Shay, Peroni, and Fleming?

By Jasper L. Cummings, Jr.

This article summarizes the 11 articles written by Stephen Shay, Robert Peroni, and J. Clifton Fleming, which are mostly about the merits and demerits of shifting to a territorial or exemption system for not taxing foreign-source income. Shay, Peroni, and Fleming were not the first to identify the current deferral system as sometimes worse (or better, depending on your viewpoint) than full exemption of foreign income, but they have most forcefully explained why deferral, and certainly exemption, is inconsistent with the underlying theory of the income tax: taxing based on ability to pay.

A. Cliffs Notes

1. The summary. Stephen E. Shay, Robert J. Peroni, and J. Clifton Fleming Jr. are unique among current tax commentators for attempting to create a set of arguably unbiased analyses of a major subject in the federal income tax: the U.S. tax rules applicable to foreign-source income and nonresidents earning U.S.-source income. They have focused on the current system, which generally defers tax on business income earned by foreign corporations owned by U.S. taxpayers. The last time anyone made this type of effort was when Boris Bittker published a series of articles on corporate taxation in the 1950s, which became the building blocks of his classic treatise on corporate taxation.1

The unifying theme of Shay, Peroni, and Fleming’s 11 articles (nine by the trio and two by a duo) is that the income tax’s underlying ability-to-pay principle should have led Congress to currently tax the income of foreign corporations to the extent owned by U.S. taxpayers. They show how even now, Congress could do so by adopting a passthrough regime for taxing the shareholders of foreign corporations. They also show how the subpart F and section 367 rules that attempt to police deferral — when combined with the foreign tax credit limitation rules, the (mis)allocation of expenses to foreign-source income, and transfer pricing rules — have resulted in a complex mishmash of law that can be worse than exempting the income of controlled foreign corporations.

Indeed, the worse-than-exemption status quo has, until recently, kept corporate America from embracing the proposals to totally exempt active foreign-source income, commonly referred to as exemption or territorial tax systems. Naturally, the trio opposes those proposals, because territoriality rejects the ability-to-pay principle more completely than deferral. But support for those proposals has been mounting over the last 20 years. Being realists, Shay, Peroni, and Fleming finally turned their attention to the proper design of a territorial system, and they found that current proposals are not nearly good enough to warrant replacing the flawed deferral system we now have.

This is not just an academic debate. It is far more realistic than the last analogous major corporate tax reform that was proposed in the waning days of the Bush I administration: taxing business income once.2 Credible proposals for enactment of a territorial system have appeared in Congress, and the big business community (that is, U.S.-based multinationals) appears to have turned on a dime in 2011 to support territoriality. It’s time to pay attention. Shay, Peroni, and Fleming are there to help. Because most of us probably have not read their long and dense writings, this article offers the Cliffs Notes version.

2. Authoritative? Why should we care what these three guys wrote in 11 articles? First, because they have gone beyond the one-off article to start to build a cohesive set of analyses. Second, they are super smart and know a lot about tax. But we should expect them to meet two additional tests: (1) do they have enough common sense to stay within
the realm of reason and reality; and (2) are they unbiased? I find them to be on the practical end of the academic spectrum.

What does it mean to be unbiased in this context? It means nobody is paying them to say these things. You might call them goo-goos — good-government types — who are concerned about the fisc and maybe even about the income tax system.

I raise the issue of bias because it is seldom examined in tax policy writings, for two opposing reasons: (1) some believe that biases don’t matter; and (2) if they do matter, some believe that readers are sophisticated enough to discount an author’s view for its biases.3

But biases obviously do matter, and I am not so confident of our sophistication as readers. Obviously, the views of self-interested persons must be considered in all matters of taxation, because the United States is a democracy and taxes always affect someone’s self-interest. But it is also true that self-interested views alone cannot control public policy. No one wants to pay taxes, except maybe the man behind the tree can’t be taxed either, there would be no tax at all if only the views of self-interested persons dictated political decisions.

Thus, because of the inherent potential unreliability of self-interested speakers on tax issues, it is incumbent on decision-makers and the rest of us to be aware when a speaker is self-interested, and in those cases to:

1. ask whether his bias has led him to leave out relevant facts or skew the analysis;

2. evaluate what ideologies underlie his bias and whether they are ideologies that we want to apply to the particular tax public policy issue at hand4; and

3. evaluate whether a reasonable balance of views is being drowned out by a better-funded touting of views of one sort. It is a simple fact that far more money is spent on promoting the tax reduction views of various groups than on promoting increases in taxation, or even imposing sufficient taxes to balance the budget.

