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Deconstructing the Rules of Corporate Tax

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DECONSTRUCTING THE RULES OF CORPORATE TAX

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The U.S. corporate tax system is failing to keep pace with the evolving global economic landscape. The overwhelmingly complex regime rewards aggressive tax planning and creates incentives for corporations to move capital offshore. Calls for fundamental reform are escalating as the current system succumbs to the pressures of declining revenues, ever-emerging loopholes, and the perpetuation of one of the highest national statutory rates in the world.[1] Indeed, President Obama

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1. *See Impact of International Tax Reform on U.S. Competitiveness*: *Hearing Before the Subcomm. on Select Revenue Measures of the H. Ways and Means Comm.*, 109th Cong. 109-82 (2006) [hereinafter *International Tax Competitiveness Hearing*]; CONG. BUDGET OFFICE, CORPORATE INCOME TAX RATES: INTERNATIONAL COMPARISONS (Nov. 2005) [hereinafter CBO

has acknowledged these shortcomings and repeatedly affirmed his commitment to significantly overhaul the corporate tax system.[2] While academics, practitioners, and the White House have proposed any number of reform measures to deal with the problems plaguing the U.S. corporate tax regime, their solutions involve varying structural and statutory changes, which are in fact extrinsic to the form of the underlying rules themselves.[3] In contrast, this Article argues for an innate form of change to the U.S. corporate tax rules, which would fundamentally affect the way in which tax lawmakers actually draft tax rules and regulations. In particular, it argues that a systemic focus and commitment by lawmakers to a more principles-based approach to regulation would significantly mitigate many of the challenges currently encumbering the U.S. tax regime. Unlike the present system, which relies almost exclusively on a complex entanglement of bright-line prescriptive rules, a principles-focused corporate tax regime would help significantly simplify tax provisions, close loopholes, make the system more responsive to a dynamic marketplace, and serve as a gateway to lowering the U.S. corporate tax rate. Thus, the implementation of more principles-based rules should be given consideration in any contemplated tax reform proposals.

I. INTRODUCTION

As significant limitations that previously stifled investment in many foreign markets have eroded, corporations are now able cost-effectively to invest capital and resources virtually anywhere in the globe. It is estimated that in the past decade, net cross-border flows of capital have

CORPORATE INCOME TAX RATES REPORT]. *See also* KPMG, KPMG'S CORPORATE AND INDIRECT TAX RATE SURVEY 13-14, RRD-96142 (2008).

2. *See*, *e.g.*, David J. Lynch, *Does Tax Code Encourage U.S. Companies to Cut Jobs at Home?*, USA TODAY, Mar. 21, 2008, at 1B; Dan Freedman, *Critics Question President's Pursuit of Overseas Tax Breaks*, HOUSTON CHRON., Mar. 1, 2009, at 5; John D. McKinnon, *Multinationals Dig in Heels on Overseas Tax*, WALL ST. J., Apr. 6, 2009, at B7.

3. For example, recommendations include replacing the corporate income tax system with a consumption tax, integrating the corporate and individual tax systems, changing corporate statutory rates, repealing corporate tax deductions, and changing the timing of income inclusions and deductions for corporations. *See*, *e.g.*, MICHAEL GRAETZ & ALVIN C. WARREN, INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS 1998; Chris Edwards, Cato Inst., No. 484, *Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax*, POL'Y ANALYSIS, Aug. 14, 2003, *available at* http://www.cato.org/pubs/pas/pa484.pdf; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2011, 40, 149-64 (2010).

increased over 300 percent.[4] This ease with which highly elastic multinational corporations (MNCs) can now move their capital and assets to other jurisdictions has put significant pressure on the U.S. corporate tax system. Not only do purely domestic transactions no longer dominate the economic landscape, but also the mix of investments has changed from primarily fixed to increasingly intangible, and the United States has gone from a relatively low-tax to a relatively high-tax jurisdiction in terms of corporate tax rates.[5] Nevertheless, there has been no fundamental revision of the U.S. tax rules governing international transactions since the adoption of the subpart F regime in 1962, and no fundamental overhaul of the general corporate tax system since 1986.[6]

Not surprisingly, there is growing evidence that our current tax system is not ideally structured to deal with the challenges of an internationally integrated economy.[7] Current data indicates that the United States is losing tax revenue as foreign markets become more attractive places to deploy capital.[8] To date, Congress, the U.S. Treasury

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4. Cross-border flows of capital total nearly $13 trillion worldwide, triple the $4.2 trillion in 1996. INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: FINANCIAL STRESS, DOWNTURNS, AND RECOVERIES: APPENDIX 1, 4 (Oct. 2008) (net cross-border flows include direct investments, portfolio investments, reserve accumulations, and other investment flows).

5. The United States had a relatively low corporate tax rate among the major member nations of the Organization for Economic Cooperation and Development (OECD) in the mid 1980s (bottom quartile), but now has the second highest corporate rate overall. *See* CBO CORPORATE INCOME TAX RATES REPORT, *supra* note 1, at 14-15. *See also* KPMG, *supra* note 1, at 13-14.

6. The Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 1009 (codified as amended at 26 U.S.C.A. § 954 (West 2007)). The most significant changes to the international tax system since the 1960s occurred in the Tax Reform Act of 1986, which adopted changes to the income source, expense allocation and foreign tax credit rules, but these changes did not alter the fundamental system. *See* American Bar Association, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 654 (Spring 2006) [hereinafter ABA INT'L TAX REFORM REPORT].

7. Indeed, in testimony in 2006 before the House Ways and Means Committee, Glenn Hubbard, the Dean of Columbia Business School and former chair of the President's Council of Economic Advisers, acknowledged that the U.S. international policies from the 1960s are not necessarily relevant to the United States' present day economic and business concerns. *International Tax Competitiveness Hearing* 109-82

8. *See* Sam Goldfarb, *Drop in Corporate Tax Revenue Contributes to Ballooning Deficit, Congressional Budget Office Says,* 2008 TAX NOTES TODAY 176-1 (Sept. 9, 2008); James R. Hines, Jr., University of Michigan Law School, Effects of Tax Reform on Foreign Direct Investment, Presentation at The Brookings Institution: Tax Reform in an Open Economy (Dec. 2, 2005) (transcript available at http://www.brookings.edu/comm/events/20051202tax.pdf). *See also* James Kvaal, *Removing Tax Subsidies for Foreign Investment*, 111 TAX NOTES 1299 (June 12, 2006); Martin A. Sullivan, *Latest IRS Data Show Jump in Tax Haven Profits*, 105 TAX NOTES 151, 151 (Oct. 11, 2004).

