ANALYZING SUBPART F IN LIGHT OF CHECK-THE-BOX

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Congress enacted the Subpart F taxation antideferral regime in 1962 as a political compromise between two fundamentally opposed viewpoints. The Kennedy Administration, on the left, sought to curb further erosion of the United States (U.S.) tax base through a *worldwide* taxation system that would tax *all* foreign-source income. The Republican-led Congress and multinational business community, on the right, sought to encourage U.S. foreign investment and corporate profit generation through the continuance of a *territorial* taxation system that taxed *only* domestic-source income. Subpart F compromised between these contradictory goals by subjecting the *passive* income of U.S. subsidiaries operating in foreign jurisdictions to current U.S. taxation, but not the *active* income. Subpart F thus exempts legitimate business income from current taxation. In 1997, the United States Department of Treasury (Treasury) and the Internal Revenue Service (IRS, Service, or Agency) published entity classification regulations that, ironically, favored the right by furthering the *avoidance* of Subpart F income. Arguing that these regulations thus disrupt the balance of the Subpart F compromise, the left has sought further action to neutralize their effects.

Intuitively, if Congress enacted Subpart F to curb erosion of the U.S. tax base, it follows that Subpart F caused greater contribution to the U.S. tax base. It also follows that if the check-the-box (CTB) regulatory regime renders Subpart F toothless, the U.S. tax base has subsequently shrunken. But is either of these conclusions true? First, absent the CTB regime, was Subpart F effective, or did the compromise itself render its policy objectives unattainable? Second, if the U.S. tax base has

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shrunken, is it resultant of CTB, or is Subpart F itself responsible for causing a gradual depletion of the U.S. tax base? As Subpart F's forty-year anniversary passed, an increasing number of multinationals began reincorporating as non-U.S. corporations, thus avoiding altogether the application of the U.S.'s semi-worldwide taxation system, and necessarily diminishing the U.S. tax base. Corporations tout as their reason for taking this drastic move the continually increasing applicability and stringency of Subpart F. They do so despite the benefits available through CTB.

This article explains the history of the Subpart F compromise and of the CTB regime that beleaguers its application. The paper then evaluates whether Subpart F as an independent system is capable of affecting the policy goals behind its creation. Subsequently, this paper analyzes what is the most prudent and economically sound course of action for healing the U.S. international taxation system. Namely, at issue is whether additional regulation, in the form of a re-vamped Subpart F or a scaled-down CTB, would solve the ailments, or whether the complete revocation of existing policies, such as the U.S. semi-worldwide taxation system or the CTB regime, is necessary. Finally, the paper concludes that the evolution of Subpart F has come full circle. In light of current inversions of major U.S. multinationals into non-U.S. multinationals, specifically to avoid the complications of Subpart F, and of the reduction of the U.S. tax base that necessarily corresponds, Subpart F undeniably results in some erosion of the U.S. tax base. Its purpose for existing is thus nullified and it is time for the U.S. to return to a policy of territorial taxation.

I. THE PAST: FORTY-YEAR ANNIVERSARY – TIME TO CELEBRATE OR DEBATE?

Before 1962, corporate subsidiaries operating outside the United States did so free from current U.S. taxation.[1] Not unless and until an overseas subsidiary repatriated income to its U.S. parent was it subject to taxation other than as imposed by the foreign jurisdiction.[2] Augmented

1. *See* Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525, 1527 (2001) ("From 1913 through the 1950s, U.S. multinational corporations operated free from current U.S. income tax to the extent that they conducted operations through foreign subsidiaries.").

2. *See* Engel, *supra* note 1, at 1527. Some foreign-source income was subject to immediate taxation under the Foreign Personal Holding Company (FPHC) antiavoidance regime adopted in the 1930s. *See id.* at 1532-33. The FPHC regime targets only certain closely held foreign subsidiaries; the subsidiary must have five or fewer U.S. owners and derive at least sixty percent of its gross

by a more international and less isolated vision toward business ventures since the end of World War II,[3] U.S. corporations took advantage of the U.S.'s territorial taxation system.[4] Corporations moved operations offshore, establishing subsidiaries in countries taxing income at rates lower than U.S. corporate income tax rates, or not taxing income at all.[5] The upsurge was great enough to cause a noticeable erosion of the U.S. tax base and prompt lawmakers to seek change.[6] In 1961, the Kennedy Administration introduced legislation groundbreaking in the field of taxation—the worldwide income tax.[7]

A. The Mission: Capital Export Neutrality

Capital export neutrality is a situation under which there exists no incentive to export capital from the U.S. to a foreign jurisdiction because income generated overseas is taxed exactly as it would be if earned within the U.S. Because this policy taxes income at the same rates regardless of where it is earned, there exists no motivation to invest abroad rather than domestically. Exportation of U.S. capital is therefore less likely, causing greater investment in domestic business and labor.[8] If a U.S. corporation chooses to invest abroad nevertheless, it does so with no competitive tax advantage over its solely domestic rivals. United States taxation of foreign-source income would thus create global tax neutrality and a level playing field between U.S. multinational corporations and U.S. solely domestic corporations.[9]

The Kennedy Administration sought to effect capital export neutrality. Under its proposed legislation, virtually all income earned by

income from designated passive sources. *See id.* at 1533-34. The regime therefore reaches neither foreign subsidiaries owned by publicly traded U.S. corporations nor those generating substantial active income. *See id.*

3. *Cf.* Engel, *supra* note 1, at 1538 (pointing to investment in foreign subsidiaries after World War II as a cause for U.S. deficit and diminished GNP growth not seen in other industrialized countries).

4. *See* Engel, *supra* note 1, at 1539. Americans generally viewed investment in offshore subsidiaries "as a favorable mechanism of promoting foreign investment." *Id*. at 1538.

5. *See* Engel, *supra* note 1, at 1532-33.

6. *See* Melvin S. Adess et al., *The Erosion of Deferral After the 1993 Act*, 47 TAX LAW. 933, 934-35 (1994); Engel, *supra* note 1, at 1525, 1539. Americans shifted to generally view investment in offshore subsidiaries "as a malignant mechanism to avoid worldwide tax." Engel, *supra* note 1, at 1538.

7. S. REP. NO. 87-1881 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3297.

8. *See, e.g.*, *President's 1961 Tax Recommendations: Hearings Before the House Committee on Ways and Means on the Recommendations of the President Contained in his Message Transmitted to the Congress*, 87th Cong. 404, 2595, 3248 (April 20, 1961) [hereinafter 1961 House Hearings] (memorializing labor groups' support for Kennedy's plan).

9. *See* Engel, *supra* note 1, at 1527.

a U.S. corporation's foreign subsidiaries would trigger current U.S. income tax liabilities to domestic shareholders.[10] Foreign-based income would thus be taxed as if generated at home, increasing the federal tax base and eliminating the competitive advantage of subsidiaries operating in tax haven nations over those operating solely in the U.S.[11] Taxing income worldwide remains a revolutionary concept forty years after the Kennedy Administration first proposed it; only a few nations exercise some form of worldwide taxation today. Political adversaries arguing as proponents of capital *import* neutrality opposed the Kennedy proposal adamantly.[12]

B. The Opposition: Capital Import Neutrality

Capital import neutrality is a circumstance whereby domestic capital investments receive no tax preference over imported capital investments because the government taxes the income generated by both equally. Because income is taxed at the same rates regardless of where the taxpayer or its shareholders reside, there is no deterrent to investing abroad. U.S. taxpayers can take advantage of global business opportunities and the benefits of foreign markets without penalization by uncompetitive taxation. If a U.S. corporation establishes a subsidiary overseas, only the foreign jurisdiction taxes its income, rather than the corporation being subject to taxation by the U.S. (at higher rates) as well. United States taxation of only domestic-source income thus fosters international competitiveness and creates a level playing field between U.S. foreign subsidiaries and their locally owned foreign rivals.[13]

The Kennedy proposal would have killed capital import neutrality. Subsidiaries already operating in tax haven jurisdictions without current U.S. tax liability were facing drastic consequences if the proposed legislation became law. Such companies would pay taxes at the same corporate income rate as domestic U.S. corporations (capital export, or global tax, neutrality), but at a *global* rate *higher* than that imposed on their local foreign competitors (capital import, or international competitiveness, non-neutrality). Such companies would, Congressional Republicans argued, lose their ability to compete in the face of

10. *See* 1961 House Hearings, *supra* note 8, at 8-10, 30, 31, 263, 264. *See also* Adess, *supra* note 6, at 934 (referring to "the Kennedy Administration's proposal to eliminate *all* deferral for foreign corporations controlled by U.S. persons") (emphasis added).

11. *See* Engel, *supra* note 1, at 1527 (noting that wholly domestic enterprises would thus remain competitive with their U.S. multinational rivals).

12. *See* 1961 House Hearings, *supra* note 8, at 309-27, 330, 331.

13. *See* Engel, *supra* note 1, at 1527, 1539-41.

decreasing profits, and ultimately lose their businesses.[14]

The political battle thus pitted global tax neutrality against international competitiveness, and both sides ultimately lost out. Although Kennedy's proposal did not pass, Democrats were resolute on change and Republicans soon compromised.

C. The Compromise: Subpart F

In 1962, Congress enacted, and President Kennedy signed into law, sections 951 through 964 of the Internal Revenue Code.[15] Commonly known as Subpart F,[16] this legislative regime seeks to prevent the deferral of U.S. income tax liability in limited circumstances. Deferral of taxes on foreign subsidiary income[17] is permitted for legitimate, active business endeavors.[18] No deferral is permitted, however, for passive, inherently mobile, foreign corporate operations, such as those producing only royalty, interest, or dividend income.[19] Because such activities are

14. *See* Engel, *supra* note 1, at 1531, 1540.

15. *See* Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified at 26 U.S.C. (I.R.C.) §§ 951-964 (1999)).

16. I.R.C. §§ 951-964 (1999). *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 69.1, at 69-2 (2001) ("The provisions are subpart F of part III of subchapter N of Chapter 1 of subtitle A of the Internal Revenue Code."). *See generally* Adess, *supra* note 6 (speaking to the history of "Subpart F"); Henry J. Birnkrant & James E. Croker, Jr., *Hybrid Regs. Raise Issues About Subpart F, Treasury's Regulatory Authority, and Check-the-Box*, 89 J. TAX'N 45 (1998) (analyzing Treasury and the IRS's attempts to establish new "Subpart F" regulations).

17. Subpart F applies solely to the corporate form. *See* Adess, *supra* note 6, at 934-35. The U.S. has the power to tax U.S. people on their foreign income, *see Cook v. Tait*, 265 U.S. 47, 56 (1924), but lacks the power to tax foreign corporations, owned by U.S. people, on their income. *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 26.1.1 (2d ed. 1998). Taxation on such income is thus deferred until the income is repatriated to the U.S. Subpart F works to curb enjoyment of this situation by *deeming* certain foreign subsidiary (controlled foreign corporation (CFC)) income as repatriated as it is earned. The U.S. shareholders of such a foreign entity (versus the subsidiary itself) are thus taxed currently on income not actually repatriated, but merely deemed repatriated by Subpart F.

