normal 21% corporate rate.

Because the FDII regime benefits exports, it likely violates Article 3 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement), which prohibits (a) subsidies that are contingent, in law or fact, upon export performance, and (b) subsidies that are contingent upon the use of domestic over imported goods.[43] Article 1 of the SCM Agreement defines a subsidy as a financial contribution by a government, including the non-collection or forgiveness of taxes otherwise due.[44]

The "taxes otherwise due" language raises questions about baselines. Some have suggested that the proper baseline should be the new participation exemption system.[45] Since a taxpayer could just incorporate abroad and take advantage of the exemption of foreign source income, then, judged against that baseline, the 13.125% rate should not be considered forgiveness or non-collection of taxes otherwise due. WTO rulings, however, tend to be formalistic and do not generally anticipate taxpayer responses. For instance, in judging former export subsi-

---

41. It is worth noting that the history of the export subsidy controversy is tortured, beginning in 1971 with the Domestic Sales Corporation, or "DISC," provisions. After a General Agreement on Tariffs and Trade (GATT) panel ruled against DISC, the United States replaced that system with the Foreign Sales Corporation ("FSC") rules in 1984. The WTO would later rule against the FSC system. In 2000, Congress enacted the Extraterritorial Income ("ETI") exclusion, which was also held to be an illegal export subsidy by the WTO. Congress finally repealed the last of the export subsidy measures – the ETI – in the American Job Creation Act of 2004. *See generally* DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RL31660, A HISTORY OF THE EXTRATERRITORIAL INCOME (ETI) AND FOREIGN SALES CORPORATION (FSC) EXPORT TAX-BENEFIT CONTROVERSY 1, 6, 8, 11-12, 14, 18 (2006).

42. *See* Rebecca Kysar, *The Senate Tax Plan Has a WTO Problem*, MEDIUM: WHATEVER SOURCE DERIVED (Nov. 12, 2017), https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99 [https://perma.cc/8ML8-KTZ4].

43. Agreement on Subsidies and Countervailing Measures art. 3.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14.

44. *Id.* at art. 1.1(a)(1)(ii).

45. *See* Sanchirico, *supra* note 37, at 9-12.

dies, the WTO ignored the fact that a firm could indefinitely defer its expatriation of income offshore, pushing its tax rate down to zero. Instead, prior export subsidies were judged against a system of worldwide taxation without deferral. Moreover, even though other countries have ostensibly territorial systems, they, like the new U.S. system, also contain worldwide features like CFC rules. So it is uncertain why pure territoriality should be considered a baseline, as has been suggested.[46]

Further, it is unclear why the comparison should be the taxation of foreign subsidiaries, given that the FDII regime also benefits domestic corporations without foreign operations at all. For such corporations to receive the FDII deduction, they need only export goods. It thus seems strained to pretend they would incorporate abroad if they have no activity abroad. Instead, the proper baseline should be the applicable tax rate imposed on the domestic corporation if it had sold its goods in the United States, rather than exported them: 21%.

Although the United States may contend that intangible income lies outside the scope of the WTO agreements,[47] the intangible income in the legislation is simply an arbitrary slice (determined through the 10% deemed return) of the income from the sale of tangible goods. Exports of tangible goods fall within the scope of the agreements, and likely so will the FDII regime, since it amounts to the non-collection or forgiveness of taxes otherwise due on an export. Accordingly, our trading partners may seek to impose sanctions, either unilaterally or after consent from the WTO's Dispute Resolution Body.[48] The Tax Commissioner for the European Commission has already indicated during a meeting of the European Parliament that the European Union is likely to submit challenges of the provision.[49] The United States will then have to choose between abandoning the FDII regime or continuing it and paying the sanctions.