The foregoing proposed approach is what any businessperson would call cold, hard analysis of the facts. It does not become less so when applied to tax debates in the public space.

3. Ideologies. Assuming Shay, Peroni, and Fleming are not self-interested, their ideologies still may matter. They are supporters of the federal income tax, which is rooted in the ability-to-pay principle of taxation. That is an ideology, but hardly a suspicious one. The income tax has been in place in the United States since 1913, has been the principal source of revenue since World War I, and is protected by a constitutional amendment. In other words, the income tax is all-American.

But the trio might have another sort of ideology that is peculiar to academics interested in tax. Are they professionally dedicated to an economic viewpoint that is not necessarily consistent with the interests and democratic values of the United States? I don’t think so, but this requires some explanation.

Some of the earliest and most vocal proponents of a territorial system for not taxing some income earned outside the residence country have been economists, and organizations relying on economists. Economists generally are weaned on the theory that anything that affects market decisions other than prices, supply, and demand is likely to cause market inefficiencies that produce something called a “deadweight loss” or “excess burden” from taxation. That is a reduction below the maximum optimal level in the production of goods and services in the world that is not compensated for by anything economists can measure or care about.5

Unfortunately, all taxes have the potential to cause some deadweight loss. Deadweight loss theory meets the definition of an ideology because it is true and probative in some instances, and is beside the point in other instances. Once a nation decides to have a tax system, there will be some deadweight loss from taxation. Moreover, when the nation is a democracy, it has the right and power to choose to arrange its system of taxation to meet a variety of goals, in addition to, but not limited to, avoiding deadweight loss.

For example, almost from its inception the Republican Party supported protective tariffs, even though virtually all economists came to agree that

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4An ideology is a belief that may be correct in some situations, but which the believer tries to apply to many situations outside the natural range of the belief.

tariffs were a huge cause of international deadweight loss and did not really help the country imposing the tariff (other than raising revenue from consumers).6

Certainly, reasonable efforts may be desirable to reduce the deadweight loss from taxation. Nevertheless, some economists and ideologists who rely on economic theories tend to use the hammer of eliminating deadweight loss in the world to turn all local tax issues into efficiency-maximizing exercises. There is no indication that Shay, Peroni, and Fleming are in those camps, although they obviously know about economic theories. Perhaps that is because they are lawyers and not economists.

So I conclude that the trio is authoritative, unbiased, and worth reading.

B. The Articles

1. The initial effort. The title of the trio’s first article gives away their point: “Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income.”7 Of course, no one has been interested in getting serious about curtailing — as opposed to expanding — deferral since the Clinton administration, which gives the article a dated feel. But these authors are both serious and consistent.

The authors fleshed out an obvious way to get serious: Tax U.S. shareholders on the income of foreign corporations as if they were partners.8 They based this suggestion on (1) fully embracing the economic principle of capital export neutrality (taxing the income from capital owned by U.S. citizens and residents the same, regardless of where the income is earned), which can be called eliminating the subsidy for foreign income; (2) ending the mishmash of subpart F rules; and (3) preventing abuse. However, they insisted that considering the alternatives to subpart F was a worthwhile exercise even if their audience wasn’t interested in getting serious.

Note to readers: If you have to rethink what you thought you knew about capital export neutrality and its twin, capital import neutrality, whenever you hear those terms, join the club. The terms are routinely used in policy debates but are rarely relevant in the everyday world of U.S. international taxation. A refresher and discussion of the confusion in the terminology appears later.

The 1999 article did not issue a full-throated objection to deferral as the original sin against the ability-to-pay principle, but it was. That principle, as contrasted with the neutrality principles, is not an economic efficiency principle but a political principle chosen to guide taxation in America in 1913. Rather, the article just assumed, without fully defending, that President Kennedy was right in 1961 when he proposed to end deferral. The article noted the intense business opposition to the Kennedy proposal, which resulted in the “compromise” of the subpart F rules.