18. *See* H. David Rosenbloom, *The David R. Tillinghast Lecture on [sic] International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 137, 157-58. A foreign subsidiary operating in purchase, sale, and service activities within its foreign jurisdiction satisfies this requirement automatically, as does a subsidiary engrossed in manufacturing activities. Deferral due to legitimate business purpose is permitted in two additional circumstances. *Id.* First, service operations requiring foreign incorporation garner deferral treatment, provided the foreign subsidiary does not receive substantial related-party assistance. *See* Treas. Reg. § 1.954-4(b) (2004). Second, licensing endeavors justifying foreign incorporation receive deferral treatment if the foreign subsidiary operates an active business enterprise. *See* Treas. Reg. § 1.954-2(d) (2004).

19. *See* I.R.C. § 954(c)(1) (West 1988 & Supp. 2000) (referring to passive investments as "foreign personal holding company income"); Rosenbloom, *supra* note 18, at 158. Deferral of otherwise passive income *is* permitted under three circumstances. First, passive income will be U.S. tax deferred if the taxpayer demonstrates that it is subject to sufficient taxation by the foreign

executable within the U.S., Subpart F presumes they are conducted offshore solely for tax avoidance purposes.[20] Thus, rather than taxing all foreign-source income as a capital export-neutral system would do, Subpart F purports to tax only income generated outside the U.S. with the particular intent of avoiding U.S. taxation. Similarly, rather than deferring all income generated in foreign jurisdictions, as would a capital import-neutral system, Subpart F theoretically defers only income earned through enterprises conducting legitimate business activities.

The system does not function as easily, however, as this explanation of its purpose may suggest. Wriggled with numerous revisions, additions, and exceptions, Subpart F is the most extensive and complicated of the international antideferral regimes.[21] Subpart F income consists of insurance and foreign base company income (FBCI).[22] Foreign base company income consists of five separate types of income, three of which arise often.[23] The first of these five, foreign personal holding company income,[24] taxes currently foreign source income in the form of dividends, interest, rents, royalties, annuities, and property sales resulting in one of these income types.[25] The second FBCI is foreign base company sales income.[26] This provision taxes

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jurisdiction. *See* Rosenbloom, *supra* note 18, at 158. This policy presumes that if the foreign subsidiary is willing to pay high-rate foreign taxes, that it must have a genuine non-tax, business purpose for operating in the foreign jurisdiction. *Id*.

Second, passive foreign-source income will be U.S. tax deferred if the income is earned by a CFC incorporated in the same country as is the payor of the income, provided the income payment does not reduce the amount of income otherwise currently taxable by the U.S. *Id*. *See also* I.R.C. § 954(c)(3). This policy means that it does not matter whether a foreign jurisdiction levies its territorial taxes upon two entities or upon one; U.S. tax treatment should likewise not be altered. *See* Rosenbloom, *supra* note 18.

Third, active businesses that generate passive-type income inherently, such as banking income, garner deferral treatment under certain circumstances. *See* I.R.C. § 954 (h), (i) (1999).

20. *See* Rosenbloom, *supra* note 18, at 158.

21. *See* Howard Gleckman, *Taxing Multinationals: The Donnybrook Ahead*, BUS. WK., Sept. 9, 2002, at 86 (noting "the way the U.S. taxes exporters and multinationals [as] especially ugly," imposing "reams of incomprehensible rules" forcing corporations to "spend a small fortune on lawyers and accountants"); *U.S. Should Respond to WTO with Territorial Tax, Says CFP, Tax-News.com, New York*, (Jan. 23, 2002), *at* http://www.tax-news.com/asp/story/story_print.asp?storyname=7060 (last visited 1/23/2005) (defining the U.S.'s semi-worldwide tax laws as extremely complex and paperwork burdensome) [hereinafter *U.S. Should Respond*]. *See also* Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 836 (2000) (touting a territorial taxation system as simpler and cheaper than the current U.S. system).

22. I.R.C. § 952 (2004).

23. I.R.C. § 954 (2004).

24. I.R.C. § 954(c) (2004).

25. *Id.*

26. I.R.C. § 954(d)(1) (2004).

foreign source income earned when a foreign subsidiary purchases goods from outside its country of incorporation, sells the goods outside such country, and either the corporation it purchased from or sold to is related.[27] A third FBCI is foreign base company services income.[28] This income is generated when a foreign subsidiary performs services outside its country of incorporation either for, or on behalf of, a related party.[29] This brief explanation may still illuminate Subpart F in a comprehendable, if not sensible, light. Added to these provisions, however, are abounding exceptions, definitions, rules of applicability, and regulations, making the provisions difficult to navigate. Congress has amended and added to the regime several times since its inception, slowly decreasing the ability of U.S. multinational corporations to defer income earned offshore.[30] Subpart F remains in effect today as an extensive and complicated antideferral regime.[31] This regime is largely, if not entirely, circumventable, however, since the establishment of the new entity classification regulations in 1997.

D. The Demise: Check-the-Box

1. Treasury and the IRS Mastermind Their Own Method

In 1997, the Treasury and the IRS[32] effected regulations permitting non-per se corporations to choose their tax treatment.[33] The regulations are known as the check-the-box[34] classification regime because an entity has merely[35] to check the appropriate box on a Form 8832 to indicate its

27. *Id.*

28. I.R.C. § 954(e) (2004).

29. I.R.C. § 954(e)(1) (2004).

30. *See generally* Adess, *supra* note 6, for a comprehensive view of the history of Subpart F up to its 1993 amendments, and BITTKER & LOKKEN, *supra* note 16, for a detailed explanation of Subpart F in its entirety.

31. *See U.S. Should Respond*, *supra* note 21; Chorvat, *supra* note 21, at 836 (touting a territorial taxation system as simpler and cheaper than a worldwide system).

32. Prop. Treas. Reg. § 301.7701, 61 Fed. Reg. 66,584, 66,587 (Dec. 18, 1996) (effective Jan. 1, 1997). The regulations provide guidance for the Internal Revenue Code entity classification rules set out at I.R.C. § 7701 (2001). *See id.*

33. Treas. Reg. § 301.7701-3(a), (c)(1)(iv) (as amended in 1999). *See* Roger F. Pillow & John J. Rooney, *Check-the-Box: Final Conversion Regs. Add Clarification While New Prop. Regs. Add Some Uncertainty*, 92 J. TAX'N 197, 197 (2000) (noting that an eligible entity may elect its classification for federal income tax purposes).

34. *See generally* Prop. Treas. Reg. § 301.7701, 64 Fed. Reg. 66591 (Nov. 29, 1999) (referring to Treas. Reg. § 301.7701 as "the check-the-box" regulations).

35. *See* Treas. Reg. § 301.7701-1(b) (as amended in 1992) (current version at Treas. Reg. § 301.7701-1 through –4 (as amended in 1999)) (applying Jan. 1, 1961 through Jun. 30, 1996). Prior

characterization choice for federal taxation purposes.[36] The CTB regulations classify a foreign business entity[37] as a corporation,[38] a partnership,[39] or as disregarded.[40] Specific foreign entities are

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to the check-the-box (CTB) regime, business entities had to meet a test to garner classification as a pass-through entity. *See id.* The test evaluated whether a business entity embodied corporate characteristics too extensively to permit taxation as a partnership. *See* John Blyth et al., *Characteristics of Corporate Status for Federal Income Tax Purposes*, *in* 16 N.Y. JUR. BUSINESS RELATIONSHIPS § 2009 (2d ed., 2003).

The IRS considered whether an entity enjoyed limited liability, provided for the continuity of its life, allowed for the free transferability of its interests, or possessed a centralized management. Treas. Reg. § 301.7701-2(a), (b), (c), (e) (as amended in 1992) (current version at Treas. Reg. § 301.7701-1 through –4); Rev. Proc. 95-10, 1995-1 C.B. 501 at §§ 4, 5.01 – 5.04; Rev. Proc. 89-12, 1989-1 C.B. 798, at §§ 4, 4.05 – 4.07.

An entity exhibiting two or fewer of these corporation-like characteristics would pass the test and be considered a partnership for U.S. federal taxation purposes. *See* Treas. Reg. § 301.7701-2(g) (as amended in 1992) (current version at Treas. Reg. § 301.7701-1 through –4) (providing several examples). If the entity was deemed to possess greater than two of the characteristics, however, it would suffer double taxation as a corporation. *See* § 301.7701-2(g) (as amended in 1992) (current version at Treas. Reg. § 301.7701-1 through –4); Blyth, *supra* note 35. The test was widely criticized because meeting it was extremely difficult and resource intensive. *See, e.g.*, Rev. Proc. 95-10, at § 3; Blyth, *supra* note 35 ("The information to be submitted with a ruling request is lengthy and detailed.").

36. *See* IRS Form 8832, *available at* http://www.irs.gov/pub/irs-pdf/f8832.pdf (in downloadable, "Adobe Acrobat Document" form), *alternatively available at* http://www.irs.gov ("Forms and Publications Finder," search, "Form 8832" for downloadable form).

37. Treas. Reg. § 301.7701-2(a), -3(a), -3(b)(2) (as amended in 1999) (clarifying subsection -3(a) that classification as an "association" equals classification as a corporation). Domestic business entities are classified under the same three titles. *Id.* at § 301.7701-2(a), -3(a), -3(b)(1).

38. A corporation enjoys limited liability but its income is taxed doubly, at both the corporate and shareholder levels.

39. Some partnership partner(s) suffers personal liability, but partnership income is taxed singly at the partner level.

40. *See* Treas. Reg. § 301.7701-1(a)(4), -2(a) (as amended in 1999); Michael Hirschfeld & Richard Wild, *Check-the-Box Knows No Boundaries (at Least, For the Moment)*, 482 PRAC. L. INST./TAX 1317, 1322 (2000). A disregarded entity is, for tax purposes, a partnership having but one partner, or rather one owner. *See id.* Its activities are treated the same as are those of its corporate parent; the entity's income and losses are considered income and losses of its parent owner. *See id.* It is thus "disregarded" because its activities do not bear consequences upon it as a separate entity. *See id* at 1325. Because it is ignored for U.S. income tax purposes, payments made between a disregarded entity and its owner are not recognized. *See* Birnkrant & Croker, *supra* note 16, at 45-46; Pat Grube, *Putting Tiered Entities Into a Foreign Holding Company Structure Using Check-the-Box*, 94 J. TAX'N 5 (2001).