To summarize, the low rate on FDII is meant to encourage firms to keep and develop intangible property in the United States. Given its serious legal uncertainty, however, firms may be unwilling to rely upon it in making their decisions

---

46. *See id.*

47. This argument was briefly raised by GOP Senators in markup. *Open Executive Session to Consider an Original Bill Entitled the Tax Cuts and Jobs Act Before the S. Comm. On Fin.*, 115th Cong., at 3:57-58, (Nov. 14, 2017), https://www.finance.senate.gov/hearings/continuation-of-the-open-executive-session-to-consider-an-original-bill-entitled-the-tax-cuts-and-jobs-act [https://perma.cc/5Q3N-L25E] (statement of Sen. Rob Portman).

48. *See* Reuven S. Avi-Yonah, *The Elephant Always Forgets: Tax Reform and the WTO* (Univ. of Mich. Law Research Paper No. 585; Univ. of Mich. Law & Econs. Research Paper No. 18-001, 2018), https://ssrn.com/abstract=3095349 [https://perma.cc/Z5SW-UE4J].

49. *See* Robert Sledz, *European Commission Says U.S. BEAT and FDII Rules May Violate International Standards*, Thomson Reuters: Tax & Acct. Blog (Mar. 27, 2018), https://tax.thomsonreuters.com/blog/european-commission-says-u-s-beat-and-fdii-rules-may-violate-intl-standards [https://perma.cc/UBG8-3QL8].

of where to place intellectual property. It is therefore doubtful that the FDII regime will accomplish its stated purpose.

C. Gaming Opportunities

The FDII regime also presents new gaming opportunities. Under some interpretations of the statute, the taxpayer may be able to get the FDII deduction by "round-tripping" transactions—that is, selling to independent foreign distributors, who then resell back into the United States. In this manner, domestic sales can masquerade as tax-advantaged export sales. The new legislation requires that taxpayers must establish to the satisfaction of the Treasury Secretary that the goods are sold for use abroad.[50] Some taxpayers, however, will take the position that the intent of an initial sale to a foreign business is sufficient (like in a value-added tax (VAT) regime). Ultimately, it will be difficult for the Internal Revenue Service (IRS) to meaningfully patrol round-tripping transactions given the legal and factual ambiguity inherent in determining the meaning of "foreign use."

D. Reform Possibilities

In light of the troubling incentives for offshoring, the likely incompatibility with WTO rules, and the potential for round-tripping strategies, the best course of action is to repeal FDII entirely.[51] This is more emphatically the case considering the mixed evidence as to whether even better designed patent boxes increase research and development (R&D) or employment and given the inefficiencies that result from privileging exports.[52] Problematically, FDII provides tax

50. I.R.C. § 250(b)(4)(A) (2018).

51. The International Monetary Fund (IMF) has also recommended that FDII be repealed in order to eliminate the economic distortion created by favoring exports over domestic sales. *IMF Concluding Statement*, *supra* note 30.

52. Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 375 (2013) (reviewing the literature to conclude that the effectiveness of patent boxes is mixed, only affecting the location of IP ownership and income rather than R&D in some countries); Stephen E. Shay et al., *R&D Tax Incentives: Growth Panacea or Budget Trojan Horse?* 69 TAX L. REV. 419 (2016) (critiquing patent boxes); *see also* Pierre Mohnen et al., *Evaluating the Innovation Box Tax Policy Instrument in the Netherlands, 2007-13*, 33 OXFORD REV. ECON. POL'Y 141 (2017) (finding that the patent box in the Netherlands has a positive effect on R&D but that the average firm only uses a portion of the tax advantage for extra R&D investment); Annette Alstadsaeter et al., *Patent Boxes Design, Patents Location and Local R&D* (IPTS Working Papers on Corp. R&D and Innovation, No 6/2015, 2015), https://ec.europa.eu/jrc/sites/jrcsh/files/JRC96080_Patent_boxes.pdf [https://perma.cc/H5BY-9N6J] (finding that patent boxes tend to deter local innovation activities unless such regimes impose local R&D conditions); Fabian Gaessler

incentives to marketing intangibles, goodwill, and going concern, rather than just R&D. Although there is a strong argument for incentivizing R&D because it generates positive spillover effects, the rationale for extending government subsidies to these other kinds of IP is attenuated.[53]

Note, however, that repealing FDII would create a wider differential between the domestic rate on exports (which would then be 21%) and GILTI (10.5%), and this could increase incentives for profit shifting. For this reason, and for others previously discussed, if FDII is repealed, Congress should strongly consider raising the rate on GILTI.