It reminds us that Colin Stam, the longtime chief of the Joint Committee on Taxation, told Congress that it would be unconstitutional to tax undistributed income of foreign corporations owned by U.S. shareholders.9 Stam was later proved wrong.10 While Stam was revered as a tax expert, The New York Times made an understatement in its obituary when it said that “his tax philosophy was generally conservative and largely oriented towards the interests of business.”11

The article quotes a congressional report explaining why Congress did not want to go as far as Kennedy wanted to go in 1962: It sought to promote exports (to the country where the CFC operated) and to provide a competitive advantage, or at least a level playing field, to U.S. businesses operating abroad. Although the export argument has waned, the competitiveness argument remains the core argument today. What Kennedy viewed as an improper subsidy, Congress viewed as a proper aid to competitive advantage — and U.S. businesses have never wavered in making that argument.

2. Responding to deferral fans. In 2000 Shay, Peroni, and Fleming addressed whether deferral has a valid basis in policy.12 They asked, must the competitiveness of U.S.-parented multinationals be protected by loosening the subpart F regime? Their answer was no, but they sort of punted because they are not economists:

We conclude that the proponents of deferral have the burden of proving that the deferral privilege is indeed necessary to overcome tax advantages enjoyed by foreign competitors.

6The Smoot-Hawley Tariff Act of 1930 was pushed through by the Hoover administration over the protest of more than 1,000 economists.
9See supra note 7, at 477.
that actually undermine the competitiveness of U.S. businesses operating abroad, and that this burden of proof has not been, and is unlikely to be, met.13

Evidently, the trio intended to emphasize the “actually undermine the competitiveness” part of their standard, as contrasted with mere tax disadvantage. The tax disadvantage is indisputable if, for example, the foreign competitor pays a 10 percent tax on selling widgets in Rajasthan, but the U.S.-owned CFC and its parent paid a combined 35 percent tax on selling widgets in Rajasthan.

In defending anti-deferral regimes in general, the authors again rehearsed the explanation of the economic principle of capital export neutrality. They said that when a U.S. tax is imposed currently on foreign-source income, that income is treated neutrally from the viewpoint of the U.S. taxpayer because it does not affect the taxpayer’s choice to invest and earn at home or abroad. The trio admitted that pure equality was not obtained when the foreign tax was greater than the U.S. tax and the credit was not refundable, but they viewed that problem to be outside the range of practical solution.

Unfortunately, the authors’ argument is like telling Ralphie that he could shoot his eye out if he gets a BB gun for Christmas. The statement is literally correct, but Ralphie strongly and correctly suspects he can enjoy a BB gun without shooting his eye out. The problem is really the speaker’s rather than Ralphie’s: The speaker is hung up on eye shooting, whereas Ralphie is interested in enjoying the gun. Like Ralphie, multinationals want to enjoy reduced taxation abroad, while Shay, Peroni, and Fleming are motivated by some combination of not encouraging capital exportation, protecting the income tax, and promoting “worldwide economic well-being.”

The trio did admit that they were not really so concerned about the well-being of the world as they were about the well-being of the United States. They saw the abandonment of capital export neutrality as an encourager of the use of CFCs by U.S. businesses to carry on business abroad, which is stating the obvious. They listed several arguably adverse consequences of the deferral regime, including (1) its unplanned nature and the arbitrary way its benefits are distributed; and (2) the accompanying repatriation problem, which one could argue hurts the United States as well as the companies.

In sum, the trio was still pulling its punches by relying on economic theories like capital export neutrality and the fact that the code says “from whatever source derived,” rather than the raw political argument of ability-to-pay taxation. Stay tuned for the next article.

3. Fairness: Getting tough. This 2001 article focused on ability-to-pay principles to oppose deferral.14 The authors justified taxing worldwide income not just because the code says so, and not only because the capital export neutrality principle says so, but also and primarily because it is America’s chosen fairest way to tax. In the cases that matter the most, hiding foreign income under the shell of a CFC doesn’t remove that income from the practical control of the U.S. shareholders and thus their ability to pay an income tax on the CFC’s income.