"Disregarded entities" are also referred to as "tax nothings." *See, e.g.*, Joel Rabinovitz & Eric M. Zolt, *Tax Nothings*, TAXES, Dec. 1997, at 869, 871; Lee A. Sheppard, *Putting Checks on the Check-the-Box Rules*, 85 TAX NOTES 1353, 1354 (1999) [hereinafter Sheppard I] (satirizing, as the creator of the catchword, that disregarded entities are 'widely known' as tax nothings). Additionally, they are known as "hybrids." *See, e.g.*, I.R.S. Notice 98-11, 1998-1 C.B. 433, II; BITTKER & LOKKEN, *supra* note 16, at ¶ 69.13.1, at 69-79 (defining a hybrid as an entity disregarded for U.S. tax purposes but treated as a corporation for the foreign country's tax purposes). Disregarded entities are referred to also as "branches." *See, e.g.*, Treas. Reg. § 301.7701-2(a) (as amended in 1999) ("if [an] entity is disregarded, its activities are treated in the designated as per se corporations and their classification as such cannot be changed.[41] Otherwise, a foreign entity defaults into a classification based upon whether it has one or more than one owner, and upon whether at least one of its owners has liability that is not limited.[42] Presuming that the foreign entity wishes to operate without personal liability, it defaults into corporate status.[43] Alternatively, an entity may file an election, or "check the box," to opt out of the applicable default classification.[44] In order to enjoy the duality of limited liability and preferential tax treatment, therefore, the foreign entity files an election to opt *out of* corporate status, or stated more correctly, to opt *into* partnership or disregarded status (for tax purposes only).[45] The benefits reapable through classification as a foreign disregarded entity extend, however, far beyond partnership-like preferential tax treatment.[46]

The CTB regime has paved the way for creative tax avoidance planning options. For example, often a U.S. corporation sets up a holding company in a (typically tax favorable) foreign country in which it conducts business. This holding company may in turn set up (or

same manner as a . . . branch. . . .").

41. Treas. Reg. § 301.7701-2(b)(8) (as amended in 1999). *Cf.* Treas. Reg. § 301.7701-2(b)(1), (3)-(7) (as amended in 1999). Domestically, the CTB regulations designate corporations organized under state laws or certain federal statutes as per se corporations. *Id.*

42. *See* Treas. Reg. § 301.7701-3(b)(2) (as amended in 1999); Hirschfeld & Wild, *supra* note 40, at 1345-49 (outlining application of the check-the-box (CTB) rules internationally).

If a foreign business entity is not a per se corporation and has only one owner, then it is classified, by default, as *disregarded* if the owner's liability is not limited (i.e., if the owner is personally liable), Treas. Reg. § 301.7701-3(b)(2)(i)(C) (as amended in 1999), and as a *corporation* if the owner's liability is limited, Treas. Reg. § 301.7701-3(a), (b)(2)(i)(B) (as amended in 1999) (instructing that the regulations' classification of an entity having one owner with limited liability as an "association" is synonymous with classification as a corporation). *See also* Hirschfeld & Wild, *supra* note 40, at 1346. *Cf.* Treas. Reg. § 301.7701-3(a), (b)(1). Domestically, an entity that is not a corporation (per se or otherwise) and has only one owner is a disregarded entity by default. Treas. Reg. § 301.7701-3(b)(1). Because liability is not considered in the domestic default classifications, a domestic check-the-box election is made only to opt *into* corporate status. Hirschfeld & Wild, *supra* note 40, at 1322-23.

If such an entity has more than one owner, then it is classified, by default, as a *partnership* if at least one owner's liability is not limited, Treas. Reg. § 301.7701-3(b)(2)(i)(A) (as amended in 1999), and as a *corporation* if all owners enjoy limited liability, Treas. Reg. § 301.7701-3(a), (b)(2)(i)(B) (as amended in 1999). *See* Hirschfeld & Wild, *supra* note 40, at 1322-23.

43. *See id.*

44. Treas. Reg. § 301.7701-3(c)(1)(i) (as amended in 1999).

45. *See* Treas. Reg. § 301.7701-3(c)(1)(i) (as amended in 1999). A foreign entity having one owner (the domestic parent) free of personal liability may elect to be treated not as a corporation, but rather as disregarded for U.S. taxation purposes. *See id.* Such classification holds for U.S. tax purposes only; the entity designated as disregarded for U.S. tax purposes remains a corporation under its host country's laws. *See* BITTKER & LOKKEN, *supra* note 16, ¶ 69.13.1, at 69-79.

46. *See, e.g.*, Grube, *supra* note 40 (explaining how to implement the CTB regime to circumvent the taxable income generated through the Subpart F regime).

purchase a controlling share of stock of) one or more operating companies in alternative foreign countries. As such, any interest, royalty, or dividend income that an operating company pays to the holding company will constitute Subpart F income to the holding company.[47] Such income creates a current tax liability to the holding company's U.S. shareholders (i.e., to the U.S. corporation).[48] Alternatively, because of the CTB regulations, the operating companies may be treated as disregarded for U.S. tax purposes. As such, any monies paid by them to the holding company would not constitute Subpart F income, but merely pass through as though earned directly by the holding company.[49] Use of the disregarded classification on U.S. foreign subsidiaries thus thwarts application of Subpart F. Its use internationally therefore draws a divided response. While practitioners and corporations implementing the system see it as revolutionizing global business and opening doors, scholars of the Subpart F regime and its intended goals tout CTB as an action of Treasury and the IRS made without aforethought or appreciation for its inevitable reverberations.[50] The IRS states that U.S. multinational corporations have been derelict in implementing CTB to avoid Subpart F income.[51] Notable, however, are the facts that the CTB regime is an IRS creation, and that the IRS promulgated CTB without soliciting any advice or opinions from Congress or practitioners.

2. Treasury and the IRS Seek to Slay Their Own System

Treasury and the IRS have attempted continually since 1997 to revoke the CTB regime through regulations. In 1998, they published temporary[52] and proposed[53] regulations intended to neutralize CTB tax planning benefits.[54] Under these regulations, the conversion of a foreign

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47. I.R.C. § 954(c) (2004).

48. I.R.C. § 951(a) (2004).

49. *See* I.R.S. Notice 98-11, 1998-1 C.B. 433 (noting a similar example as a planning option disfavored by the IRS); Hirschfeld & Wild, *supra* note 40, at 1350.

50. *See, e.g.*, Sheppard I, *supra* note 40, at 1353 (submitting that Treasury had long been warned "that extending the check-the-box privilege to *foreign* entities was a really dumb idea") (emphasis added). *Cf.* Engel, *supra* note 1, at 1528 (highlighting that CTB is a system the merits of which are overwhelmingly regaled on the *domestic* front).

51. *See, e.g.*, Engel, *supra* note 1, at 1528.

52. Temp. Treas. Reg. §§ 1.904-5T, 1.954-1T, -2T, -9T, 301.7701-3T (1995).

53. Prop. Treas. Reg. §§ 1.702-1, 1.952-1, 1.954-1 through –4, -9, 63 Fed. Reg. 14,669 (Mar. 26, 1998).

54. *See* Temp. Treas. Reg. §§ 1.904-5T, 1.954-1T, -2T, -9T, 301.7701-3T (1998); Prop. Treas. Reg. §§ 1.702-1, 1.952-1, 1.954-1 through -4, -9, 63 Fed. Reg. at 14,671-73 (demonstrating the regulations' function as neutralizing international CTB). Treasury and the IRS issued the

entity's taxation classification would be ignored. More accurately, a corporation would be limited in its ability to elect to convert its foreign entity from one classification to another.[55] Thus, the designation of a foreign entity as disregarded would be revoked under the proposed regulations, causing any interest, dividend and royalty income realized by the entity to be treated as Subpart F income to U.S. shareholders. These conversion regulations[56] would have, as regards international operations, converted the CTB system into a nullity.[57] In response to what became a highly political outcry,[58] however, the proposed conversion regulations were withdrawn.[59] The IRS insisted, however,

temporary and proposed regulations concurrently with IRS Notice 98-11. I.R.S. Notice 98-11, 1998-1 C.B. 433. Rather than merely alerting practitioners and businessmen to the IRS's position on such transactions, Notice 98-11 was implemented immediately via the temporary regulations. *See Treasury Caves on Foreign Hybrid Regs.–For the Moment, Anyway*, 89 J. TAX'N 3 (Jul. 1998). *But see* Albertina M. Fernandez, *IRS's Danilack Defends Notice 98-11*, 98 TAX NOTES 97-5 (1998) (denying that the conversion regulations indicate Treasury and the IRS's intention to repeal the CTB regime).

55. *See* Temp. Treas. Reg. §§ 1.904-5T, 1.954-1T, -2T, -9T, 301.7701-3T (1995); Prop. Treas. Reg. §§ 1.702-1, 1.952-1, 1.954-1 through –4, -9, 63 Fed. Reg. 14,669 (Mar. 26, 1998). *See also* I.R.S. Notice 98-11, 1998-1 C.B. 433.

56. *See generally* Prop. Treas. Reg. § 301.7701, 64 Fed. Reg. 66,591 (Nov. 29, 1999) (dubbing as "the conversion regulations" the proposed and final regulations under section 7701 dedicated to redefining the tax consequences of changes in entity classification).

57. Hirschfeld & Wild, *supra* note 40, at 1354.

58. *See Treasury Caves on Foreign Hybrid Regs.–For the Moment, Anyway*, *supra* note 55 (speaking to Treasury/IRS negotiations with Congress); *Service Puts Six-Year Moratorium on Foreign Hybrid Regs.*, 91 J. TAX'N 67 (Aug. 1999) (indicating Jul. 9, 1999 newly-proposed regulations to be the result of political pressure). *See, e.g.*, Rep. Amo Houghton, et al., *W&M Letter to Rubin on IRS Authority in International Tax Areas*, 98 TAX NOTES 80-73 (1998) (reprinting a letter to Treasury Secretary Rubin recommending withdrawal of the conversion regulations, signed by 32 members of the House Ways and Means Committee); Bill Archer & Charles Rangel, *Letter to Treasury Secretary Rubin from Reps. Archer and Rangel Regarding Regulations on Hybrid Arrangements*, *available at* WL 1998 56 DER L-1 (Mar. 24, 1998); Sens. Connie Mack & John B. Breaux, *Mack/Breaux Letter to Paull on Notice 98-11*, 98 TAX NOTES 81-27 (1998).

See also Paul Cherecwich, Jr. & Tax Executives Institute Inc., *TEI Calls Hybrid Arrangements Notice 'Poor Tax Policy'* 98 TAX NOTES 54-34 (1998) (reprinting a letter from the Tax Executives Institute to Associate Chief Counsel Michael Danilack); Thomas J. Usher, *Business Group Reiterates Opposition to Tax Treatment of Hybrid Entities*, 98 TAX NOTES 103-20 (1998) (reprinting a letter from The Business Roundtable to Secretary of the Treasury Rubin); Arthur Andersen LLP & O'Brien-Calio, *Hybrid Branch Coalition Letter to W&M and Finance Leaders*, 98 TAX NOTES 132-19 (1998); Mark McConaghy & Bernard M. Shapiro, *Price Waterhouse Letter Asking Taxwriters to Address Notice 98-11 Concerns*, 98 TAX NOTES 117-31 (1998).