> There is troubling evidence that tax havens are already seriously undermining the U.S. tax base. U.S. multinationals now earn almost half of their foreign profits in tax havens, suggesting aggressive income shifting. Tax havens

Department (Treasury) and the Internal Revenue Service (IRS) have been unable to keep pace with the proliferation of corporate expatriations,[9] the shifting of resources out of the U.S. tax base to low-tax jurisdictions,[10] and the rise of cross-border activities that create opportunities for MNCs to engage in "tax arbitrage" transactions.[11] Indeed, while U.S. tax policymakers have become increasingly aware that significant steps must be taken in order to maintain the United States' attractiveness as a place for investment and prevent further erosion of the U.S. tax base, the U.S. corporate tax system continues to be burdened by overwhelming complexity and one of the highest statutory rates in the world.[12]

In order to address these globalization-induced challenges, proposed changes to the corporate tax rules affecting MNCs have historically been supported by, or analyzed in relation to, any number of economic policy benchmarks, including capital export neutrality, capital import neutrality, and capital ownership neutrality.[13] These constructs

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> account for less than one percent of the world's population but more than eight percent of American multinational's foreign investments in property, plant, and equipment.

James Kvall, International Tax Reform, *in* Options for Tax Reform 85, 92 (Center for American Progress ed., conference materials, Washington, D.C., Mar. 23, 2006) (available at http://www.americanprogress.org/kf/tax%20layout.pdf).

9. For a discussion of corporate expatriations, *see infra* note 63 and accompanying text.

10. *See*, *e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-950, U.S. MULTINATIONAL CORPORATIONS: EFFECTIVE TAX RATES ARE CORRELATED WITH WHERE INCOME IS REPORTED (Aug. 12, 2008) (finding U.S. multinational corporations have been increasing the extent of their foreign operations to take advantage of lower tax rates in other countries).

11. *See*, *e.g.*, Guttormet Schjelderup et al., *Corporate Tax Systems, Multinational Enterprises, and Economic Integration* 2 (CESifo, Working Paper No. 1241, 2004):

> The rise in FDI and multinational firm activity is one of the most pronounced trends in the world economy over the last two decades . . . [and] has worried policymakers and academics, since multinationals are known to shift profits to low tax countries and governments are prone to compete for shifty profits.

Id.

12. *See*, *e.g.*, Michael Joe, *Shulman Promises "Aggressive Agenda" in Curbing International Tax Abuse*, 2009 TAX NOTES TODAY 36-1, 3 (Feb. 26, 2009) ("We're also going to continue to challenge taxpayers who are using the complexity of global commerce or global capital markets to push the envelope. Where there is complexity, that is where there is potential for evasion."). *See also supra* note 5.

13. Under "capital export neutrality," taxes do not distort location decisions when the tax on foreign investment is the same as that on domestic investments (often seen to support a worldwide tax model). *See* C. Neil Stephens, *A Progressive Analysis of the Efficiencies of Capital Import Neutrality*, 30 L. & POL'Y INT'L BUS. 159, 160-61 (1998). Other economists have argued that "capital import neutrality," or the ability of a firm to achieve the same tax rate on its foreign investments as a domestic firm in the same location, is the most important goal in maximizing worldwide economic welfare (often associated with a territorial system). *Id.* at 163-64. Mihir Desai and James R. Hines, Jr. expanded on this literature by offering another paradigm—"capital

are intended to foster an economically efficient allocation of worldwide capital. More recently, MNCs and tax policymakers have also emphasized the need for any overhaul of the U.S. corporate tax system to take into account concerns of competitiveness.[14] That is, while the efficient collection of revenue remains a key goal of tax regulators, it is also important that the United States does not unduly inhibit the flexibility and productivity of U.S.-based MNCs through a comparatively burdensome tax regime.[15]

Regardless of the underlying policy benchmark employed, the various reform proposals that have been made to date have centered primarily on large-scale extrinsic changes to the overall corporate tax system, such as moving from a worldwide to a territorial-based regime, eliminating deferral, implementing integration, and relying more on a consumption-based tax system.[16] These proposals, however, do not

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ownership neutrality"—pursuant to which economic efficiency is increased if an asset is able to be owned by the person who is in the best position to generate the maximum value from the asset. Mihir Desai and James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003).

14. In fact, Michael Knoll introduced a new metric against which proposed changes to the U.S. international tax regime can be measured—competitiveness neutrality. *Taxes and Competitiveness* (U. of Penn. Law School Inst. for Law & Econ. Res., Working Paper No. 06-28, 2006) (stating that competitiveness neutrality is achieved when taxes do not cause competitors to change their relative valuations of any investments). He acknowledged that "[a]round the world, the tax laws are [being] shaped by concerns with competitiveness," because governments often respond favorably to arguments that certain tax policies are putting it at a competitive disadvantage. *Id*. at 1.

15. If global economic integration permits capital, workers and profits to migrate to low-tax jurisdictions, the tax base will shrink and the United States' fiscal burden may increasingly fall on purely domestic U.S. companies and individual taxpayers. Accordingly, U.S. policymakers are inevitably concerned about the competitive viability of U.S.-based MNCs, because the U.S. economic base is inextricably linked to their success and growth. If U.S.-based MNCs are profitable, it can increase the United States' tax base, spur the growth of the economy, increase the number of jobs and salaries for U.S. workers and benefit U.S. shareholders. If, however, the United States puts a relatively large burden on U.S.-based MNCs, then over time their after-tax returns will be low relative to their foreign competitors. This will lead MNCs, which are focused on maximizing profits and returns to investors, to take their business and capital offshore. *See*, *e.g.*, *International Tax Competitiveness Hearing*, *supra* note 7, at 2 (focusing on how a reformation of the tax system could be used to increase the competitiveness of U.S. companies operating abroad and stimulate the economy at home); Remarks at *Secretary Henry M. Paulson's Conference on U.S. Business Tax Competitiveness* on July 26, 2007) [hereinafter Paulson's Tax Competitiveness Conference] (examining ways in which our current business tax system affects economic growth and U.S. competitiveness in the global economy). *See also* Heidi Glenn, *Business Leaders Would Give up Tax Breaks for Lower Rates*, 2007 TAX NOTES TODAY 145-3 (July 27, 2007).

16. *See*, *e.g.*, Press Release, U.S. Dep't of Treas., Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas (May 4, 2009) (available at http://www.treas.gov/press/releases/tg119.htm); Reuven Avi-Yonah, *Tax Reform in the (Multi)National Interest*, 124 TAX NOTES 389 (July 27, 2009); J. COMM. ON TAXATION, THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S.

focus on key intrinsic problems that exist with respect to the underlying rules themselves. In this Article, I will explore another path to reform that would more directly address these shortcomings—the systematic use of principles-based rules in U.S. tax laws.[17]

Generally speaking, as defined herein, principles-based rules are rules in which the principle underlying the rule is actually stated on the face of the rule. In contrast, prescriptive rules are rules for which the lawmaker *ex ante* prescribes an outcome for a set of anticipated factual situations by applying, but not stating directly, the underlying principle.[18] As currently constructed, the U.S corporate tax regime is

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INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES, JCX-22-06, at 5 (June 22, 2006):

> Proponents argue that territorial tax systems are less complex from an administrative and compliance standpoint than worldwide tax systems. It is true that many complicated features of a worldwide system are not necessary in a pure territorial system. For example, the foreign tax credit and anti-deferral regimes, two of the most complex features of a worldwide tax system, are not necessary in a pure territorial system.

Id.