If FDII is maintained, new legislation or regulation should tighten limitations on round-tripping. The Treasury Department could turn to the foreign base company sales rules that determine the destination of a sale. Problems with those rules, however, illustrate just how difficult it is to police the line between foreign and domestic use.[54]

IV. THE BEAT REGIME

A. Threshold Matters

One of the more interesting provisions in the new legislation is the base erosion and anti-abuse tax (BEAT), which strengthens U.S. source-based taxation. The BEAT applies to certain U.S. corporations that excessively reduce their U.S. tax liability by making deductible payments, such as interest or royalties, to a foreign affiliate in which the U.S. corporation owns at least a 25% stake. These

et al., *Should There be Lower Taxes on Patent Income?* (Nat'l Bureau of Econ. Research, Working Paper No. 24843, 2018), http://www.nber.org/papers/w24843.pdf [https://perma.cc/UZ8V-DFCZ] (finding that the impact of patent boxes on invention is not affected and that the instrument is instead there to facilitate shifting corporate income to low tax jurisdictions). For further discussion of the patent box literature, see David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches under the 2017 Tax Legislation*, 103 MINN. L. REV. (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423 [https://perma.cc/JE8H-GJYT].

53. *See* Sanchirico, *supra* note 37, at 20.

54. These regulations allow the corporation to determine the country of use "if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination." *See* 26 C.F.R. § 1.954-3(a)(3)(ii) (2018). This leaves firms with flexibility to make this determination. The Treasury Department should use its authority to impose an interpretation of the FDII statute that requires U.S. taxpayers to do a true inquiry into whether the foreign recipient will sell the product back into the United States. The adequacy of any such approach, however, is uncertain given the fact-intensive nature of the inquiry.

payments are referred to as "base erosion payments." Importantly, the BEAT applies to all multinationals with U.S. affiliates, whether a U.S. or foreign parent owns them. Accordingly, the BEAT is a step towards equalizing the treatment between U.S. and foreign multinationals, the latter of which could previously reduce their U.S. tax liability through earnings stripping in a way that was unavailable to U.S. multinationals.

Unfortunately, the scope of the BEAT allows many multinationals with significant base-shifting activity to avoid the tax. This is because the regime only applies to corporations that have average annual gross receipts in excess of $500 million over three years. Outside of some enumerated exceptions, BEAT is also not triggered until a multinational makes base erosion payments that exceed 3% (2% for financial groups) of the overall deductions taken by the corporation.[55]

Assume for instance, a U.S. corporation makes base erosion payments to its foreign affiliate producing deductions in the amount of $300,000. Further assume other deductions amount to $9,700,000 (so total deductions are $10,000,000). In this case, the corporation would be subject to the BEAT since it meets the 3% threshold. But if it were to reduce its base erosion deductions by just one dollar, or increase its other deductions by the same amount, it would entirely escape the BEAT. The corporation could further game the denominator of overall deductions by entering into hedged transactions.[56]

Both features have the unfortunate consequence of creating a cliff effect. Multinationals with $499 million in average annual gross receipts avoid BEAT altogether, as do such companies with a base erosion percentage of 2.99%. This has implications for horizontal equity, since two similarly situated taxpayers will