59. *See* I.R.S. Notice 98-35, 1998-2 C.B. 34 (announcing Jul. 6, 1998 that Notice 98-11, and both the temporary and proposed conversion regulations, would be withdrawn). Notice 98-35, in addition to effectively withdrawing the conversion regulations, defined its own "transition rules." *Id.* In the Notice the IRS also promised to propose regulations on the check-the-box election matter again in the future. *Id.*

Prop. Treas. Reg. §§ 1.904-5, 1.952, 1.54-1, -2, -9, 64 Fed. Reg. 37,727 (Jul. 13, 1999), published Jul. 13, 1999 technically withdrew the proposed regulations, *id.* at 37,729, and T.D. 8827, that the regulations were not killed, but merely postponed.[60] In 1999, the Agency therefore published new proposed regulations,[61] but set them to take effect so distant in the future[62] that IRS challenges based on them were rendered unlikely for many years.[63]

II. THE PRESENT: MID-LIFE CRISIS - IS SUBPART F A SELF-PRESAGED FAILURE?

In addition to the fact that taxpayers use the CTB regime to circumvent antideferral, practitioners and congressmen speculate that Subpart F on its own does not bring about its desired results.[64] But what are the regime's desired results? The capital export neutrality advocate may state *that* policy objective as the goal behind Subpart F.[65] A capital import neutrality advocate, on the other hand, may state *its* policy goal as Subpart F's desired result. Because Subpart F is a compromise, however, neither spectrumal policy agenda can be its goal; compromise

64 Fed. Reg. 37,677 (Jul. 13, 1999), published the same day, actually removed the temporary regulations. *Id.*

60. I.R.S. Notice 98-35, 1998-2 C.B. 34.

61. Prop. Treas. Reg. §§ 1.904-5, 1.952, 1.54-1, -2, -9, 64 Fed. Reg. 37,727 (Jul. 13, 1999). The proposed regulations withdrew I.R.S. Notice 98-35, basically restated the previous temporary and proposed conversion regulations, and set an at-least-six-year moratorium on their own effectiveness. *See id.*

62. *See id.* The newly-proposed conversion regulations guarantee a moratorium of at least six years. *See id.* Because the regulations, published in July 1999, were written to take effect no sooner than five years from their (earliest) July 1, 2000 finalization date, the regulations cannot take effect before July 1, 2005. *See id.* Congress was likely to impose a moratorium on the regulations had the IRS not done so itself. *See* David Benson & Margaret O'Connor, *Treasury's Retreat on Hybrid Branches*, 84 TAX NOTES 769, 771 (1998); H.R. CONF. REP. NO. 105-599, at 122-28 (1998) (proposing a six-month moratorium on the Agency's original conversion regulations).

63. *See* Hirschfeld & Wild, *supra* note 40, at 1354; *Treasury Caves on Foreign Hybrid Regs.– For the Moment, Anyway*, *supra* note 55. *But see* Harvey & Klein, et al., *Treasury and the IRS Unveil Ambitious Business Plan for 2001*, 3 BUS. ENTITIES 55 (Jul.-Aug. 2001). Treasury and the IRS list as a priority project for completion by June 30, 2002, "[f]inal regulations amending the check-the-box regulations under Section 7701." *See id.* (listing "[g]uidance concerning certain extraordinary transactions involving disregarded entities" as a separate project).

64. *See, e.g.*, Chorvat, *supra* note 21, at 842-44. *See also* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975 (1997) [hereinafter Peroni I]. In 1997, before establishment of the check-the-box regime, many Congressional and business leaders argued that the antideferral regimes were hindering international competition and contributing to the U.S. trade deficit. *Id.* at 976. *Cf.* Engel, *supra* note 1, at 1538-39. In 1961, before enactment of the Subpart F antideferral regime, many political leaders asserted that investments in foreign subsidiaries were impeding domestic growth and causing a budget deficit. *Id.*

65. *See, e.g.*, J. Clifton Fleming, Jr. et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837, 837-38 (2000).

is its goal.[66] The important questions therefore become whether the Subpart F compromise creates policy more injurious than either the capital export or the capital import neutrality policies, and whether the compromise is economically justified.

A. Economic Justification - Efficiency

The primary focus behind any economic analysis of a taxation system is the system's efficiency consequences. Efficiency in this context concerns the enhancing of worldwide economic efficiency, or the increasing of worldwide income.[67] Because this paper examines the U.S.-specific Subpart F regime, however, its economic analysis necessarily focuses on the policy issue of efficient *U.S. corporate* capital allocation.

1. Efficiency Harmed Equally by Subpart F as By Capital Import Neutrality

The typical argument against the U.S. pre-1962 territorial tax system is that it caused capital flight; U.S. corporations exported their capital investments to lower tax rate jurisdictions.[68] Domestic opponents disfavor capital flight because they believe it depletes the amount of capital resources reinvested into U.S. corporations and results in an inefficient allocation of capital resources.[69] Additionally, they proffer that tax-driven capital flight causes a depletion of the U.S. tax base. The depletion of the tax base before 1962 seemingly supports this latter belief. Economic studies suggest, however, that a territorial system would glean economic results equal to those garnered by the Subpart F regime. When taxation deferral exists in some form (as active income

66. That is to say, the policy objectives of capital export neutrality and of capital import neutrality are necessarily rendered unattainable by the Subpart F compromise. The best the left could hope for in supporting Subpart F was greater contribution to the U.S. tax base; to hope for greater would have been folly, to hope for less would have rendered Democratic support of the regime senseless. The right sought merely to stave off complete worldwide taxation as much as possible.

67. Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255, 256 (2000) [hereinafter Altshuler I]; Chorvat, *supra* note 21, at 837-38.

68. *See, e.g.*, Engel, *supra* note 1, at 1538-41. *But see* Chorvat, *supra* note 21, at 845 ("[A territorial] system will *not* cause a flight of investment away from the United States.") (emphasis added).

69. *See* Chorvat, *supra* note 21, at 842-45. Capital flight contributes to less capital repatriation, and hence less reinvestment, not merely because capital exists outside the U.S., but because capital is *retained* outside the U.S. in avoidance of repatriation of taxes. *See id.* at 844-45. Basing capital allocation decisions solely on taxation is inefficient. *See id.* at 837-38.

deferral is currently permitted under Subpart F), the amount of capital retained in foreign subsidiaries, rather than repatriated to the U.S. parent for reinvestment, is *equal* regardless of the national tax system implemented.[70] The fact that Subpart F income is *taxed* currently to U.S. shareholders does not mean such income is repatriated. Capital allocation under a territorial system would be equally inefficient to capital allocation under the current system. Moreover, what prevents U.S. multinationals from reinvesting into their U.S. operations is uniform whether a territorial or the Subpart F system is in place. Because capital repatriated to the U.S. parent results in an immediate tax liability, corporations save money by instead maintaining the capital offshore.[71]

2. Subpart F Not Economically Justified (because resource-intensive)

Given that the two systems are equally detrimental to U.S. reinvestment and the U.S. tax base,[72] the political-right reasons that we might as well rid ourselves of the encumbrancing Subpart F.[73] The U.S. would ultimately recognize greater income from savings on Subpart F maintenance and compliance expenditures.[74] The middle, however, argues that given the equal economic results, we might as well preserve Subpart F because its antideferral provisions provide at least some

70. *See* Chorvat, *supra* note 21, at 843-45 (employing several economists' and tax policy analysts' empirical research and findings). Economic illustrations suggest additionally that a worldwide taxation system, without deferral, would also see economic results equal to those of the Subpart F regime. *See id.* at 844.

71. *See* Chorvat, *supra* note 21, at 843-45; Gleckman, *supra* note 21, at 88 (noting that half of U.S. companies' foreign earnings are repatriated each year); Kurt Ritterpusch, *Tax Laws Hurt U.S. Workers Overseas, Contribute to Trade Deficit, Speakers* Say, DAILY TAX REP., May 5, 2004, at G-5 (stressing that it is U.S. tax policy that causes much multinationally-earned funds to remain offshore rather in the hands of U.S. workers). *See generally* Rosanne Altshuler et al., *Do Repatriation Taxes Matter? Evidence from the Tax Returns of U.S. Multinationals*, *in* THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS 253 (Feldstein et al., eds., 1995).

72. The Subpart F system, absent CTB, would garner nominal income from the passive income it reaches. The anti-territorial arguments stem, however, from the premise that less capital flight occurs in a non-territorial system (resulting in a great increase in tax revenue). Because economic studies show this basic premise to be false, the author considers the two systems' effects on the tax base as "equal" for her purposes, despite the nominal difference that would be caused by the passive income taxation.

73. *See* Gleckman, *supra* note 21, at 87 (quoting economist Rosanne Altshuler as saying, "We've created a huge amount of complexity, and we collect very little revenue.").

74. *See* Chorvat, *supra* note 21, at 837, 845 ("[A]dopting an actual [territorial] system would be *more efficient* than the current U.S. system.") (emphasis added); Gleckman, *supra* note 21, at 89; Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001).

nominal increase in the U.S. tax base.[75] This line of reasoning is circular, however, given that any income subject to current taxation under Subpart F necessarily is not maintained offshore inefficiently.[76] The amount of income held offshore, in avoidance of repatriation taxation, should be less under the Subpart F system than it would be under a territorial system. Yet, economic analysis concludes that capital allocation to foreign subsidiaries is equally inefficient under both systems.[77] What does this suggest? That non-tax, business economic reasons to invest and operate internationally exceed purely tax economic incentives not to. Economic analysis thus seemingly favors territoriality as the most efficient taxation system. Subpart F loses because its convoluted structure of subject income, exceptions, limitations, and rulings make it prohibitively cost-intensive.[78]

The political-left contends, however, that if economic data find Subpart F and territoriality to result in the same detrimental incentive to hold capital offshore, economic data support establishment of a worldwide taxation system. A worldwide, complete antideferral, system curbs all tax-driven incentive to maintain income in foreign subsidiaries. Corporations therefore allocate capital to its most efficient use, including reinvestment in the U.S.-based parent corporation.[79] The author has found to date, however, no *economic* studies mentioned that suggest the economic superiority of a worldwide taxation system.[80] Additionally, the same analysts concluding the equality of Subpart F with a territorial system, as to capital retention offshore, suggest further that territoriality

75. *See* Gleckman, *supra* note 21, at 86 (finding that the U.S. Treasury collects as little as $5 billion a year from its international tax regime).

76. Subpart F deems subject income repatriated currently, creating an immediate tax liability. A territorial system permits the corporation to repatriate income when it chooses to do so; only physical income payment to the U.S. parent constitutes repatriation and creates a tax liability. The incentive to hold income offshore, in avoidance of repatriation taxation, therefore exists only under the territorial system. If a corporation chooses nonetheless to maintain offshore, income that has incurred current tax liability under Subpart F, it does so for *non-tax*, and therefore presumably efficient, reasons.

77. Keep in mind that the economic data analyze Subpart F *absent* the CTB regulations' effects on it. Given CTB, the left would again lose on its 'U.S. tax base' argument.

78. *See* Gleckman, *supra* note 21, at 88. "Companies are diverted from the business of selling products and instead focus time and money on cutting taxes . . . [with] the nation's 500 biggest companies spend[ing] more than *$1 billion a year* complying with the tax laws . . . perhaps half of [which] cost is linked to international tax rules." *Id.* (emphasis added).

79. Altshuler I, *supra* note 68, at ¶ 8.

80. See Fleming, *supra* note 66, at 25-66, for acknowledgment by pro-worldwideist tax practitioners that they base their contentions solely on tax theory, and not on economic data or findings. Compare Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni II], which mentions economic studies in its discussion of anti-deferral.

is the superior economic choice in a taxation system.[81]

B. Policy Creation - Competition

The primary focus of the policy analysis on Subpart F must be its effects on competitiveness, or on the maximization of U.S. (corporate) income.[82] Because it is neither a purely worldwide nor a purely territorial taxation system, Subpart F necessarily accomplishes neither of the competitiveness goals of capital export[83] or capital import[84] neutrality. What, then, are the effects on competition of the semi-worldwide, semi-territorial, Subpart F regime? The evaluation flows from the previous efficiency analysis.