The article observed that the ability-to-pay principle was seldom linked to the subpart F debate, and the authors seemed surprised about that, but the disconnect is not surprising.15 Opponents of income taxation long have viewed taxing in relation to ability to pay as the original ideological sin of taxation in America. That sin has motivated proponents of consumption taxation (excises, tariffs) since at least 1894, when a group of shareholders in Pollock successfully sued their own corporation to prevent it from paying the new income tax (which the corporation wanted to pay).16

Although the income tax was grudgingly admitted back into the law in 1913, the opponents never gave up. Roll forward to 1981: President Reagan obtained enactment of a version of the Kemp-Roth tax cut proposal, which was designed to drastically reduce the progressivity of the income tax, a goal of Republicans since at least the Mellon Plan of 1924. Then in the 1990s, under the direction of then-Speaker of the House Newt Gingrich and tax activist Grover Norquist, Republicans discovered the theory that all income tax increases could be avoided, regardless of deficits — a point that had eluded Reagan.17 The poster child for failing this lesson was George H.W. Bush, who lost reelection due in part to breaking his “read my lips, no new taxes” pledge.

Against this background, defending ability-to-pay taxation was no small thing for the trio to

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15Id. at 302. However, the article went on in footnotes to list numerous academic disputes about “self-inflicted wounds” and the like, which did consider the issue. Presumably the authors meant it was seldom discussed among real people in politics.


17Reagan signed four tax increase acts between 1982 and 1984.

13Id. at 838.
undertake in their 2001 article, particularly in the politically charged area of taxing foreign income.

The article excused the lack of prior analysis of the interrelationship of the ability-to-pay principle and taxing foreign income by the fact that most foreign income is earned by multinational U.S. corporate parents, which present “perplexing issues” of fairness. Section IV of the article addressed those perplexities, which mostly boiled down to the fact that U.S. corporations can have foreign shareholders. To the extent they do, taxing the corporation’s foreign income arguably deviates from the ability-to-pay principle, because the foreign shareholders who indirectly have the ability to pay should not be paying U.S. tax at all. Of course, the trio would avoid that problem by currently taxing the U.S. citizens and resident shareholders on their share of the income of the foreign corporations.

However, the concern about foreign shareholders stems from the assumption that the corporate tax is simply a proxy for a shareholder tax. The article viewed that economic theory as so obvious that it was stated only in a footnote: “Because the corporate level tax is generally regarded as borne by living taxpayers and not the entity itself, the question of a corporation’s ability to pay is commonly viewed as irrelevant.”

But then the article had to backtrack and admit that the individuals bearing the corporate tax may not be just the shareholders. Now even the JCT agrees with them. It has officially decided to treat 25 percent of the burden of the corporate tax as falling on workers. It seems to me that if 25 percent of the corporate tax falls on workers and some unknowable portion falls on consumers, we are left with only two choices: (1) throw up our hands and conclude that no one owes the corporate tax, and don’t impose it, or (2) impose it on the corporation because the corporation has the cash and is a convenient collection point. The latter conclusion was reached in 1909, when Congress imposed the first corporate income/excise tax, and it seems to have worked out fairly well so far.

In sum, the 2001 article was a fairly strong defense of ability-to-pay taxation — that is, income taxation. In response to the complaints that U.S. corporations are treated worse than foreign corporations are treated by their countries, it said the other countries just don’t place as high a value on ability-to-pay taxation as the United States does. That was a fairly gutsy thing to say, but then, 2001 was a gentler time.

4. The source rules. In 2002 the authors turned to a nominally different topic: the income source rules. After a lengthy description of the statute, they concluded that it is right for the United States to tax foreigners earning income here, as long as the rules treat them fairly relative to U.S. citizens and residents doing business here, which they mostly do. The trio explained this as an application of the other fundamental economic principle of international taxation: capital import neutrality. However, one would be hard-pressed to derive that observation from the article’s conclusion:

Our examination of source rules confirms that although taxation at source has a robust normative foundation, the source rules that implement this form of taxation lack a strong theoretical or prescriptive content.

What this means is that the world generally agrees (that is, it is “normative”) that it is right to tax income earned in your country. But the rules by which the IRS identifies locally earned income are sort of an inconsistent hodgepodge and lack unifying principles. In other words, the source rules are similar to much of the rest of the federal income tax laws.

Of course, taxing nonresidents on U.S.-source income is not really a different subject from deferring taxation of active business foreign income earned by CFCs. It is the bookend to the taxation of the worldwide income of U.S. taxpayers, who get to enjoy source-based taxation imposed by other countries. Moreover, as explained below, the two principles fit together nicely when viewed from the standpoint of the country one lives in, rather than from a hypothetical worldwide perspective.