17. In the late 1990s, David Weisbach studied the use of standards (which, while generally broader, are conceptually similar to principles-based rules) in the context of tax anti-abuse provisions, and concluded that standards would lead to simplification because prescriptive rules, which dominate the tax law, are "systematically more complex." David Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 867 (1999). For a discussion of the definitional distinction between standards and principles-based rules, as used herein, see *infra* note 70 and accompanying text.

18. Indeed, in certain regulatory regimes, policymakers have recommended the expanded implementation of principles-based rules as a way to improve the United States' overall systems and competitive position. Specifically, comprehensive reports on the declining competitiveness of our capital markets have suggested that incorporating more principles-based regulations could improve the United States' competitive position. *See* COMM. CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; OFFICES OF NEW YORK CITY MAYOR MICHAEL R. BLOOMBERG & SENATOR CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 8 (Jan. 2007), *available at* http://www.abanet.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf [hereinafter BLOOMBERG-SCHUMER REPORT]; U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS (Mar. 14, 2007) (together, the "Capital Markets Reports"). Despite some of their differences in methodology and scope, all of these reports generally conclude that although the United States still generates more financial revenue than any other country in terms of gross dollars, other nations are growing at much faster rates. *See* INTERIM REPORT, *supra* at ix; BLOOMBERG-SCHUMER REPORT, *supra* at ii; *Capital Markets Reports*, *supra* at 15. Thus, it is asserted that absent any changes, the United States could soon lose its status as the financial capital of the world. *See id*. While the Capital Markets Reports acknowledge that many of the causes of the United States' declining competitiveness are due to improved markets abroad, reduced barriers to international capital flow and the evolution of increasingly complex financial products that are beyond its control, they conclude that, at least to some extent, a number of the causes are self-imposed. *Capital Markets Reports*, *supra* at 15-17. In particular, the reports observe

dominated by a complex array of bright-line prescriptive rules. Not only is the sheer volume of these rules staggering, but they often lack coherence, are both over- and under-inclusive, and fail to adequately adjust to evolving financial transactions. Indeed, the U.S. system provides taxpayers the incentive to spend significant time and resources exploiting these weakness and gaps in the rules in order to counteract the effect of the United States' high statutory tax rate.

In this Article, I will analyze the effects that an increased focus on principles-based tax rules would have on this flawed system. I conclude that principles-based rules should significantly supplement, and in many instances supplant, the current prescriptive tax rules in order to: (i) aid in the goal of simplification, (ii) close loopholes, (iii) allow the corporate tax rules to be more adaptable in an evolving and complex global market, (iv) reduce the social costs of highly structured transactions, (v) facilitate the ability of the United States to coordinate rules and policies with other jurisdictions, and (vi) provide a more effective constraint against highly engineered transactions. Furthermore, because principles-based rules will have the effect of restricting the ability of MNCs to engage in self-help measures to minimize their effective tax rate, they would serve as a gateway towards lowering our high statutory corporate rates, a goal that is supported by policymakers, academics, and MNCs alike.

Part II of this Article will examine two key issues plaguing the current U.S. corporate tax regime. Part III explores how principles-based rules could affect our corporate tax regime and how such rules could be useful in responding to the challenges facing our tax policymakers. It also examines how a principles-based approach could facilitate the lowering of statutory corporate tax rates.

II. SHORTCOMINGS OF A PRESCRIPTIVE U.S. CORPORATE TAX REGIME

Globalization has both magnified the competitive pressures that MNCs feel from their foreign competitors and increased the ability of jurisdictions around the world to effectively compete for their resources. From a policy perspective, the United States should at least strive to be competitively neutral, in that its tax provisions should not materially alter the natural flow of capital and resources or deter businesses from

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that our financial markets may be losing competitive ground because they are at times stifled by an unduly stringent and intricate regulatory system. *Id.* As a result, one of the key reforms suggested by the Capital Markets Reports is that the United States simplify and streamline its regulatory process by switching to a primarily principles-based approach to regulation. *Id.* at 6-10.

incorporating or employing capital into the United States. Any number of factors affect the decision of where MNCs will engage in business activities, including the strength of the economic markets, quality of the labor force, stability of the government, degree of infrastructure modernization, litigation environment, and geographical location.[19] Taxes, however, are also of critical, and sometimes paramount, importance in the decision-making process.[20] In a highly competitive global environment where MNCs are focused on maximizing their after-tax profits, the way in which the United States taxes MNCs meaningfully affects their investment decisions, their plant and headquarter locations, and the manner and location in which they choose to raise and deploy capital.[21]

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19. *See*, *e.g.*, Mauro Ghinamo et al., *FDI Determination and Corporate Tax Competition in a Volatile World* (CESifo, Working Paper No. 1965, 2007).

20. Michael Boskin, professor of economics at Stanford University and former chairman of the President's Council of Economic Advisors, named taxes as one of three most important factors affecting U.S. competitiveness. Paulson's Tax Competitiveness Conference, *supra* note 15. In addition, a survey in the BLOOMBERG-SCHUMER REPORT found that CEOs and senior executives considered a favorable corporate tax regime to be a relatively important factor in determining a jurisdiction's overall competitiveness. BLOOMBERG-SCHUMER REPORT, *supra* note 18, at 62.

21. *International Tax Competitiveness Hearing*, *supra* note 7, at 7 (statement of Glenn Hubbard). Ireland's low corporate tax rates for manufacturing and financial services are believed to be a primary reason for its success in attracting foreign direct investments. Eckhard Janeba and Michael Smart, *Is Targeted Tax Competition Less Harmful than its Remedies*, at 2 (CESifo, Working Paper No. 590, 2001). In 2000, Ireland had more foreign direct investments than Japan or Italy (even though it has less than 4 million people). *See* UNITED NATIONS, WORLD INVESTMENT REPORT 2001, at 291 (2001); OECD REPORT ON HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 21 (Apr. 1998). Martin Sullivan has the following to say on the rise of international tax competition for capital:

> Tax competition is a complicated game. Sovereign governments bait their hooks with tax breaks and try to reel in globe-trotting taxpayers that bob and weave their way around the world looking for tax advantages. At the same time, each jurisdiction must keep an eye on other jurisdictions, which may adjust their taxes to promote their own economic interests at the expense of others.
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> But it costs to play the game. Tax avoidance can drain a taxpayer's time, money, efficiency, and reputation. And for governments there can be losses in revenue and domestic political support. You are likely to see more of the game when the cost of playing is low. For taxpayers, that means ease of movement. For governments, that means a small domestic tax base.
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> So where do you find the most game? It can turn up anywhere, but it is thickest among small countries trying to attract mobile capital. And so, for example, corporations in integrated Europe set up holding companies in low-tax Luxembourg, and hundreds of billions of dollars are kept a few mouse clicks away from their U.S. owners in banks in the tax-free Cayman Islands.
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> Globalization has broadened and deepened the presence of tax competition in international markets.