1. U.S. Competitiveness Injured More Greatly by Subpart F than by Capital Import Neutrality

a. The Worldwide System

Presuppose a situation where the only two countries in the world, X and Y, implement worldwide taxation systems. Country X taxes its corporations (or their shareholders) on their (or their subsidiaries') income earned both in country X and in country Y. Country X does not tax income generated within its borders by country Y corporations at all. Country Y's tax system mirrors country X's. Theorize further that country Y's corporate income tax rate is lower than country X's tax rate. If a country X corporation invests its capital in country Y, it receives no tax benefit in doing so because its income is taxed at country X's

81. *See* Chorvat, *supra* note 21, at 844-57; *U.S. Should Respond*, *supra* note 21.

82. *See supra* § I. The policy goals at issue in creating the Subpart F compromise were capital export neutrality and capital import neutrality. *See supra.* The primary focus of these policies is competition; a desire for increased competitiveness between multinational and solely domestic U.S. corporations is pitted against a desire for increased competitiveness between U.S. multinationals and their local foreign rivals. *See supra.* A secondary focus of the policies is the efficient allocation of corporate capital. *See id.* The effects of Subpart F on this policy issue are analyzed in conjunction with an analysis of economic results of Subpart F. *See supra* § II.A. *See also* Chorvat, *supra* note 21, at 837 (noting that competition-oriented policies are necessarily nationalistic).

83. U.S. corporations are not prevented completely from making investment decisions based on international tax rates because active foreign-source income is not taxed currently by the U.S. International tax competition, or tax arbitrage, therefore exists to some extent, and the goals of capital export neutrality are not achieved.

84. Similarly, U.S. multinationals are prevented from enjoying free tax competition because their passive foreign-source income is taxed currently by the U.S. International tax competition is therefore curbed and the goals of capital import neutrality are not met.

(higher) tax rate regardless of where it is earned. Regardless of whether, and to what extent, the corporate tax rates of the two states differ, the rates do not cause inefficient capital allocation. The states enjoy capital export neutrality and *worldwide* income is maximized.

The policy has a drastically different effect, however, on the countries' individual national welfares. Because their country taxes income at a higher rate (than does country Y), country X corporations realize lower after-tax capital returns on investment than do country Y corporations. Country X corporate residents therefore have less income to reinvest, and hence lower savings, than their country-Y business rivals. Because country X does not tax any of the income generated within its borders by country Y corporations, this imbalance does not even out. Country X's comparatively high tax rate weakens its corporations and destroys their ability to compete with country Y corporations. Country X's economic welfare as a whole is disadvantaged and its international competitiveness necessarily destroyed. The worldwide taxation system is thus *domestically* injurious because it does not respect capital import neutrality.

b. The Territorial System

Presume a second situation where the two countries, X and Y, employ territorial taxation systems. Country X taxes its corporations solely on their income earned within country X (and not on their income earned within country Y). Country X also taxes income generated within its borders by country Y corporations. Country Y's tax system mirrors country X's. Hypothesize further that country Y's corporate income tax rate is lower than country X's tax rate. A country X corporation has an incentive to invest its capital in country Y because income generated by the investment will be taxed at a rate lower than if the corporation invested within its own country. Country X corporations may therefore base investment decisions on tax rate differentials. Doing so results in inefficient capital allocation and the failure to maximize worldwide welfare. The territorial taxation system thus prevents capital export neutrality and causes harm to the *global* reallocation of wealth.

The policy has a drastically different effect, however, on the countries' individual national welfares. Because country X taxes investments made within its borders congruently (regardless of whether made by country X or country Y corporations), country X corporations realize after-tax capital returns on domestic investments equal to those of country Y corporations investing within country X. Similarly, country

X corporations investing in country Y realize after-tax capital returns equal to those of country Y corporations also investing within that country. Country-X corporate residents have income and savings equal to their country-Y business rivals and therefore are able to compete internationally. The countries' corporations are free to compete efficiently on business-oriented, market-based, non-tax, grounds. The two states' economic welfares have the potential to be equal. Whether they are is determined by how well the countries' corporations compete. The states effect capital import neutrality and garner the opportunity to maximize their individual *national* welfares.

c. The Realistic System

Neither of the above-mentioned situations exist or could ever occur. There are far more than just two countries in the world, even if one only considers the countries U.S. multinationals conduct business within regularly. Maximization of worldwide economic efficiency (in relation to taxation), or of U.S. (corporate) income, requires that *all* nations partake of a purely[85] worldwide or purely territorial taxation system, respectively. All states must individually agree, with all other states, to implement domestically the same worldwide or territorial systems. All states must create and implement these systems. All states must permit other states to inspect, comment on, and demand change of, their system. This is the only way to ensure conformity and to ensure a system maximizing worldwide economic efficiency or individual domestic incomes (U.S. domestic income), whichever is its objective. This is impossible.[86] Each of these economic objectives is therefore unachievable and unrealistic.[87] Analyzing which (if either) of the situations is more advantageous may have theoretical value, but doing so

85. *See* Altshuler I, *supra* note 68, at ¶ 4. In fact, no nation has a pure system of any kind. *Id.* Territorial systems typically adopt some anti-abuse (anti-deferral) measures, and worldwide systems may permit some deferral. *Id.* The author therefore uses "purely" loosely in this context to denote nations employing systems as worldwide, or as territorial, as possible; these systems are not compromise systems such as Subpart F.

86. *See, e.g.*, Daniel J. Mitchell, *A Tax Competition Primer: Why Tax Harmonization and Information Exchange Undermine America's Competitive Advantage in the Global Economy*, *at* http://www.heritage.org/Research/Taxes/BG1460.cfm (July 20, 2001) (last visited 2/23/2005). U.S. corporations subject to the semi-worldwide, semi-territorial, Subpart F system conduct business, for example, in and with predominantly territorial European systems. *See id.* Ironically, the OECD, comprised of the same territorial-taxation-system EU nations as is the WTO, seeks for its nations to shift to worldwide taxation systems. *Id.*

87. *See* Graetz, *supra* note 75, at 294 (denoting worldwide economic efficiency as unrealistic and hence of little policy value).

provides no practical value.

What then, are the effects on domestic competition of the realistic Subpart F regime? Simply put, the effects are better than those seen in a globally implemented worldwide system, and less advantageous than those seen in a globally implemented territorial system. They are better than those probable in a domestically implemented worldwide system, and less advantageous than those possible in a domestically implemented territorial system. This is everything we need to know to answer our policy question; the Subpart F compromise creates a competitiveness policy more injurious than would be the territorial, capital-import-neutrality, policy.

2. Subpart F Not Economically Justified

Is it a bad thing that it is impossible to achieve a purely worldwide, capital export neutral system? Such a system would eliminate international tax competition, a form of competition Democrats typically chastize because of its resulting inefficient allocation of capital resources.[88] Other than capital allocation, what does the elimination of competition in this context effect? "[T]ax competition pressures politicians to be fiscally responsible," in order to preserve low tax rates and "to attract economic activity (or to keep economic activity from fleeing to a lower-tax environment)."[89] When a government is fiscally irresponsible with taxpayer dollars, or otherwise fails to serve its function by acknowledging taxpayer needs and promulgating sound policy, taxpayers can, in a competitive system, take their business elsewhere.[90] Exporting capital investment to foreign, lower-tax jurisdictions forces a domestic government to use most efficiently its monetary resources - taxpayer dollars. If the government abuses its fiscal power, it will have to cease doing so in order to regain (and to prevent the addition to) corporate capital invested offshore; it will have to cut abusive expenditures to lower tax rates. International tax competition therefore serves as a check on governmental power and forces more efficient use of taxpayer capital. Similar policy objectives

88. *See supra* § II.A.1.and accompanying footnotes (expounding upon the arguments against international tax competition).

89. Mitchell, *supra* note 87.

90. *See* Gleckman, *supra* note 21, at 86 (quoting a practitioner's belief that competitive pressures will continue to force down corporate tax rates due to the mobility of capital). "Tax rates in other countries are much lower. It's not a choice. If you don't deal with [it], you get extinguished." *Id.* at 88 (quoting Stanley Works Chief Executive Officer John Trani).

underlie all forms of competition.[91]

The maximum-welfare tax system that the political left proposes would ultimately leave citizens exploited by their governments, and governments shackled by their membership in a global bureaucracy. These facts theorize again on a non-existent and impossible globally implemented system. Similar results may transpire, however, through implementation of a domestic worldwide taxation system.[92] Without international tax competition, a government is free to levy taxes at its will. Because a worldwide taxation system taxes resident income regardless of its source, a taxpayer has no recourse against a government abusing its fiscal power. If corporations export their capital, income they generate will be taxed at the same oppressive rates as if earned at home.[93]

Given the impossibility of maximizing either worldwide income or U.S. (corporate) domestic income through a fictitious world, the U.S. goal should be to maximize its income within the existing world. Congressional installation of a territorial taxation system would best serve this goal.[94] One need not look beyond the fact that territoriality maximizes U.S. corporations' international competitiveness[95] and individual incomes to conclude that the Subpart F regime is not economically justified. The existence of a better alternative invalidates continued use of the current compromise system.

Some tax practitioners and economists thus conclude that the Subpart F compromise system does not serve policy or economic goals. In fact, it is injurious, they believe, to competitiveness concerns and causes the inefficient maintenance of corporate capital offshore.[96] They

91. *See generally id.* (detailing the benefits of competition to entrepreneurship, economic growth, and consumer welfare in addition to governmental restraint and economic efficiency).

92. What will occur if the fifteen European Community countries conform to one, worldwide, taxation system? The abusive governmental practices resultant of a worldwide taxation system are even less theoretical when viewed in the context of this block of states, than when viewed in the context of one state.

93. *See generally* Mitchell, *supra* note 87.

94. *See supra* §§ I.B.1., II.B.1.b and accompanying notes (explaining that territorial tax systems maximize domestic income).

95. *See U.S. Should Respond*, *supra* note 21.

96. *See, e.g.,* Ritterpusch, *supra* note 72, at G-5. United States tax treatment of U.S. nationals working overseas is so unfavorable that it discourages such practice and has depleted the nation's presence and market share around the world. *See id.* "It's very difficult to get our share of the market when we carry around like a backpack of cinder blocks the Internal Revenue Code." *Id.* (quoting political economist Daniel Mitchell). These problems "signal[ ] the need for a territorial tax system." *Id.*

"U.S. tax laws have become, in essence, penalties that non-U.S. nationals do not have to work through, thereby giving them more opportunities to build experience working abroad." *Id.*

state further that installation of a territorial system would not merely be less injurious, but would be more economically efficient and therefore more policy-sound.[97] We must therefore look at these experts as pro-territorialists. There are, however, pro-worldwideist tax practitioners who conclude similarly that the Subpart F compromise cannot, and has not, achieved sound policy objectives.[98] Their arguments seem to center, however, on the premise that the Subpart F system is a failed one solely because that system cannot achieve capital export neutrality (their favored policy). The author has found to date no *economic* studies mentioned that proffer the economic superiority of a worldwide taxation system over the Subpart F system.[99]

Subpart F is not capable of achieving the policy goals behind its creation. The system fails because there exists an alternative option (territoriality) demonstrating equal, if not improved, results to that of Subpart F, but without Subpart F's complications and resource-intensiveness. The current international tax system thus clearly needs help. Merely because it proves Subpart F inept, territoriality is not necessarily the answer. While there is avid support for establishing a territorial tax system in the U.S., there is just as avid support for continuance of some form of compromise tax system, be it through increased regulation or through the retraction of the CTB regime, and equally avid support for instituting a worldwide taxation system.