5. The credit rules. In 2003 the trio tackled another major topic that is nominally separate from deferral: the FTC rules. The authors favor a per-country credit limitation. As with the article on sourcing, their principal motivation seems to be to protect the U.S. tax base.

The credit rules are even more tightly connected to deferral than the source rules. Deferral is a deviation from taxation of worldwide income of

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18See supra note 14, at 302.
19Id. at n.46.
21See supra note 14, at 350.
23Id. at 154.
U.S. taxpayers, and the principal and proper amelioration of the burden of worldwide income taxation is the FTC and not deferral. In contrast, territoriality is the ultimate amelioration and largely would eliminate the need for the credit.

Historically the federal tax laws have waffled back and forth between using an overall limitation on the FTC and a per-country limitation. As practitioners know, this is where the source rules, discussed in the trio’s prior article, come in: foreign-source income/total income X total tax = maximum amount of foreign tax paid that is creditable. Just as deferring the taxation of CFC income violates export tax neutrality, cross-crediting is the bogeyman here. It presumably allows more credits than should be allowed by swapping low-taxed income with high-taxed income in computing the FTC limitation fraction.

The article explained that there are three major competing considerations in selecting a rule for the FTC limitation: (1) the theoretically pure limit of the credit to the tax paid on the income actually taxed in the United States (that is, no cross-crediting); (2) the desire of U.S. taxpayers to maximize the use of FTCs (usually by cross-crediting); and (3) the complexity of limitations on cross-crediting. In 1986 another approach was tried, one that used limits based on types of income (so-called baskets) rather than a per-country limit.

The authors found the 1986 regime to be inadequate for goal 1 and too complex in its own right. They acknowledged but waived off complaints about the complexity of and potential loopholes in a per-country limitation.

Most of us may be unable to evaluate the complexity versus purity versus loopholiness considerations of a per-country limitation. As long as there is an FTC and a limitation, taxpayers and politicians will probably be debating the merits.


a. The 2004 act. By 2004 the authors (without Shay) turned back to their main subject of deferral of taxation of business income earned by foreign corporations owned by U.S. taxpayers, prompted by proposals that later were enacted in the American Jobs Creation Act of 2004. Congress did not take their advice.

First Peroni and Fleming criticized the proposal to reduce the number of categories or baskets of foreign income used for credit limitation purposes because it moved away from the per-country ideal and back toward the overall bogeyman of cross-crediting. Second, they criticized what became section 965, the “one-time” reduced taxation of repatriation. They pointed out with perfect logic that there wouldn’t be a lockout problem for foreign earnings, which might arguably be addressed by the reduced taxation of repatriation, if tax wasn’t deferred on the foreign income of CFCs in the first place.

b. Neutrality confusion. Their 2005 article used the two neutrality principles in a way that may be commonplace but detracts from clarity of analysis: It referred in passing to any U.S. tax rule that has a tendency to reduce U.S. tax on foreign-source income as an application of capital import neutrality. That makes sense only if one applies the two economic neutrality principles from a worldwide viewpoint rather than the viewpoint of one country imposing its own taxes, like the United States. But because very few humans other than economists worry more about the world at large than about their own countries, that usage can be confusing.

When most of us think about capital import and export neutrality, being Americans before we are citizens of the world, we likely view the two economic principles from the perspective of the United States. That leads to a perfectly cohesive regime in which the two principles are not competing, but rather are compatible: The United States applies capital export neutrality to the extent it taxes its citizens and residents on their worldwide incomes, and it applies capital import neutrality when it taxes nonresidents on U.S.-source income (on which citizens and residents also are taxed).