Unfortunately, however, the U.S. corporate tax system is increasingly perceived, both domestically and abroad, as being disadvantaged in many respects, including its relatively high statutory corporate tax rates and unduly complex tax provisions. While I do not believe that the United States should attempt to "compete" for tax base with the tax haven jurisdictions[22] by drastically reducing rates or providing disproportionate tax breaks to large MNCs, I do believe that the United States should strive to remain relatively in sync with other large Organization for Economic Cooperation and Development (OECD) nations, such that our tax rates do not serve as an impediment to U.S. investment. In addition, our overly complex tax provisions and the resulting high costs of complying with these laws are "widely viewed as an impediment to the ability of U.S. multinational corporations to effectively compete in the international business arena and place them at a competitive disadvantage relative to multinational corporations chartered in other countries."[23]

These competitive differences between the United States and other jurisdictions are important because the pressures that U.S.-based firms feel from their foreign counterparts push them to more proactively pursue any number of tax-saving strategies.[24] On the opposite side of the table, tax regulators are increasingly frustrated by their less than successful attempts to preserve the dwindling corporate tax base.[25] In a

Economic Analysis: Tax Competition on the Interstate— One Bourbon, One Scotch, No Beer, 115 TAX NOTES 822 (May 28, 2007). *See also* Kristian Behrens and Pierre Picard, *Tax Competition, Location, and Horizontal Foreign Direct Investment*, at 2 (CORE Discussion Paper No. 2005/91, Dec. 21, 2005) (*available at* http://www.core.ucl.ac.be/services/psfiles/dp05/dp2005_91.pdf) ("It is a widely documented fact that incentives are a pervasive instrument used by governments and developers to attract mobile capital and foreign direct investment.").

22. For instance, rates should not be reduced to a level that would lead to "harmful" tax competition, as is alleged of certain "tax haven" jurisdictions such as Barbados, Bermuda and the Cayman Islands, which level little to no income taxes on their residents. *See* OECD REPORT, *supra* note 21.

23. Dennis R. Lassila & L. Murphy Smith, *Tax Complexity and Compliance Costs of U.S. Multinational Corporations,* 10 ADVANCES IN INT'L ACCT. 207, 207 (1997) ("Complex tax laws and the costs of complying with those laws are a major concern to U.S. multinational corporations.").

24. These strategies can include self-help measures such as shifting mobile economic activity to lower-tax jurisdictions, transfer pricing manipulation, re-incorporating outside of the United States and engaging in earnings stripping and cross-border arbitrage transactions. DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RL31444, FIRMS THAT INCORPORATE ABROAD FOR TAX PURPOSES: CORPORATE "INVERSIONS" AND "EXPATRIATION" 2 (Jan. 26, 2007) [hereinafter CONGRESSIONAL REPORT ON CORPORATE INVERSIONS AND EXPATRIATIONS].

25. Corporate tax revenue has dropped substantially since the 1960s. *Drop in Corporate Tax Revenue Contributes to Ballooning Deficit, CBO Says*, 2008 TAX NOTES TODAY 176-1 (Sept. 10, 2008). Although corporate revenues spiked briefly from 2003 to 2006, they stabilized in fiscal 2007

very real sense, the U.S. corporate tax system represents the worst of both worlds: (i) a high statutory tax rate with relatively low, declining effective rates (and thus corporate tax revenue); and (ii) complex rules that fail to protect the corporate tax base, but can be manipulated, with significant social costs, by sophisticated MNCs to lower their effective rates. While the issues plaguing our current U.S. corporate tax system are too numerous to discuss, I will focus on two issues that are particularly relevant to this Article: (i) complexity and (ii) our high statutory corporate rates.

A. Complexity

With over 1,000 forms and nearly 100,000 pages of Code and Treasury regulations,[26] the U.S. tax system can be fairly categorized as a thicket of complicated rules. As Willard Taylor notes, the current U.S. tax system is "a cumbersome creation of stupefying complexity" with "rules that lack coherence and often work at cross purposes."[27] Not surprisingly, simplification has been described as the "holy grail" of tax policy.[28] Each new tax law or regulation, no matter how simple in

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and actually declined last year. *Id.* According to the Congressional Budget Office, corporate tax revenues were expected to fall from 2.7 percent of GDP in fiscal 2007 to 2.2 percent of GDP in fiscal 2008. *Id.*

26. This page count is based on the CCH compilation of the Internal Revenue Code of 1986, as amended, (the "Code") and the Treasury regulations promulgated thereunder. According to a recent World Bank study, the United States has the fifth-longest tax code for businesses among twenty highest GDP ranking countries. WORLD BANK AND PRICEWATERHOUSECOOPERS, PAYING TAXES: THE GLOBAL PICTURE 16, table 2.1 (2006), *available at* http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf.

27. Testimony of Willard Taylor, Meeting of the President's Advisory Panel on Federal Tax Reform, PowerPoint slide 9 (Mar. 31, 2005), http://govinfo.library.unt.edu/taxreformpanel/meetings/meeting-03312005.html (last updated Aug. 12, 2005). *See also* Reuven S. Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy*, The Brookings Institute Discussion Paper, at 5 (June 2006) ("The U.S. system is also notoriously complex: observers are nearly unanimous in lamenting the heavy compliance burdens and the impracticality of coherent enforcement.").

28. Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267 (1990). The President's Advisory Panel on Federal Tax Reform, which outlines ways in which the United States can improve its tax system, also states that it has made "simplification a priority." *See* PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 51 (Nov. 2005), *available at* http://taxreformpanel.gov/final-report; J. COMM. TAXATION, STUDY OF THE OVERALL STATE AND FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, JCS-3-01 (Apr. 2001). However, some scholars have been more skeptical of the importance of simplification. *See*, *e.g.*, Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 743 (2003) ("It is a mistake to distinguish simplicity as a tax policy criterion distinct from efficiency. Simplicity is part of what scholars mean by efficiency, nothing more.").

isolation, seems only to add to the overall complexity of the system. Nevertheless, the reduction of complexity in the U.S. tax system remains "a worthwhile, although somewhat elusive, objective of tax reform efforts."[29]

There are many causes for the complexity of the U.S. corporate tax rules, ranging from deficiencies in our political law-making process to the inherently complex actors and transactions which the system must attempt to effectively address.[30] Furthermore, in addition to the regular sources of complexity encountered in the purely domestic provisions of the Code, the tax rules governing international transactions face the additional pressure of having to intersect with the rules of all of the other taxing jurisdictions around the world.[31] Any inconsistencies between the tax provisions of the United States and those of another country, including sourcing rules, debt-equity characterizations, entity classifications, and the timing of deductions and inclusions, can lead to undesirable outcomes or the opportunity for arbitrage. Therefore, U.S. tax policymakers must endeavor to protect against any unintended results, such as the potential double taxation or double non-taxation of income, which lead to distortive planning behaviors by taxpayers.

Furthermore, the core of the current corporate tax rules affecting MNCs were put in place in 1962 and 1986.[32] Since these rules were enacted, legislators and tax regulators have addressed the changing needs of the corporate tax system by adding patchwork rules on top of the existing framework, with no fundamental review of, or modification to, the increasingly outdated system. As a result, the United States has gone "from a complex to a super-complex regime. . . ."[33] Indeed, the American Bar Association, in its recent report evaluating various tax

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29. Robert J. Peroni, J. Clifton Fleming, Jr., & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 105-06 (Oct. 6, 2003). *See also* Lassila et al., *supra* note 23, at 235-36 ("Because tax laws have a significant impact on the activities of multinational corporations, tax complexity and compliance costs should be continually examined.").