III. THE FUTURE: LOOKING TOWARD RETIREMENT – RENOVATION OR RESTORATION?

A. Renovation through Regulation. . .

1. . . . Re-vamp Subpart F

Forty years after Kennedy's proposal, there still exists avid support

"[T]he tax laws make hiring U.S. nationals overseas too expensive for many companies, and should be replaced with policies that encourage U.S. individuals to work overseas." *Id.* "The problem is one of our own making, 'not that we're sending jobs [overseas], it's that we're not exporting our products to [foreign countries] because we don't have people there selling them.'" Ritterpusch, *supra* note 72, at G-5.

97. *See* Chorvat, *supra* note 21, at 838, 845-56; *U.S. Should Respond*, *supra* note 21; Gleckman, *supra* note 21, at 88 (stating that today's Subpart F system is so inefficient that a return to a territorial system may generate $7 billion).

98. *See, e.g.*, Fleming, *supra* note 66, at 25-66.

99. *See id.* To the contrary, pro-worldwideist tax practitioners acknowledge that no economic studies may so exist. *Id.*

for the establishment in the U.S. of a truly worldwide taxation system.[100] Whether through additional regulations supplementing Subpart F or through a newly created regulatory or legislative regime, the liberal left seeks to renovate antideferral by completing it.[101] Such advocates view taxation deferral in the international context as a privilege, as an exception to the rule of taxation.[102] They believe investment decisions based on tax rates are inefficient decisions, and that international tax competition injures domestic U.S. corporations. Worldwide system proponents find it important to remember, in evaluating the Subpart F compromise, that the regime permits much taxation deferral. They argue that Subpart F is too weak, is openly avoidable, and permits vast deferral of taxation on foreign-source income.[103]

2. . . . Scale-down CTB

Many moderate practitioners and politicians, both Republican and Democrat, advocate alternatively the continuance of a compromise

100. *See Fact Sheet on John Kerry's Plan to Create 10 Million Jobs*, U.S. NEWSWIRE, Mar. 26, 2004 (reprinting the "John Kerry for President" release of Kerry's election platform tax plan that seeks to tax immediately *all* corporate income whether earned domestically or internationally). *Cf.* Gleckman, *supra* note 21, at 87 (defining one policy option where "[c]ompanies would pay tax on [] revenues in the year they are earned, rather than when they repatriate the money back to the U.S.[; i]n return, they would get a tax-rate reduction"). Kerry's tax plan mimics almost word for word the policy defined in Gleckman's September 9, 2002 Business Week article, except it is unclear whether Kerry supports taxation of domestic and foreign-source income at equal rates, or whether he actually intends to make the foreign-source income rate higher. *See id.* C*f. Fact Sheet on John Kerry's Plan to Create 10 Million Jobs*, U.S. NEWSWIRE, Mar. 26, 2004. Regardless of any corporate tax rate change, U.S. levies on its corporations remain in excess of the average for major industrialized nations. *See* Howard Gleckman, *Is Kerry's Jobs Proposal Jinxed? Rejiggering foreign taxes is politically savvy, but it won't help unemployment much,* BUS. WK., Apr. 12, 2004, at 36, 38 (discussing Kerry's international tax reform plan).

101. *See generally* Fleming, *supra* note 66; Peroni II, *supra* note 81.

102. *See, e.g.*, *Fact Sheet on John Kerry's Plan to Create 10 Million Jobs*, U.S. NEWSWIRE, Mar. 26, 2004. Kerry views the current deferral of taxation on non-Subpart F income as a "tax break". *See id.*

103. *See* Peroni I, *supra* note 65, at 975-76; Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F? Response to Professor Engel*, 79 TEX. L. REV. 1609 (2001) [hereinafter Peroni III] (considering arguments favoring worldwide taxation compelling and those favoring territorial taxation or continued compromise weak).

See Mitchell, *supra* note 87. It is interesting to note that this typically Democratic point of view mimics what the Organization for Economic Cooperation and Development (OECD) seeks to do through its proposed global information exchange program. *Id.* The OECD demands that member countries impose economic sanctions against nations refusing to share financial and investment information that would enable the OECD countries to monitor, and thereby tax, their residents' worldwide income. *Id.* Implementation of the program would prevent international tax competition. *Id.*

system.[104] Regardless of whether they do so because they believe the Subpart F regime works well, or because they view fruition of either alternative – a worldwide or a territorial system – as politically unachievable,[105] these proponents support a middle ground.[106] Treasury and the IRS have favored additions to the CTB regulations as a method of so renovating the existing antideferral regime.[107] One such addition receiving vast support is the Treasury's proposed extraordinary transaction regulation (ETR).[108] The ETR scales down the current applicability of the CTB by revoking the classification of a foreign entity as disregarded when such designation is made in conjunction with an extraordinary transaction.[109] The regulation defines the sale, exchange, transfer, or other disposition of a ten percent or greater interest in a foreign entity as an extraordinary transaction triggering the classification revocation.[110] The proposed regulation thus prevents tax avoidance in perhaps the more limited instances where foreign entity reclassification "materially alters the federal tax consequences" of an extraordinary transaction.[111] The ETR prevents circumvention of this rule via a shelf entity[112] by also retracting an entity's disregarded classification when

104. *See* Gleckman, *supra* note 21, at 87-88 (noting many Democrats' fear of anything more than modest reform, as well as a multinational corporation's council's preference that Congress "repair[ ] the current system rather than replacing it").

105. *See, e.g.*, Engel, *supra* note 1, at 1562 ("After years of debate, any triumph of purity seems doubtful. Neither the political forces in favor of a pure antideferral approach nor the political forces in favor of a pure territorial approach have the clout for complete victory.").

106. *See* Engel, *supra* note 1, at 1563-80 (arguing in favor of retaining a system of compromise).

107. *See, e.g.*, *supra* § I.D. (outlining Treasury and the IRS's attempt to regulate international CTB out of existence).

108. *See, e.g*, *IRS Elves Get Early Start on Reg. Projects*, 92 J. TAX'N 4 (2000) (referring to the reclassification of foreign entities in the face of extraordinary transactions as abusive and inappropriate); Lee A. Sheppard, *News Analysis – Interest Deduction Denial by the Back Door*, 90 TAX NOTES 1599, 1602 (2001) (citing as logical the IRS's ability to insert additional transactions into its definition of an "extraordinary transaction") [hereinafter Sheppard II].

109. *See* Prop. Treas. Reg. § 301.7701-3(h)(1)(i), 64 Fed. Reg. 66,591 at 66,592 (Nov. 29, 1999). The extraordinary transaction must occur within a period beginning one day before and ending 12 months after the date that the foreign entity is reclassified to disregarded status. *See* Prop. Treas. Reg. § 301.7701-3(h)(1)(i)(A), 64 Fed. Reg. at 66,594. The entity must have enjoyed corporate status at some point during the 12 months preceding the extraordinary transaction. *See* Prop. Treas. Reg. § 301.7701-3(h)(1)(i)(B), 64 Fed. Reg. at 66,594.

110. *See* Prop. Treas. Reg. § 301.7701-3(h)(1)(i)(A), 64 Fed. Reg. at 66,592, 66,594.

111. *See* Prop. Treas. Reg. § 301.7701-3(h)(3), 64 Fed. Reg. at 66,594 (providing exception where taxpayer demonstrates that a reclassification otherwise falling within the ETR "does not materially alter the Federal tax consequences of the extraordinary transaction").

112. *See* Pillow & Rooney, *supra* note 33. A shelf entity is a U.S.-owned foreign entity classified as disregarded for U.S. purposes for longer than twelve months plus one day prior to its execution of an extraordinary transaction. *See id.* The shelf entity's established disregarded status

such entity makes an "acquisition transaction" in conjunction with an extraordinary transaction.[113]

It is instances where the tax consequences of an extraordinary transaction would be significantly different, if not for the concomitant change in classification, that Treasury and the IRS tout the ETR as seeking to curb. As such, the proposed regulation is essentially an anti-abuse measure. Applicable where a corporation exercises an entity reclassification blatantly with the sole purpose of avoiding the taxation of a large deal, the merits of the anti-abuse rule are virtually unchallengeable. Whether or not the ETR is indeed more limited in scope than its predecessor conversion regulations, however, is reliant upon what transactions the ETR deems "extraordinary" for the regulation's application.[114] While the ETR proposal provides examples, it does not limit itself in application to situations mimicking these examples. In fact, Treasury and the IRS expressly leave open for themselves[115] the opportunity to add transactions to the extraordinary transaction definition as they see fit. However, because Treasury and the IRS promulgated the ETR in response to the moratorium Congress placed on the conversion regulations, some practitioners and politicians fear the government seeks still full conversion of the CTB's international tax effects.

B. Restoration through Revocation. . .

1. . . . Put a Stop Order on Check-the-Box

Implementing the previously discussed proposed conversion regulations would restore the pre-CTB Subpart F regime by effectively revoking the application of CTB internationally.[116] Doing so remains a

is used in an attempt to circumvent the ETR's twelve-month stay on extraordinary transactions. *See id.* at 204-06.

113. *See* Prop. Treas. Reg. § 301.7701-3(h)(2)(i), 64 Fed. Reg. 66,591, 66,594 (Nov. 29, 1999).

114. *See generally* Pillow & Rooney, *supra* note 33 (calling into question the vagueness of the extraordinary transaction definition). The regulations do not define, for example, what constitutes an "interest" for purposes of the ten percent threshold. *Id.* at 206. Whether attribution rules apply or whether only directly owned shares of stock are to be considered is not discussed. *Id.* Furthermore, whether stock is the only subject of concern or whether other rights bear the "interest" designation is not defined. *Id.* Additionally, what is an "other disposition" is left open for interpretation. *Id.* For example, one knows not whether a liquidating distribution would fall within the provision. *Id.*

115. *See* Birnkrant & Croker, *supra* note 16, at 51-53 (analyzing administrative versus Congressional authority).

116. *See supra* § I.D.

viable goal; the IRS asserts its intention to see the conversion regulations effected, and many tax scholars advocate restoration of Subpart F.[117] Alternatively, some compromise advocates seek direct revocation of the CTB internationally through amendment of the CTB regulations. Removing the international portion of the CTB regulations from the books would effect the same goal as effecting the conversion regulations, but with less paperwork and greater ease to both the government and taxpayers.