---

55. I.R.C. § 59A(c)(4). In other respects, BEAT is arguably overinclusive. For instance, BEAT captures routine transactions such as repurchase agreements and posted collateral, as well as certain debt instruments required by regulators. *The New 'Not Quite Territorial' International Tax Regime*, DAVIS POLK 13 (Dec. 20, 2017), https://www.davispolk.com/files/2017-12-20_gop_tax_cuts_jobs_act_preview_new_tax_regime.pdf [https://perma.cc/A4SM-YA5G]. As a result, nonabusive transactions may fall within BEAT's ambit. There is also a question as to whether Congress intended that GILTI be included in the BEAT tax base without regard for foreign tax credits. There are numerous other technical problems and unanswered questions left open by BEAT, particularly with regard to services, as others have explored. *See, e.g.*, Manal Corwin et al., *A Response to an Off-BEAT Analysis*, 158 TAX NOTES 933 (2018); Martin A. Sullivan, *Can Marked-Up Services Skip the BEAT?*, 158 TAX NOTES 705 (2018); Martin A. Sullivan, *Marked-Up Services and the BEAT, Part II*, 158 TAX NOTES 1169 (2018); Laura Davison, *Most Wanted: Tax Pros' Technical Corrections Wish List*, BLOOMBERG (Apr. 13, 2018) https://www.bna.com/wanted-tax-pros-n57982091110 [https://perma.cc/R7H8-HUKP] (discussing ambiguity regarding which payments are included and how to aggregate income).

56. Richard Rubin, *Companies Hope to Beat a New Tax Called the BEAT*, WALL ST. J. (June 26, 2018, 5:30 AM), https://www.wsj.com/articles/companies-hope-to-beat-a-new-tax-called-the-beat-1530005401 [https://perma.cc/6L5Q-4LCG].

be taxed very differently.[57] It also produces efficiency losses, since cliff effects push the marginal tax rate on the activity in question very high.[58]

Another problem with cliff effects is that they reward taxpayers who are resourceful enough to create structures so that they fall just on the right side of the line. For instance, taxpayers may check the box with regard to foreign affiliates so that they become disregarded entities and payments to them are disregarded. Although the taxpayer would lose out on deductibility for purposes of their regular tax liability, the cliff effect in the BEAT may mean such a tax increase is outweighed by the benefit of avoiding BEAT liability.[59]

B. Gaming Opportunities with Cost of Goods Sold

Importantly, base-erosion payments generally do not include payments for costs of goods sold, except if the company inverted. If a foreign parent incorporates the intellectual property of a U.S. affiliate into a product and then sells the complete product back to a U.S. affiliate, the cost of the product sold does not fall within BEAT. Even if the U.S. subsidiary pays a royalty to the foreign parent for the right to use a trademark on goods purchased by the subsidiary from the parent, pre-existing regulations require that the royalty be capitalized into the costs of goods sold. This means that these royalty payments skip the BEAT entirely.[60] This gap in the law creates significant planning opportunities, allowing a large amount of base shifting to escape BEAT liability.[61]

C. Reform Possibilities

The BEAT thresholds established by the 2017 legislation should be revisited. It may be reasonable to exempt some smaller corporations from the regime's scope since such companies may not be able to profit shift as effectively and BEAT poses a greater challenge for them as an administrative matter. Instead of

---

57. *See* Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931, 955-57 (2016) (discussing equity concerns of income-based cliff effects); *see also* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 30-31, 50 (2006) (discussing cliff effects in the context of non-refundable credits and other tax incentives).

58. *See* Viswanathan, *supra* note 57, at 958-59.

59. Shaviro, *supra* note 20.

60. 26 C.F.R. § 1.263A-1(e)(3)(ii)(U) (2018). There is a question as to whether Congress intended such royalties to escape the BEAT. One government official has indicated that this was not the intent of Congress and that the outcome may be changed through a technical correction. Jasper L. Cummings Jr., *Selective Analysis: The BEAT*, 158 TAX NOTES 1757, 1763 (2018).