30. In fact, Micheal DiFronzo, IRS Deputy Associate Chief Counsel (International), was recently quoted as saying "complexity of business necessitates a complex rule." David D. Stewart, *Drafters of Temporary Branch Regs Defend Rules' Complexity*, 58 TAX NOTES INT'L 408, 408 (Feb. 2, 2009). *See also* Charles E. McLure, Jr., Hoover Institution, Stanford University, The Budget Process and Tax Simplificaiton/Complication, Prepared for Presentation at the Joint AICPA Tax Division/ABA Tax Section "Invitational Conference on Reduction of Income Tax Complexity," Washington, D.C., (Jan. 11-12, 1990), *in* 90 TAX NOTES TODAY 10-30 (Jan. 12, 1990).

31. Peroni et al., *supra* note 29, at 107.

32. *See supra* note 6.

33. Stanford G. Ross, *U.S. International Tax Policy: Where are We? Where Should We be Going?*, 47 TAX NOTES 331, 331 (April 16, 1990).

reform proposals, recognized that the "accretion of tax rules without periodic thorough reviews of the needs of the system" is a key source of complexity in the corporate tax regime.[34]

Lastly, the corporate tax provisions affecting MNCs often lack an underlying cohesive policy direction. Robert Peroni *et al*. observes that there is no general consensus concerning which economic model (*e.g.*, capital export neutrality, capital import neutrality or capital ownership neutrality) should drive U.S. tax policy, and unsurprisingly, "the current rules reflect schizophrenia in the tax system caused by the fact that the U.S. tax system reflects all three economic models."[35] Furthermore, the international tax provisions contain conceptually inconsistent structural elements relating to cross-border investments, such as the selective look-through treatment of U.S.-owned foreign corporations.[36] The end result is that these numerous inconsistencies "lead to an incoherent tax system that is tremendously complex" and produce a "set of rules that lack coherence and often work at cross purposes in terms of achieving some ultimate policy goal."[37]

James Hines, in his statement at the International Tax Competitiveness Conference, noted that the U.S. tax rules are "dizzyingly complex," and that there has to be a reason that no other countries are in a hurry to adopt rules anything like the U.S. rules for taxing international income.[38] Perhaps this is because the enormous complexity of the U.S. corporate tax rules yields any number of

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34. *See* ABA INT'L TAX REFORM REPORT, *supra* note 6, at 690.

35. Peroni et al., *supra* note 29, at 106-07. For example, the residence-based worldwide system itself is supported by capital export neutrality principles. On the other hand, the deferral regime moves more in the direction of capital import neutrality.

36. *See id.*:

> The code has two inconsistent approaches to how it views a U.S. corporation that owns stock in a foreign corporation. In some instances, under the deferral privilege, a U.S. shareholder is allowed to avoid U.S. tax on the profits of a foreign corporation until they are repatriated, thereby treating the U.S. shareholder as the owner of stock in the foreign corporation and the foreign corporation as an entity distinct from its U.S. shareholder. By contrast, other code rules, such as the indirect foreign tax credit allowed by sections 902 and 960 and the look-through rules in sections 904(d)(3) and (d)(4), treat a U.S. corporate shareholder that owns at least 10 percent of the voting stock as equivalent to operating a foreign branch and therefore as, in effect, the owner of the foreign corporation's underlying assets and income.

Id.

37. *Id.* at 107-08.

38. James R. Hines, Jr., University of Michigan Law School, Speaker at Paulson's Tax Competitiveness Conference, *supra* note 15. In addition, Safra Catz, President and CFO of Oracle Corporation, Panelist at Paulson's Tax Competitiveness Conference, *supra* note 15, noted that the complexity of the U.S. tax system is "outrageous."

efficiency, administrative, and equity difficulties, including: (i) increased compliance costs to taxpayers; (ii) challenging and expensive administration and enforcement of the tax laws; and (iii) the proliferation of complex and high-friction tax planning.

First, the overwhelming complexity of the corporate tax rules can result in extremely high compliance costs for taxpayers, even for those who are merely trying to comply with (and not manipulate) the laws.[39] The U.S. tax system is estimated to impose a hidden compliance cost on taxpayers of over $260 billion each year.[40] This does not include the countless dollars spent by MNCs on "tax planning" in and around these rules. Not only that, but "the cost of compliance with the international rules is understood to be proportionately much higher than for the domestic rules."[41] This creates an extraordinary amount of social waste and also can result in lower profits for MNCs, higher prices of goods and services for customers, and decreased amounts of capital available for domestic and foreign investment.[42] As a result, these effects can impair the ability of U.S.-based MNCs to remain competitive in the global economy.[43] Jim Owens, Chairman and CEO of Caterpillar, Inc., stated that "tax makes a substantial difference in U.S. competitiveness," and he specifically was troubled by the complexity of a tax system that results in Caterpillar spending $40 million annually on tax planning, preparation, and filing.[44]

Second, the high level of complexity in the U.S. tax rules makes the administration of the tax system more difficult and costly for the government.[45] Not only does the sheer volume and intricacy of the

39. "By reducing complexity, the tax system would no longer be the substantial impediment to international trade that it now is." Lassila et al., *supra* note 23, at 209-10 (citations omitted).

40. SCOTT HODGE, J. SCOTT MOODY, & WENDY WARCHOLIK, TAX FOUND., ISSN 1068-0306, SPECIAL REPORT: THE RISING COST OF COMPLYING WITH THE FEDERAL INCOME TAX 1 (Dec. 1, 2005), *available at* http://www.taxfoundation.org/files/sr138.pdf.

41. *See* ABA INT'L TAX REFORM REPORT, *supra* note 6, at 717. *See also* Lassila et al., *supra* note 23, at 209-10 (finding in results of a survey of the 1000 largest U.S. MNCs that corporate tax preparation is very complex and quite costly and is more burdensome to corporations with a high degree of international business).

42. Peroni et al., *supra* note 29, at 105-06.

43. *Id*.

44. James W. Owens, Chairman and CEO, Caterpillar, Inc., Panelist at Paulson's Tax Competitiveness Conference, *supra* note 15. In addition, Mobil Oil reported that completing and filing its 1993 U.S. federal income tax return cost $10 million and that the return was 6300 pages long. *See* Lassila et al., *supra* note 23, at 209.