2. . . . Rescind Cross Border Tax, Subpart F

Forty years after fierce opposition to the Kennedy proposal forced compromise, proponents of a U.S. territorial tax system retain a loud voice.[118] In fact, in light of recent events,[119] the conservative political right had, for a time, great momentum to revoke the Subpart F regime entirely and restore the U.S. to territoriality.[120] The right views taxation deferral in the international context as the rule, and Subpart F's antideferral provisions as its exception.[121] Even if Subpart F does not affect capital repatriation directly, support for the regime's revocation

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117. *See, e.g.*, Engel, *supra* note 1, at 1603-06 (proffering several alternative systems, all geared at continued compromise).

118. *See* Gleckman, *supra* note 21, at 87 (noting House Ways & Means Committee Chairman Bill Thomas as wanting to "scrap the whole mess" because it is "out of sync with the rest of the world"); Ritterpusch, *supra* note 72, at G-5 (highlighting Veronique de Rugy as advocating a territorial tax system as an "incremental step[ ]" to fundamental tax reform). *See also* Nancy Ognanovich, *Cheney Attacks Kerry's Proposals to Cut Corporate Tax Rates and Alter Subpart F*, DAILY TAX REP., Mar. 30, 2004, at G-8 ("The way to add jobs in this economy is to win the competition for world markets, and to sell more goods that say 'Made in America'" (quoting Vice-President Dick Cheney)); Martin Crutsinger, *Bush Avows Free Trade Despite Dem Attacks*, ASSOC. PRESS, Apr. 9, 2004 (speaking to President Bush's proponents of "tearing down barriers to U.S. exports").

While Democrats, John Kerry specifically, admonish the Bush Administration for the U.S.'s nearly $500 billion trade deficit, *see* Crutsinger, *supra*, some political economists blame the U.S. international taxation system for "the ballooning trade deficit," *see* Ritterpusch, *supra* note 72, at G-5. Such economists call for a territorial taxation system to relieve the export deficit. *See id.* If the economics of such conclusions are correct, the '"economic isolationist,'" nature of Kerry's worldwide taxation platform would further obliterate U.S. exportation. *See* Crutsinger, *supra* (quoting President Bush).

119. *See infra* § III.C.

120. The more immediate concerns of the war on terror, U.S. operations in Iraq, the presidential election, and existing tax cuts that were slated to expire at the end of 2004 tabled the conservatives' focus on massively overhauling the international tax regime and pushing for restoring territorialism to U.S. income taxation. Nonetheless, legislation calling for the repeal of portions of the international tax code and Subpart F particularly has been promulgated continually. *See, e.g.*, Fairness, Simplification and Competitiveness for American Business Act, H.R. 285, 108th Cong. (2003).

121. *See* Rosenbloom, *supra* note 18, at 156-63 (2000).

exists nonetheless in the fact that it provides no greater economic benefit than does its non-existence.[122] Given that its eradication would cause no injury, lawmakers need no additional reason to cease maintenance and enforcement of the intricate, resource-intensive Subpart F regime. An additional positive benefit exists nonetheless. The U.S. government and its taxpayers would ultimately recognize greater income, from savings on Subpart F maintenance and compliance expenditures, if lawmakers revoke the regime.[123]

C. Attainability – Is it Too Soon to Retire, Or is the Time Right?

The current political make-up of Congress does not permit establishment of a worldwide, greater anti-deferral taxation system. Continued compromise is always the most likely outcome. Even if done through extensive, long-term, hotly-contested debate, in the end some form of compromise system is still the easiest to enact.[124] However, three sets of events timely cause the establishment of a territorial tax system to be a realistic possibility. First, vast implementation of the CTB regime to circumvent Subpart F, as discussed previously, has sparked many to reconsider the usefulness of Subpart F and whether lawmakers should not simply revoke the regime.

1. U.S. Corporate Icons Inverting Into non-U.S. Corporations

Second, many large, well-known, U.S. corporations have, in recent years, reincorporated as non-U.S. corporations in avoidance of the Subpart F regime.[125] Reincorporating under Bermuda law, for example,

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122. *See supra* § II.

123. *See* Gleckman, *supra* note 21, at 89 (quoting two economists as saying that the U.S. international tax regime "is so inefficient . . . that exempting overseas income from taxes would actually generate $7 billion more for the Treasury than the current regime, which is supposed to be taxing it"). Corporations and tax practitioners have, without a doubt, masterminded numerous means by which to circumvent Subpart F. *See generally id.* However, any tax savings generated by such acts cost business – not only in exorbitant accountant and tax attorney fees, but in lost entrepreneurial opportunities and sound business judgment – as time and focus are shifted from the business of doing business to the art of cutting taxes. *See id.* at 88. *See also, e.g.*, Chorvat, *supra* note 21, at 836 (calling on the U.S. to adopt a territorial, or exemption, system with retention of certain anti-abuse rules).

124. *See* Gleckman, *supra* note 21, at 86, 89 (pondering whether Congress will merely band-aid the crisis with corporate tax cuts or initiate true reform and concluding it will go the route of the modest fix).

125. *See* Glen Johnson, *Congress Looks to Plug Tax Loophole – Bill Targets Advantages Sought by U.S. Firms that Incorporate Offshore*, BOSTON GLOBE, Mar. 12, 2002, at D1 (3d ed.); David Cay Johnston, *U.S. Corporations Are Using Bermuda to Slash Tax Bills*, N.Y. TIMES, Feb. 18, 2002, at A1; Susan Pulliam, *Reincorporating Companies Find Bermuda a Place to Shed Some*

subjects a (formerly U.S.) corporation to the domestic taxation laws of Bermuda. What were foreign corporate operations in Bermuda thus become domestic operations, and what were domestic corporate operations in the U.S. invert to foreign operations. Because Bermuda implements a territorial taxation system, the U.S. operations are thus subject only to taxation by the U.S. as a foreign taxing jurisdiction; Bermuda does not also tax the foreign-source income. By inverting, the corporation thus eliminates application of, and the hassles of dealing with, dual taxation and the Subpart F regime with all its rules, exceptions, credits, and exceptions to exceptions. Additionally, the corporation enjoys a lower (or no) domestic income tax rate in its new home country than it paid in the U.S.[126]

U.S. icon corporations state as their reason for reincorporation the oppressive nature of Subpart F, and the U.S. semi-worldwide taxation system in general.[127] Regardless of whether this is the sole reason for the recent inversions, two things are clear. First, only renovation of the U.S. international taxation system is likely to provide a long-term incentive for these corporations to return to the U.S. or to prevent further inversions.[128] Second, the type of renovation the corporations demand,

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of Those Extra Taxes, WALL ST. J., Feb. 19, 2002, at C4. Tyco International, Ingersoll-Rand, and Accenture have all re-incorporated in foreign nations. *See* Gleckman, *supra* note 21, at 86-89.

See also Tim McLaughlin, *Tyco Shareholders Approve Bermuda, PwC*, REUTERS, Mar. 7, 2003 (reporting the company's shareholder vote to remain incorporated in Bermuda). Pro-tax liberal Democrats have coined the heads of inverting corporations, "'Benedict Arnold CEOs.'" *See* Gleckman, *supra* note 101, at 36 (quoting John Kerry).

126. *See* Johnson, *supra* note 126, at D1; Johnston, *supra* note 126, at A1; Pulliam, *supra* note 126, at C4. Inversions have occurred recently predominantly because of the weakened economy. *See* Johnston, *supra*. Stock prices have dropped significantly for many multinationals, resulting in the realization of little or no capital gains to shareholders upon the sale of such stock. *See id.* Invoking a § 367 constructive stock sale through inverting does not, therefore, currently serve as a barrier to inversion for many corporations. *See id.* In fact, some multinational shareholders have benefited from their corporations' inversions through the recognition of resultant stock sale losses. *See id.* This turn of events is ironic because President Bush and Republicans in general have had as a driving force behind their political strategies and policy proposals, since even before the waging of war against the U.S. on Sept. 11, 2001, the strengthening of the U.S. economy. Incidentally, that the U.S. economy has continued to strengthen seems a fairly accepted belief since Federal Reserve Chairman Alan Greenspan recently spoke to Congressional committees on the issue.

127. *See* Ritterpusch, *supra* note 72, at G-5 (citing U.S. tax policy as the *cause* of companies' essential renouncement of their U.S. citizenship). "[W]orldwide taxation is a burden that is driving American companies to other nations." *U.S. Should Respond*, *supra* note 21.

128. *See generally Gleckman*, *supra* note 101 (summarizing economists' and multinational CEOs' sentiments that a territorial system is required to remedy inversions). *But see* Curt Anderson, *Democrats Take on Tax Havens Issue*, ASSOC. PRESS, Jul. 31, 2002 (defining other means by which to prevent inversions); Allan Sloan, *Is Moving Offshore Going Too Far?*, WASHINGTON POST, May 28, 2002, at E1 (admonishing PricewaterhouseCoopers for its plans to invert its consulting arm). Stanley Works, another U.S. corporate icon, caved to a public outlash

and for which the inversions open the door, is the restoration of a territorial system.[129]

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against its inverting overseas, despite having already finalized the decision for economic, business reasons. *See* Masha Herbst, *Stanley Approves Tax Move to Bermuda*, WASHINGTON POST, May 10, 2002, at E3 (noting the business reasons behind Stanley Works' decision to invert); *Gleckman*, *supra* note 101 (explaining Stanley Works' decision not to invert).

Whether it is because they are moderates advocating reparation of the current system, or conservatives trying to gain any headway at a time when they will not win on drastic reform, House and Senate Republicans continue to legislate changes to the existing system. *See, e.g.*, American Jobs Creation Act, H.R. 4520, 108th Cong. (2004); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. (2004). Democrats have won a key measure in the Senate form of the ETI repeal bill. *See* S. 1637. This legislation would cause inverting corporations to recognize tax on stock options in the inversion process, curbing what is currently a major appeal of inversions. *See* Kurt Ritterpusch, *Export Tax Repeal Bill Would Strip Benefits of Inverting Firms' Deferral of Stock Gains*, DAILY TAX REP., May 12, 2004.

Even treaty negotiations, arguably Republican right now, demonstrate some similar maneuvers to penalize inverted corporations; a recent U.S-Barbados treaty protocol was executed specifically so that a corporation will now be eligible for U.S.-Barbados treaty benefits only if its principal class of stock is listed and traded in the corporation's state of incorporation. *See* Alison Bennett, *United States, Barbados Sign Tax Protocol Aimed at Shutting Down Treaty Abuses*, DAILY TAX REP., Jul. 15, 2004. This precludes inverted U.S. corporations, which are incorporated in Barbados but trade on U.S. stock markets, from reaping whatever treaty benefits they relied upon in making the economic choice to invert. *See id.*

John Kerry believes that instituting a worldwide taxation system will cause U.S corporations to return home or never leave; presumably, Kerry discerns that because such a system taxes income at the same rates regardless of whether it is earned within or without U.S. borders, such a system will remove all motivation to invest abroad rather than domestically. *See* Gleckman, *supra* note 101, at 36, 38 (stating Kerry's plan and noting that economists see no change in unemployment resulting from it). One of the critical points Kerry's reliance on the Kennedy-era plan ignores is the overwhelming mass of U.S. business investment that *already exists* overseas. At the time of the Kennedy Administration's plan, foreign trade, albeit booming after the release of isolationism and the promotion of economic freedom resulting from World War II, it was still miniscule at best in comparison to the depth to which American commerce pervades the globe today. While Kerry's plan seeks specifically to "punish[ ] others that are scrambling to compete overseas," *see* Gleckman, *supra* note 101, at 36, it will also cause "a cash-flow nightmare for businesses" already operating overseas, *see* Gleckman, *supra* note 21, at 89.