61. Kamin et al., *supra* note 52, at 57.

a cliff effect, however, the BEAT could be phased in at different income levels. This would reduce the loss in social welfare by lowering the marginal tax rate below 100%.[62]

Separate and apart from the cliff effect, however, another criticism of the $500 million threshold is that it is simply too high. In the section 385 regulations, which also focus on base erosion, large multinationals are defined as having either $50 million in annual revenues or assets exceeding $100 million.[63] These levels are much more appropriate for identifying multinationals with sufficient base shifting activity, and the BEAT threshold should be lowered to similar amounts.[64]

The 3% threshold for the base erosion percentage should simply be eliminated because of the efficiency and equity costs of the cliff effect. Even if the 3% base erosion percentage is maintained for administrative reasons, it should be restructured to turn on a threshold of base erosion payments as a percentage of taxable income rather than a percentage of total deductions. A small percentage of total deductions could be a large percentage of taxable income, thereby representing a significant degree of base erosion in relation to the company's overall operations.

Solving the cost of goods sold issue is not so easy. This is because there is no proven method to separate out the intangible component of a tangible sale.[65] Additionally, the inclusion of cross-border sales of inventory would present trade and tax treaty issues, similar to those presented by the originally proposed House excise tax.[66] Indeed, the inherent difficulty in designing an inbound regime like BEAT raises the argument that more fundamental changes to business taxation may be necessary.

---

62. Cliff effects based on income impose a marginal tax rate exceeding 100%. This will induce taxpayers to reduce their income so that they fall under the cliff, thereby discouraging socially desirable work. Viswanathan, *supra* note 57, at 959-60.

63. 26 C.F.R. 1.385-2 (a)(3)(ii)(A).

64. *See* Bret Wells, *Get With the BEAT*, 158 TAX NOTES 1023, 1030-31 (2018).

65. *See* Itai Grinberg, *The Senate Introduced a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule* 7 (Nov. 12, 2017) (unpublished manuscript), https://ssrn.com/abstract=3069770 [https://perma.cc/D4KD-GRHT].

66. *See* Reuven S. Avi-Yonah & Nir Fishbien, *Once More, With Feeling: The 'Tax Cuts and Jobs' Act and the Original Intent of Subpart F*, at 12 n.32 (Univ. of Mich. Pub. Law Research Paper No. 578; Univ. of Mich. Law & Econs., Research Paper No. 17-020, 2017), https://ssrn.com/abstract=3074647 (discussing the WTO problems presented by the House excise tax).

V. GOING FORWARD: TRUE INTERNATIONAL TAX REFORM

It is not only necessary to deal with the flaws in the recent tax legislation, but the United States must also manage larger challenges stemming from changes to the global economy. Taxing corporate income will continue to be a formidable challenge given the global nature of today's economy, the mobility of capital and intellectual property, and strategic responses from other countries. Because of these pressures, corporate income tax revenues are likely to shrink. In fact, as previously mentioned, if one ignores the one-time repatriation tax, the new international tax provisions lose revenue going forward.[67]

Our international tax system badly needs reform to strengthen rules governing corporate residence. Rather than follow the place of incorporation as the sole determinant of corporate residency, a notoriously artificial and gameable definition, corporate residency could account for factors such as the location of a company's headquarters or be linked to the residency of its shareholders.[68] Our source rules also fall far short in reflecting modern economic reality, and should be thoroughly reexamined. For instance, the rules might be revised to reflect a more destination-based approach, perhaps assigning income to the jurisdiction of the customer base.[69]

Given the nation's bleak fiscal outlook and tax competition from other countries,[70] it may also be necessary to explore other sources of revenue. Destination-based taxes, which tax where goods are consumed, are of particular interest given the relative immobility of the customer base. Origin-based taxes, like our current corporate income tax, instead levy taxes based on where income is produced or earned—an artificial, easily manipulated, and mobile construct.

Other developed nations have increasingly relied on consumption taxes, like VATs, as supplements to traditional business income taxes. A VAT would not only raise badly needed revenues, but it could apply to the sale of inventory with-

---

67. *See supra* note 9.

68. For discussion of a shareholder-based approach, see J. Clifton Fleming, Jr., et al., *Defending Worldwide Taxation With a Shareholder-Based Definition of Corporate Residence*, 2016 BYU L. REV. 1681, 1702-09 (2017).