45. Peroni et al., *supra* note 29. In addition, Fred Goldberg stated at Paulson's Tax Competitiveness Conference, *supra* note 15, that "there is a perception, accurate in my view, that the current international tax system is grotesquely complicated from the prospective of

corporate tax provisions create problems for administrators, but these issues are also compounded by the often convoluted structures that sophisticated taxpayers create in order to achieve tax-favorable results. At times it can be difficult, or nearly impossible, for the IRS to fully unravel the transactional web that is woven in order to accurately decipher the true economics and intentions of the taxpayer. As noted by David Schizer, complex tax structures can be arranged to "have extraneous pieces that are included solely to befuddle auditors" and when "[f]acing a large and complicated return, auditors try to intuit what questions to ask, without really knowing where the bodies are buried."[46] Thus, the corporate tax provisions are "in many respects too complex for many [IRS] auditors to understand and therefore for the government to audit effectively."[47]

Lastly, the complex tax rules often "engender elaborate and expensive tax-planning maneuvers and inefficient structuring of business transactions."[48] As discussed more fully below, the more complicated the Code, the easier it is for taxpayers to find loopholes to exploit, or strategies to circumvent, various tax provisions.[49] Former IRS Commissioner Mark Everson noted that as "the Code continues to expand, becoming more complex and challenging to administer, large businesses and wealthy individuals are able to utilize every available resource to explore opportunities to reduce their tax liability by using the most intricate and complicated Code provisions . . . ."[50] Not only is this kind of tax planning highly inefficient, but it can also result in inequities

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administration and compliance . . . ." Fred T. Goldberg, Jr., Skadden, Arps, Slate, Meagher & Flom LLP, Moderator and Contributor at Paulson's Tax Competitiveness Conference, *supra* note 15.

46. *See* David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 335 (Spring 2006). *See also* JOINT COMMITTEE ON TAXATION, 1 REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, JCS-3-03, at 373-74 (Feb. 2003):

> In structuring complex international investments and operations, prudent tax planning typically requires a U.S.-based multinational enterprise to use a combination of many different entities in many different jurisdictions, even if the enterprise's tax planning goals are limited to the generally unobjectionable ones of deferring U.S. Federal income tax on active, non-subpart-F income until such income is repatriated, and mitigating the double taxation of foreign income to the extent allowable under the foreign tax credit and the U.S. tax treaty network.

Id.

47. *See* ABA INT'L TAX REFORM REPORT, *supra* note 6, at 717.

48. Peroni et al., *supra* note 29, at 105-06.

49. *See infra* section III.B.1.

50. Mark Everson, Comm'r, Internal Revenue Serv., Before the S. Comm. Homeland Sec. & Gov't Affairs' Permanent Subcomm. Investigations Hearing on Offshore Abuses: The Enablers, the Tools, and Offshore Secrecy (Aug. 1, 2006).

to taxpayers who do not have the resources to engage in sophisticated tax planning and to those who lack the international diversification to readily move profits and capital offshore.[51]

B. High Statutory Corporate Rate

The most common complaint against the United States in terms of "competitiveness" is its relatively high corporate tax rates.[52] Following the significant corporate tax rate reductions implemented as part of the Tax Reform Act of 1986,[53] the United States had a relatively low corporate tax rate in comparison to other OECD countries.[54] Subsequently, however, corporate tax rates have been coming down around the world.[55] In 2000, only five OECD countries had higher statutory corporate income tax rates than the United States (Chart A). Since then, all five of those countries have reduced their top statutory rates, and four of them significantly lowered their rates to below the U.S. rate. In fact, between 2000 and 2008, the vast majority of the OECD countries significantly reduced their statutory corporate tax rates. Today, Japan is the only OECD country that has a higher statutory corporate tax rate than the United States.[56]

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51. *See* ABA INT'L TAX REFORM REPORT, *supra* note 6, at 717 (these rules "are unfair to those who do not have foreign income and to those who do have foreign income but do not engage in sophisticated tax planning."). There is also a notion that a complex tax system that requires MNC managers to create convoluted transactional structures in order to achieve tax avoidance goals is not ideal from a corporate law perspective because such structures give managers additional capacity to hide self-dealing from shareholders. Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition* 106 MICH. L. REV. 1229 (2008) (demonstrating that tax-motivated corporate locational decisions can lead to an efficiency cost to the extent that MNCs are steered into suboptimal legal regimes from a corporate law standpoint).

52. There are obviously any number of considerations other than competitiveness that go into the formulation of a tax system, including revenue demands, fairness, economic efficiency and political considerations. Accordingly, while this Article will not specifically address how competitiveness, as a policy goal, should fit in terms of our nation's overall political agenda, I will assume that competitiveness is at least *a* goal that is important to the United States, given its potential impact on our economy and in light of the increasing amount of attention it has received by tax policymakers and scholars alike.

53. The top corporate rate was reduced from 46 percent to 34 percent. Tax Reform Act of 1986, PL 99-514, § 601, 100 Stat. 2085, 2249 (codified as 26 U.S.C. § 11 (2006)).

54. *See* CBO CORPORATE INCOME TAX RATES REPORT 50, *supra* note 5.

55. *Id.*

56. Similarly, the Canadian C.D. Howe Institute issued a report ranking the corporate tax competitiveness of eighty-one countries. Canadian C.D. Howe Institute, *Canadian Report Ranks U.S. Low on Corporate Tax Competitiveness*, 2006 TAX NOTES TODAY 189-7 (Sept. 28, 2006). The United States came out near the bottom of the pack, with an average effective tax rate on capital higher than seventy-five of the eighty-one countries ranked. *Id.*

Chart A

Corporate Tax Rates, Change From 2000 to 2008 Sorted by Statutory Rate in 2008						
					2000 to 2008	
Rank	**Country**	**2000**	**2006**	**2008**	**Change**	**% Change**
1	Japan	40.9	39.5	39.5	-1.4	-3.3%
2	United States	39.4	39.3	39.3	-0.1	-0.4%
3	France	37.8	34.4	34.4	-3.4	-8.9%
4	Belgium	40.2	36.0	34.0	-6.2	-15.4%
5	Canada	44.6	36.1	33.5	-11.1	-24.9%
6	Luxembourg	37.5	29.6	30.4	-7.1	-19.0%
7	Germany	52.0	38.9	30.2	-21.8	-42.0%
8	Australia	34.0	30.0	30.0	-4.0	-11.8%
9	New Zealand	33.0	33.0	30.0	-3.0	-9.1%
10	Spain	35.0	35.0	30.0	-5.0	-14.3%
11	Mexico	35.0	29.0	28.0	-7.0	-20.0%
12	Norway	28.0	28.0	28.0	0.0	0.0%
13	Sweden	28.0	28.0	28.0	0.0	0.0%
14	United Kingdom	30.0	30.0	28.0	-2.0	-6.7%
15	Italy	37.0	33.0	27.5	-9.5	-25.7%
16	Korea	30.8	27.5	27.5	-3.3	-10.7%
17	Portugal	35.2	27.5	26.5	-8.7	-24.7%
18	Finland	29.0	26.0	26.0	-3.0	-10.3%
19	Netherlands	35.0	29.6	25.5	-9.5	-27.1%
20	Austria	34.0	25.0	25.0	-9.0	-26.5%
21	Denmark	32.0	28.0	25.0	-7.0	-21.9%
22	Greece	40.0	29.0	25.0	-15.0	-37.5%
23	Switzerland	24.9	21.3	21.2	-3.7	-15.0%
24	Czech Republic	31.0	24.0	21.0	-10.0	-32.3%
25	Hungary	18.0	16.0	20.0	2.0	11.1%
26	Turkey	33.0	30.0	20.0	-13.0	-39.4%
27	Poland	30.0	19.0	19.0	-11.0	-36.7%
28	Slovak Republic	29.0	19.0	19.0	-10.0	-34.5%
29	Iceland	30.0	18.0	15.0	-15.0	-50.0%
30	Ireland	24.0	12.5	12.5	-11.5	-47.9%
OECD Averages		**33.6**	**28.4**	**26.6**	**-7.0**	**-20.2%**