See Gleckman, *supra* note 21, at 86 ("If nothing else, there is broad agreement that the system needs fixing."). "In the end, Washington is going to have to find a way to modernize its tax code. Or else it can expect to see more and more U.S. companies shipping out." *Id.* at 87.

129. *See* Johnston, *supra* note 126, at A1 (noting statements that U.S. tax laws discriminate against U.S.-based multinational corporations and that the inversions to Bermuda should prompt Congressional change); Pulliam, *supra* note 126, at C4 (quoting Treasury assistant secretary for tax policy, Mark Weinberger, as suggesting that antiquated U.S. international tax laws are driving corporations to invert); Richard A. Westin, *Expatriation and Return: An Examination of Tax-Driven Expatriation by United States Citizens, and Reform Proposals*, 20 VA. TAX REV. 75, 79 (2000) (stating that the problem of inversions "invites radical solutions" by Congress).

Westin states, in 2000, that (citizen) tax-motivated inversions will increase in popularity due to the strength of the U.S. economy. *See id.* It is interesting to note that current (corporate) inversions are occurring precisely because of the U.S. economic downturn. *See* Pulliam, *supra*, at C4.

2. WTO's Ruling that U.S. Domestic Tax Policy Violates GATT

A third timely event opening the congressional door for revocation is the WTO's ruling that the U.S.'s tax treatment of corporate export income constitutes an unfair trade subsidy in violation of the General Agreement on Tariffs and Trade (GATT).[130] The World Trade Organization (WTO) and the European Union (EU) have attacked the U.S.'s sovereign right to enact and maintain its own taxation system, imposing sanctions against the U.S. ostensibly for being unique.[131] The U.S. risks being forced to harmonize its taxation rates and system with those of the EU social welfare states due to its membership in the GATT and the WTO.[132] Conceding *any* sovereign rights to formulate domestic economic policy is dangerous and grossly unpatriotic. Compromising American competitiveness – especially to cohere to historically failed European ways of economizing – is treasonous. Transforming the U.S. *back* to a system of solely territorial taxation would "be fitting revenge."[133]

The existence of the Foreign Sales Corporation (FSC) and Extraterritorial Income Exclusion Act (ETI) regimes evidences lawmakers' recognition that the U.S. semi-worldwide taxation system is injurious to U.S. multinational competitiveness, and that such competitiveness is crucial to the U.S. economy. Primarily, the fact that Congress created the FSC regime, and replaced it with the ETI regime upon FSC's forced demise, demonstrates a clear belief that relief from semi-worldwide taxation is necessary to U.S. exporting corporations. Additionally, the fact that lawmakers do not even consider as a viable option—in light of the WTO's denouncement of the ETI regime—the application of U.S. tax law without some FSC or ETI-like provisions, demonstrates further the belief that the U.S. international tax laws are

130. *See Taxes— Thomas, Rangel Urge Administration to Lead on FSC*, CONGRESSDAILY, Feb. 27, 2002 (defining the WTO ruling as a possible "launching point" for comprehensive tax reform); *U.S. Should Respond*, *supra* note 21. While the U.S. would be chagrinned to change its taxation system *in response to* the WTO ruling, *see Trade, Deputy Treasury Secretary Argues WTO Case on FSCs*, CONGRESSDAILY/A.M., Nov. 28, 2001 (suggesting the WTO ruling disrespects U.S. sovereignty because it will *force* the U.S. into reforming its tax system), the ruling does provide additional support to those already pushing *for* revocation of the semi-worldwide system. *See U.S. Should Respond*, *supra* ("[T]he WTO has given U.S. policy makers a reason to junk worldwide taxation of corporate income and instead implement a territorial tax system.").

131. *See* Doug Palmer & Patrick Lannin, *E.U. Hits U.S. Goods with Sanctions*, REUTERS, Mar. 1, 2004.

132. *U.S. Should Respond*, *supra* note 21.

133. *Id.* Territoriality would be "fitting revenge" on the OECD and the EU because restoring a territorial system of taxation will enhance U.S. multinational competitiveness. *See supra* § II.B.1.b. and accompanying notes.

harmful to U.S. corporations. Lawmakers angered by the WTO ruling advocate the complete overhaul of the U.S. international taxation system before they even consider unbuffered application of the U.S. laws, as they now exist. Ironically, it appeared for some time that the blow from the WTO had opened up a door to pro-territorialists; because the Congress needs not merely to revoke the ETI provisions, but to promulgate a new (and somehow GATT-friendly) export-promoting system in its place, the time was ripe for strong advocation of scrapping the international taxation system altogether and starting anew. Unfortunately, in light of the recent congressional bills that appear close to concluding the ETI issue, it appears that the opportunity has been lost to be fought another day.[134]

IV. CONCLUSION

The evolution of Subpart F has come full circle; in light of current inversions of major U.S. multinationals into non-U.S. multinationals, specifically to avoid the complications of Subpart F, and the reduction of the U.S. tax base that necessarily corresponds, Subpart F undeniably results in some erosion of the U.S. tax base. Its purpose for existing is thus nullified and it is time for the U.S to return to a policy of territorial taxation.

The recent inversions are both the impetus and the support Congressional Republicans need to take action. Congress has had essentially no reason to act until now. Republicans have had no reason to stir-up trouble because Treasury and the IRS pushed back the effective date of regulations that would neutralize the CTB regime. Democrats have not had the political or business sector support required to justify attempts to push forward their cause for deferral – the Subpart F compromise is the best they could do. Some argue that "[n]either the political forces in favor of a pure antideferral approach nor the political forces in favor of a pure territorial approach have the clout for complete victory."[135] If this is true, then neither the relative strength nor the economic truth behind either extreme policy perspective is of consequence – for neither is potentially executable.

But is it true that neither end of the spectrum has enough clout to enact a system vastly different from Subpart F? Clearly, this was the fact in 1962. But over forty years later, the world has changed.

134. *See* H.R. 4520, *supra* note 129; S. 1637, *supra* note 129; Ritterpusch, *supra* note 72, at G-5 .

135. Engel, *supra* note 1, at 1562.

Treasury and the IRS themselves accept the possibility that the evolution of the global economy may have modified the effectiveness of Subpart F. Facts are that U.S. multinationals are inverting continually, and it is the Democrats who are arguing for government action in response; Democrats are complaining that President Bush should be somehow counteracting inversion.[136] This situation provides Republicans greater ability to create real international tax law change – to repeal Subpart F and semi-worldwide taxation. Although there is a congressional political party split, the recent inversions counteract the Democrats' argument for antideferral. After all, if corporations are inverting even when they have the CTB "anti-Subpart F" regulations at their disposal, *how* can one accept that corporations will be *less* likely to invert with even partial antideferral (Subpart F without CTB), let alone with complete antideferral (revocation of Subpart F and its replacement with a complete antideferral system)? Perhaps ironically, Republicans lose the strength of this argument as the U.S. economy strengthens. The incentive thus exists for congressional Republicans to act *now*.

Even if a territorial system favors foreign investment and depletes the *potential* tax base, the end-all question is, does it reduce *actual* tax dollars collected? Economic studies say "no." And if they are not convincing enough, just look at the facts. Tyco and Ingersoll-Rand have depleted their actual U.S. taxes paid by thirty and forty million dollars, per year, respectively, by inverting to Bermuda. Stanley Works would have depleted its actual U.S. taxes paid by thirty million dollars, per year, if it had inverted. The territorial system would prevent these and other U.S. multinationals, icons and newbies alike, from fleeing their U.S. home. It would take away the incentive, if not the need, to abandon the U.S. The IRS estimates that it currently loses seventy billion dollars per year in potential tax revenues through inversions that have already taken place. Additionally, the retention of vast amounts of capital offshore, resultant of Subpart F, necessarily has caused a depletion in the potential U.S. tax base. This is true not because, absent Subpart F, multinationals would repatriate their foreign-source income, subjecting it to U.S. taxation. It is true because, absent Subpart F, a territorial system favoring repatriation of capital back into the U.S. becomes a real possibility. Policy papers ignore the potentiality of increased domestic tax revenues generated by corporate reinvestment. The U.S. government

136. *See* Johnston, *supra* note 126, at A1; Pulliam, *supra* note 126, at C4. *But see* Engel, *supra* note 1, at 1570; *Treasury Releases Fact Sheet on Subpart F Study*, 2001 TAX NOTES 1-15 (2001) (regarding *lack of concern* for whether U.S. multinationals expatriate as a Democratic viewpoint).

will necessarily lose tax dollars currently reaped through Subpart F antideferral if the regime is revoked. The author proffers that this sum is miniscule in comparison to the sum of tax dollars that business-minded, real American ingenuity will generate as a result of the freeing-up of resources currently sucked-up by attention to tax law issues. The sum is obliterated if territoriality sparks even nominally the reinvestment of U.S. corporate capital repatriated to the U.S. The tax results of implementing territoriality in taxation cannot be worse than Subpart F. Whether we expend valuable time and capital to negotiate around Subpart F, or whether we simply do not have Subpart F, the tax dollars that the U.S. recognizes are at least equivalent.

This territorial system must, however, somehow encourage the repatriation of capital back into the U.S. in addition to favoring the domestic maintenance of corporate parents. Because the only partial antideferral nature of the Subpart F regime encourages international tax competition to some point, it causes capital to be trapped outside the U.S. The better approach is to encourage the most efficient allocation of capital resources, through establishing a territorial system allowing free international tax competition, but to couple the system with an ability to repatriate profits to the U.S. for corporate reinvestment. Proposed methods for encouraging repatriation are: (1) provision of a tax rate reduction, (2) provision of tax deferral on income repatriated for designated uses, (3) provision of a tax exemption for repatriated capital invested in designated forms, and (4) provision of a tax exemption for all repatriated capital. What the author proposes is therefore not a pure territorial taxation system, given that such a system taxes all income upon receipt within the U.S. The author's system would rather tax income as *earned* within the U.S. Some form of repatriation tax alleviation system, as described above but beyond the scope of this article, would render the author's system modified-territorial.

On its face, the Subpart F compromise seems fair, if not ideal. Penalize for reducing the U.S. tax base and depleting domestic reinvestment in those capital exports that have no purpose other than to avoid U.S. taxation. Permit to compete on equal grounding in the global economy and improve the U.S. trade deficit those capital exports invested to compete commercially and generate profits for U.S. parents. Perhaps the Subpart F compromise is ideal politically or philosophically – but is it not beneficial economically. Subpart F is tax law, and ultimately tax law (supposedly) concerns the efficient and fair collection and maintenance of tax dollars. The more efficient, more competitive (and therefore fair), and less administratively overbearing means of collecting U.S. multinational dollars is through establishing a territorial taxation system. The first step necessary to accomplishing this goal is Congressional repeal of Subpart F.