Confusion can arise when experts use capital import neutrality to refer to any U.S. tax rule that tends to reduce U.S. tax on foreign-source income. This can include the current system of deferred taxation of active CFC income, and also lesser benefits like cross-crediting for FTC purposes, and greater benefits like territoriality. That use of the term shifts the focus of analysis from that of the

26See generally Cummings and Robert P. Hanson, American Jobs Creation Act of 2004 (2005).
28Id. at 1394. “One can view the current foreign tax credit limitation in section 904(a) and (d) as a compromise between the strict capital export neutrality approach that would require an item-by-item application of the foreign tax credit limitation and a capital import neutrality approach that would allow unlimited cross-crediting of high and low foreign taxes in the form of an overall limitation with no separate categories.”
speaker’s residence, which is the natural viewpoint of U.S. residents, to the worldwide focus, which is the natural viewpoint only of economists. The shift can lead the listener to wonder how not taxing foreign income has anything to do with importing capital into the United States. Of course, it does not (except to the extent repatriation of untaxed foreign income gets mixed into the discussion). The capital import neutrality proponents are simply persons pursuing their own interests in reducing their own taxes who have adopted a worldwide viewpoint as their own because it suits their interests.

Sensing the problematic nature of this shift, think tanks and business groups advocating capital import neutrality are forced to come up with arguments based not on worldwide economic improvements but on benefits to the United States. They generally argue for the benefits of hoped-for repatriations of capital that has been locked out by the deferral rule, a hope for more domestic investment by the corporations that have been freed to invest more freely abroad (which seems counterintuitive), and the like.

7. Territoriality. In 2005 Fleming and Peroni, again without Shay, responded to a specific legislative proposal to not tax dividends from foreign corporations. Simply put, the authors didn’t like it. They viewed territoriality as doubling down on deferral of taxation of foreign-source income, actually turning it into permanent deferral. In addition to thinking that a territorial system would be very complex, they thought it would lose federal revenue. And of course, that is the point. U.S. corporations would not support territoriality — and a growing number do support it — if they did not think that it would save them money.

8. Territorial taxation again.

a. A new principle. In 2009 Shay returned to the masthead of the article, just before reentering Treasury. This article focused on the similarities between the U.S. system of nominal taxation of worldwide income plus deferral of active business income earned by foreign corporations, and the regimes by which some other countries exempt active business income of corporations but otherwise tax individuals on their worldwide incomes and tax passive income from all sources. The trio emphasized the hybrid nature of both regimes, calling the first “hybrid worldwide” and the latter “hybrid exemption.”

The article’s point is encompassed in these two sentences:

Because of deferral of U.S. tax on foreign-source active business income, liberal cross-crediting opportunities, and other defects, the U.S. system can actually produce a worse-than-exemption result in the form of a negative rate of U.S. tax on foreign-source income. Moreover, the current U.S. system involves more complexity than the typical hybrid exemption system without achieving a dramatically greater revenue yield. The authors agreed that a well-designed hybrid exemption system might be preferable to the current U.S. system. But they concluded that the better solution is to perfect the U.S. hybrid worldwide system rather than replace it with even a well-designed hybrid exemption system.

Their reasons for continuing to prefer worldwide taxation continued to be motivated by protection of the U.S. fisc and the ability-to-pay principle. They explained a variety of specific ploys that U.S. taxpayers would use to game any territorial system that might be adopted by the United States, principally the intense pressure that would be put on transfer pricing. In good academic style, they called these “distortion inefficiencies.”

Attempting to be up-to-date, the article addressed a new, third economic principle asserted to lead to right answers to the deferral issue: capital ownership neutrality and national ownership neutrality. This principle was evidently invented in 2003 by a couple of economics professors. The idea is that economic efficiency worldwide and for the United States would be improved if the taxation of income from capital didn’t depend on who owns the capital. It’s fairly obvious that such a result could be achieved by the source country applying capital import neutrality and the residence country using a territorial system — that is, not applying capital export neutrality. The new principles appear to be mostly a retread of capital import neutrality enforced on the capital exporting countries.

Shay, Peroni, and Fleming pointed out how capital ownership neutrality can cause U.S. capital owners to select an inferior place abroad to do


32 Id. at section I.

business simply to avoid the higher U.S. tax, even though doing business in the United States otherwise would be more beneficial to all concerned, not to speak of the loss of revenue to the United States. In other words, a newly discovered principle that is intended to take taxes out of the equation affecting business decisions actually puts them front and center in forcing business decisions without regard to normally determinative business factors.

The article again defended the taxation of foreign-source income on the fundamental principle on which a progressive income tax inevitably must be based: ability to pay. The taxpayer with foreign income can pay the U.S. tax as well as the taxpayer with U.S. income. Why shouldn’t it pay its fair share?