69. Paul Oosterhuis & Amanda Parsons, Destination-Based Income Taxation: Neither Principled nor Practical? (Oct. 27, 2017) (unpublished manuscript) (draft on file with author).

70. There is already evidence that other countries are considering lowering their tax rates in response to recent tax legislation. Laura Davison, *U.S. Tax Overhaul Spurs Others to Re-Evaluate Rates: Tax Counsel*, BLOOMBERG (Feb. 22, 2018), https://www.bloomberglaw.com/product/tax/document/X2OS9H7S000000?emc=txtmin%3A8&jcsearch=bna%252000000161b9e6d96ba7e9ffef3c5c0000#jcite (quoting a key drafter of the tax legislation, who has met with representatives from other countries who are pursuing such changes).

out causing trade or tax treaty issues, therefore helping with inbound base erosion.[71] A VAT is often dismissed as a political nonstarter in the United States, but the destination-based cash flow tax proposal of the House is essentially a modified VAT with a deduction for wages. This new type of consumption tax progressed surprisingly far in the reform process.[72]

Finally, the international system of taxation is predicated on divisions of taxing jurisdiction that have no bearing in the modern global economy. A longer-term objective should be to develop a consensus as to how to tax remote businesses selling into markets from abroad. This should include serious re-examination of our double tax treaty regime, which reinforces archaic conceptions of how income should be allocated among states.[73]

CONCLUSION

Although there are reasons to like some aspects of the 2017 tax legislation's international tax regime, it also has several serious flaws and will continue to be challenged by base erosion and tax competition. If the U.S. rules on international tax remain stagnant, then the TCJA will have been a wasted chance to tackle serious problems posed by the modern global economy. If, instead, the new provisions are an incremental step on the path to true reform, the international provisions in the Act can be judged more leniently. Only time will tell what that verdict will be.

Rebecca M. Kysar is a professor of law at the Fordham University School of Law. This Essay is based on testimony I presented before the U.S. Senate Committee on Finance on April 24, 2018.[74] *I am grateful to Cliff Fleming, Chye-Ching Huang, David Ka-*

---

71. For a compelling justification of the VAT, see MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 61-83 (2008).

72. Republicans had advanced the destination-based cash flow tax proposal in their blueprint for tax reform, which was released in June 2016. *A Better Way, Our Vision for a Confident America: Tax*, HOUSE TAX REFORM TASK FORCE 27-29 (June 24, 2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf [https://perma.cc/W77D-YJRL]. House Republicans eventually abandoned the plan in the summer of 2017 after significant debate. Press Release, Speaker Ryan Press Office, Joint Statement on Tax Reform (July 27, 2017), https://www.speaker.gov/press-release/joint-statement-tax-reform [https://perma.cc/XG4V-2CNH].

73. *See* Rebecca M. Kysar, Unravelling the Tax Treaty (unpublished manuscript) (draft on file with author).

74. *See Early Impressions on the New Tax Law: Hearing Before the S. Comm. on Fin.*, 115th Cong. (2018) (statement of Rebecca M. Kysar), https://www.finance.senate.gov/download

min, Edward Kleinbard, Mike Schler, and Steve Shay for helpful comments and suggestions on that testimony. Thanks also to Molly Klinghoffer for excellent research assistance.

/04242018-kysar-testimony [https://perma.cc/F4TA-2CZA]. I developed much of my analysis in drafting the international tax sections of papers discussing the recent tax legislation. *See* David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks and Glitches Under the 2017 Tax Legislation,* 103 MINN. L. REV. (forthcoming 2019), https://ssrn.com/abstract=3089423 [https://perma.cc/8238-SVFL]; David Kamin et al., The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the House and Senate Tax Bills (Dec. 13, 2017) (unpublished manuscript), https://ssrn.com/abstract=3084187 [https://perma.cc/A3ZE-R7QN].