Source: OECD

The impact of the United States' high corporate tax rates on MNCs is further complicated by its worldwide system of taxation.[57] Because U.S.-based residents are ultimately taxed on their worldwide income and are supposed to pay residual tax to account for any differences in tax rates in the foreign jurisdiction, they do not *naturally* benefit from lower rates that could be achieved by investing directly in other lower-rate jurisdictions.[58] Thus, the U.S. corporate tax rules can result in the imposition of a burden on U.S.-based MNCs that is not imposed on many of their foreign counterparts.[59]

MNCs are under significant competitive pressures to lower the tax costs of their U.S. and foreign business activities. As sophisticated MNCs have become more elastic, they are increasingly focused on, and able to react more quickly and efficiently to, differences in the markets. MNCs do not feel particularly restricted by their geographical location and are able easily to move resources and profits from jurisdictions they perceive as overly burdensome to ones they consider more optimal.[60]

57. Under a worldwide tax system, such as that employed by the United States, residents are taxable on their worldwide income, no matter where that income is derived. 26 C.F.R. § 1.1-1(b) (2008). On the other hand, non-resident MNCs are only subject to tax on income earned in the United States. 26 U.S.C. § 882 (2006). The potential double taxation of MNCs under a worldwide system by both the resident and source countries on foreign income is mitigated through the allowance of a credit in the resident country for taxes paid to the foreign source country. In the United States, the credit for foreign taxes is limited to an MNC's U.S. tax liability, although cross crediting is generally permitted such that excess credits generated from income earned in high-tax countries can be used to offset additional taxes owed on income earned in low-tax jurisdictions. In contrast, under a territorial system, a corporation pays tax only to the country in which the income is generated. Accordingly, it does not owe any tax to its resident country on its foreign income. Most European countries, such as France, Sweden, Luxembourg, Spain, Germany, and (to some extent) the United Kingdom, as well as countries such as Canada, Australia, Hong Kong, and Singapore, have adopted territorial-based systems. Japan also has a worldwide tax system.

58. However, MNCs are often able to structure their affairs to avoid the residual tax that they are supposed to incur on their foreign-source income by engaging in highly structured transactions and/or permanently shifting income offshore. *See* DEP'T TREASURY, EARNINGS STRIPPING, TRANSFER PRICING, AND U.S. INCOME TAX TREATIES 1-2 (2007), *available at* http://treas.gov/offices/tax-policy/library/ajca2007.pdf. For example, because the taxation on foreign income is deferred until such income is brought back into the United States, MNCs attempt to avoid the residual tax that would be imposed on those earnings if they are brought back to the United States. *Id.* at 2. In an effort to reclaim some of these "trapped" profits, Section 421 of the American Jobs Creation Act of 2004 ("JOBS Act"), Pub. L. 108-357, added a temporary provision intended to encourage the repatriation of certain low-taxed foreign earnings. American Jobs Act of 2004, Pub. L. No. 108-357, § 421, 118 Stat. 1418, 1458-59 (2004).

59. David Sicular et al., *Report on Outbound Inversion Transactions*, 1014 N.Y. ST. B.A. TAX SECTION 1, 9 (May 24, 2002). *See also* Reuven S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, 61 BULL. INT'L TAX'N 130 (2007).

60. Historically, the United States benefited from being a "home market" for many of the world's largest MNCs. Haroldene Wunder, *The Effect of International Tax Policy on Foreign Direct Investments*, 35 TAX NOTES INT'L 733, 733 (Aug. 23, 2004). Two recent phenomena,

Indeed, the wave of corporate "inversions" or "expatriations"[61] in the late 1990s and early 2000s, in which U.S.-based MNCs moved their headquarters (but not operations) outside of the United States,[62] was believed to be symptomatic of the relatively high tax burden certain U.S.-based MNCs believed that the U.S. tax system placed on their firms.[63] MNCs such as Cooper Industries anticipated a $55 million annual U.S. tax savings, and Ingersoll-Rand expected $40 million of

however, are greatly mitigating this traditional home market advantage. First, there is evidence that foreign-based MNCs are representing an increasing presence in the global economy. *Id.* In fact, although U.S.-based MNCs represented almost half of the world's largest MNCs during the 1960s, today they represent only one-fifth. *Id*. Second, this smaller portion of U.S.-based MNCs is increasingly willing to invest and engage in large multi-billion dollar transactions abroad and is much less likely to feel in any way tied to their home market as a primary locus for executing transactions, raising capital, and employing workers. Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 478 (Winter 2005). The amount of truly captive resources is shrinking and an increasing amount of their tax base can be shifted to locations that maximize the MNCs' after-tax profits. *Id.* at 480. Thus, open fiscal borders, worldwide economic development, and capital mobility are creating an environment in which elasticity is very high. *See id.* at 477-80.

61. U.S.-based MNCs alter their organizational structures by substituting the U.S.-based parent of the MNC's group for a foreign-based parent corporation (typically a country with low corporate tax rates). *See* U.S. DEP'T TREASURY, OFFICE OF TAX POLICY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 2 (May 2002). There are typically two sources of potential savings from these types of transactions: (i) elimination of tax on foreign-source income if the foreign U.S. parent is subject to a territorial tax system and (ii) through earnings-stripping or other similar transactions, they are able to shift historically U.S.-source income to the lower rate foreign jurisdiction. *See* EARNINGS STRIPPING, *supra* note 58, at 1-2. A detailed analysis of inversions can be found in Mihir A. Desai and James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409 (Sept. 2002).

62. CONGRESSIONAL REPORT ON CORPORATE INVERSIONS AND EXPATRIATIONS, *supra* note 24, at summary ("Over the past several years, reports indicate that an increasing number of U.S. firms have altered their structure by substituting a foreign parent corporation for a domestic one . . . and the recent inversions do not appear to be accompanied by substantive shifts of economic activity from the United States. . . . "). Earnings-stripping transactions are another common way to shift high-tax U.S. profits to low- or no-tax foreign jurisdictions. *See* EARNINGS STRIPPING, *supra* note 58, at 1-2. A common structure involves a loan between a parent and a subsidiary. *See id.* at 9-10. The U.S. borrower entity deducts the interest expense and the interest income is taxed to the foreign lender at the lower foreign rate, assuming that a treaty eliminates the 30 percent withholding. *Id.* The earnings-stripping provisions, which deny the interest deduction for interest payments to related parties, only apply after certain thresholds of interest payments and debt levels are exceeded, and thus this type of shifting is still pervasive. *See* I.R.C. § 163(j) (2006).