Finally, the article turned to the real practical issue, the application at the federal level of the beggar-thy-neighbor problem that American states have wrestled with for decades: If they are taxed too much by the United States, U.S. taxpayers will expatriate or otherwise figure out how to keep their cash out of the clutches of the U.S. Treasury and hence out of the country. Focusing primarily on corporations, the article rehearsed the artificiality of our definition of corporate residency and presented the two main competing choices for dealing with it: Allow either artificial determinants like place of incorporation, if not source of income, to determine taxation, or tax worldwide income without regard to those determinants. The authors chose the latter for all the reasons discussed above. They would solve the problem of taxing based on artificial distinctions by eliminating the distinctions, treating foreign subsidiaries as domestic, or simply taxing corporate shareholders on a passthrough basis (their original proposal).

It is not clear that the authors fully grasped or responded to the political implications of these arguments.

b. E. Cary Brown. As quoted above, in this article the trio invoked the “worse than exemption” characterization of the current state of the law (some say “better than exemption”). The idea is that the combination of benefits to the domestic owner from deferral of foreign income plus generous FTCs loses more revenue than would adoption of a territorial or exemption regime. The phrase was first used in print in connection with territoriality in Lee A. Sheppard’s 2005 article reporting on a symposium on the Bush tax proposals.34 She quoted professor Michael J. Graetz as arguing that given that fact, the United States might as well move to a territorial system and simplify the law. Of course, the trio sees it just the other way.

There are two important points about the worse-than-exemption argument. First, it appears to be true; it provides the best explanation for why the U.S. corporate community delayed embracing the 2005 (and earlier) territorial proposals until 2011. Second, it has an interesting connection to the 1981 tax act and one of the foundational principles in tax policy.

MIT professor E. Cary Brown showedmathematically that deducting the cost of an investment when it is made can produce the same tax result as exempting from tax the normal return on the investment in the future, subject to various factual assumptions.35 This concept underlies the flat tax and other consumption tax proposals that would allow businesses to expense capital investment in plant and equipment and allow individuals to deduct savings.

In a more practical vein, the concept was applied to the accelerated depreciation plus investment tax credits enacted in the 1981 tax cuts (in addition to across-the-board Kemp-Roth rate cuts). The first time the phrase appeared in print in Tax Notes was when the National Association of Manufacturers (NAM) wrote in to argue that the Republican accelerated depreciation proposal would not produce results better than expensing.36 NAM turned out to have been wrong, and four tax increases followed in a failed effort to stanch the red ink caused by the 1981 act.

In contrast to the NAM statement, there has been little discussion of the deferral system being better than exemption in the business community. But it must be in many cases, and that must have contributed to the delay in embracing territoriality — or maybe it was just “the devil that we know” effect. The embrace came only after the Republicans reclaimed the House in 2011, which meant that a territorial system, if enacted, could be counted on to be at least as good as, if not better than, deferral.

9. Worse than exemption. Having found a calling card, the trio next titled an article “Worse Than Exemption” and basically replayed the Tax Notes article’s discussion of the ploys of tax avoidance

under a territorial system for the academic audience. The principal projected ploys are (1) aggressive transfer pricing that strips gross and net income from the U.S. tax base; (2) expense allocation anomalies that improperly increase foreign-source income and FTCS; and (3) cross-crediting producing unduly generous FTCS. Again, the authors wanted a well-designed worldwide tax system, not an exemption system.

10. Properly designed territorial system. By 2012 the three authors had been forced to face the reality of mounting business support for territoriality proposals, so they endeavored to flesh out a well-designed territorial system, if one were to be adopted. Yet, the authors continued to be zealous protectors of the U.S. fisc, which impelled them to design a territorial system that leaked the least tax from the system.

They properly perceived that U.S. corporations will not easily give up the best tax-reducing features of the worldwide income/tax deferral system without a fight. As present as the trio may be, however, they were unable to explain how politics might prevent that result. But if the politicians can find a way, the trio offered a plan to preserve the revenue gains that they say moving from the poorly structured worldwide system to a well-structured exemption system could provide.

Their plan is based principally on these elements:

- exempt only foreign income that has borne some definable amount of foreign tax; and
- don’t let ancillary rules, like most importantly transfer pricing and expense allocation, eat away at the remaining income that should be taxed by the United States.

Of course that is easier said than done.

As to the shift of business viewpoint, a review of articles or reports by business groups appearing in Tax Notes over the last 20 years on the subject of territorial taxation suggests several conclusions: (1) aside from the National Foreign Trade Council (NFTC), early support for territorial taxation came mostly from conservative tax lobbying organizations and think tanks; (2) 2011 was the watershed year in which the major business organizations apparently first firmly supported the territoriality proposal; and (3) U.S.-based multinationals with substantial foreign activities have been the key proponents.

- On March 1, 1994, the American Council for Capital Formation (a lobbying group formed by Charls Walker originally to lobby for capital gains tax reduction) issued a report that responded to Clinton proposals to reduce deferral by proposing a territorial system.
- In 1999 the NFTC endorsed territoriality.
- In 2002 the Cato Institute endorsed territoriality.
- On September 25, 2003, the Heritage Foundation endorsed territoriality.
- In 2006 the vice president of Pepsi endorsed territoriality.
- Also in 2006, the American Enterprise Institute endorsed territoriality.
- At least by 2011, territoriality was endorsed by the U.S. Chamber of Commerce, Kimberly-Clark, Wal-Mart, NAM, the Tax Foundation, and the Business Roundtable.

11. Territoriality: Political reality. Most recently, the trio addressed the specific proposals in Congress for territorial systems. They don’t like the proposals because they would lose too much revenue and don’t constitute an improvement over the current system. The changes the trio would propose to improve the bills would drive away the corporate supporters.

In other words, the authors are saying that the corporate community that finally was converted to support a territorial system — and that generally
purported to do so on the basis of (1) fairness (to themselves), that is, the taxpayer-centered view of capital import neutrality, (2) preventing them from being runaway corporations, and (3) general improvement in the worldwide economic environment — would not support a system that actually does what they said they wanted.

The undesirable features of the earlier Camp and Enzi proposals the trio identify are (1) they do not adequately link U.S. tax exemption to foreign tax payment on the affected income, permitting untaxed or nearly untaxed income; (2) under-allocation of expenses to untaxed income; (3) insufficient prevention of leakage of gain out of the U.S. tax system; and (4) various loopholes opened or not closed.

C. Principles Versus Politics

The foregoing chronological review of the trio’s articles reveals that after initially relying on the economic principle of capital export neutrality to end deferral, they ultimately stand on the political principle of ability-to-pay taxation and would yield it only grudgingly to a well-designed territorial system, which they have proposed but others have not embraced. Their articles organize all the best arguments and provide resources for the ongoing debates. The most recent article should be a valuable resource to congressional staff if the territoriality bills gain any traction, which currently seems unlikely.

But an overhaul of the taxation of foreign income will occur eventually, and the decision will be a political one that cares not one whit about import or export neutrality, except as it concerns these political issues:

- How much do politicians care about ability-to-pay taxation? Democrats may, but they either don’t really understand it or want to talk too much about it. Republicans generally don’t care at all.
- How much revenue would be lost by a territorial system as designed by Congress, and how much do politicians care about that loss?

Democrats probably care more than Republicans, who likely believe that the revenue pickup from repatriations, etc., will balance out any losses.

- How much traction does the runaway corporation argument have, either based on “fairness” to “our” corporations and businesses when operating abroad, or based on arguments about jobs that might be lost in the United States on account of running away, or that territoriality would release a torrent of repatriation that would enhance gross national product? The answers to this question probably will provide the most important talking points in the debate.

The articles of Shay, Peroni, and Fleming can’t make people care about ability-to-pay taxation. Their articles can warn about revenue loss, but in the end some combination of the Congressional Budget Office and the JCT will come up with estimates for a bill, and Congress will decide how it feels about the particulars of the bill and the revenue effects at hand. And the trio’s articles do not really take on the fairness to U.S. corporations, ancillary effects on domestic workers, and offsetting benefits repatriations.

So in the end, this fine set of articles probably won’t affect the enactment or not of a territorial system. Their principal positive effects are (1) to assemble and analyze the law and lore of these important issues; (2) to do so in an unbiased way; and (3) to stand up for the ideology of the American income tax. What were the authors thinking when they chose to stand up for the income tax? It’s not a popular position these days. They were probably thinking that in the long view, they are in pretty good company.