63. CONGRESSIONAL REPORT ON CORPORATE INVERSIONS AND EXPATRIATIONS, *supra* note 24. It is also believed that certain cross-border mergers, in which the foreign-based corporation becomes the parent after the merger (*e.g.*, the Daimler-Chrysler transaction), are made more attractive by the fact that worldwide taxation lowers the relative value of U.S. companies. *See*, *e.g.*, Daniel J. Mitchell, *Heritage Calls for International Tax Reform*, 2003 TAX NOTES TODAY 188-78 (Sept. 25, 2003).

savings in the first year and larger amounts thereafter.[64] Although legislation contained in the 2004 JOBS Act is aimed at curtailing expatriations,[65] this inversion activity is a signal of the magnitude of the competitive pressures that a number of U.S.-based MNCs felt, given that they believed it worthwhile to incur the tax[66] and other costs associated with relocating to a foreign residence in order to avoid U.S. taxation of their worldwide income.[67]

Because of the pressure on U.S.-based MNCs to maximize their after-tax returns to investors, our relatively higher statutory rates almost inevitably result in their adoption of aggressive self-help measures, including the exploitation of loopholes, to reduce their effective corporate tax rates.[68] Indeed, notwithstanding the United States' higher

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64. Kirsch, *supra* note 60, at 480-81.

65. After numerous legislative attempts to curtail this activity in the past failed, finally tax legislation aimed at prohibiting or limiting inversions was contained in the JOBS Act. American Jobs Act of 2004, Pub. L. No. 108-357, § 421, 118 Stat. 1418, 1458-59 (2004). This provision applies to inversions occurring after March 4, 2003 and provides two levels of penalty: (i) for foreign parents that are at least 80 percent owned by the former domestic parent's owner, that entity is treated as domestic; (ii) for foreign parents that are at least 60, but less than 80, percent owned, the parent is not treated as domestic, but any toll taxes that apply to transfers of assets cannot be offset by foreign tax credits or net operating losses. I.R.C. § 7874 (2006).

66. I.R.C. Section 367 can require the recognition of gain on a transfer of assets from a U.S. corporation to a foreign corporation. I.R.C. § 367 (2006).

67. *International Tax Competitiveness Hearing*, *supra* note 7, at 13-14 (statement of James R. Hines, Jr., Ph.D., Professor of Business Economics, University of Michigan):

> The wave of corporate inversions from 1996 to 2002 reflects these incentives as a number of American firms thought it worthwhile to incur the tax and other costs associated with relocating to foreign residence in order to avoid U.S. taxation of their worldwide incomes.
>
> The corporate inversion phenomenon is not quantitatively huge in and of itself. Only 25 large firms inverted. It is instead a signal of the magnitude of incentives created by the U.S. residence taxation. For every firm that changes its nationality by inverting, there were several others whose U.S. tax liabilities or potential tax liabilities on foreign income were significant enough to make them contemplate inverting or else never establishing U.S. residency in the first place.
>
> Taxation on the basis of residence makes most sense when residence is an immutable characteristic of a person or a firm. In the global economy, residence is a matter of choice not only because people and companies can move but also because the weight of economic activity is itself responsive to tax burdens, even in circumstances in which people in firms never change their tax residences.

Id.

68. It is estimated that for non-financial companies the average effective corporate tax rate (*i.e.*, the percentage of total corporate profits paid to the U.S. government) is almost nine percentage points lower than the top statutory rate. JOEL FRIEDMAN, CTR ON BUDGET & POLICY PRIORITIES, THE DECLINE OF CORPORATE INCOME TAX REVENUES 6 (Oct. 24, 2003), http://www.cbpp.org/10-16-03tax.pdf. Sophisticated MNCs often engage in complex cross-border arbitrage transactions in

statutory rates, the average OECD country receives 3 percent of its GDP from corporate tax revenues, while the United States generates closer to only 2 percent.[69] Reuven Avi-Yonah and Kimberly Clausing observe that there are several reasons for the relatively lower amount of U.S. corporate tax revenue, including "the increasingly aggressive use of corporate tax shelters . . . and stronger incentives for tax avoidance, which tend to increase as the U.S. tax rate is high relative to other countries."[70] Thus, as the gap between the U.S. corporate crate and other jurisdictions continues to widen, the more avidly U.S.-based MNCs will pursue aggressive tax planning devices. Accordingly, it will be difficult for the United States to both maintain these higher corporate tax rates and prevent distortive taxpayer behaviors, particularly in the absence of any other significant tax policy changes.[71]

III. THE ROLE OF PRINCIPLES-BASED RULES IN CORPORATE TAX REFORM

A fundamental policy decision by U.S. tax lawmakers to move towards a more balanced principles-based regime could significantly mitigate many of the challenges facing the current system and enable the United States to lower its statutory corporate rate in a revenue-neutral way. The current U.S corporate tax system is burdened by a thicket of

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order to achieve tax savings, and substantial empirical evidence now exists that MNCs are also able to significantly reduce their corporate tax burden through transfer pricing, earnings stripping and other profit shifting strategies. Sam Bucovetsky & Andreas Haufler, *Tax Competition When Firms Choose Their Organizational Form: Should Tax Loopholes for Multinationals be Closed?* (CESifo, Working Paper No. 1625, 2005). *See also* Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT'L TAX J. 703, 721 (2009) (suggesting that U.S. corporate tax revenues in 2004 were approximately 35 percent lower due to income shifting). In fact, in recent years many high-tech, pharmaceutical and other soft asset MNCs are moving a significant portion of their profits offshore through a variety of arrangements that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration in order to reduce their effective tax rates. Martin A. Sullivan, *Economic Analysis: Drug Firms Move Profits to Save Billions*, 112 TAX NOTES 472, 472 (Aug. 7, 2006).

69. Avi-Yonah et al., *supra* note 27, at 5, 10 ("despite a corporate tax rate one standard deviation above that of other OECD countries, the U.S. corporate tax system raises relatively little revenue, due in part to the shifting of income outside of the U.S. tax base").

70. *Id*. at 11. *Cf.* William Barker, *Optimal International Taxation and Tax Competition: Overcome the Contradictions* 22 NW. J. INT'L L. & BUS. 161, 189 (2002) ("The lower the rate and the less elastic the tax base, the lower the effect taxation will have on economic decision-making." (citing VITO TANZI, TAXATION IN AN INTEGRATING WORLD 4 (1995)).

71. For a general discussion of rate lowering proposals, see Harry Grubert & Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income 5 (draft Dec. 12, 2006) (suggesting that the "optimal" rate structure would include a corporate rate of 28 percent), http://econweb.rutgers.edu/altshule/research/200626.pdf.

prescriptive rules.[72] These complex rules are challenging and expensive to administer, impose extraordinarily high compliance costs on MNCs,[73] and ultimately fail to adequately respond to the rapidly changing global marketplace and to taxpayers seeking to exploit their weaknesses. Based on the analysis that follows, I believe that not only could the use of more principles help address these issues, but other important benefits could be realized as well. Accordingly, the implementation of more principles-based rules should be given consideration in any contemplated tax reform proposals.

A. Principles-Based Rules versus Prescriptive Rules

The debate over the use of principled versus prescriptive rulemaking is gaining renewed traction in other areas of the law,[74] and there are certainly advantages and disadvantages to each regulatory approach. For definitional purposes, I will assume that a principles-based rule sets forth an explicit general standard governing which conduct is or is not permissible. On the other hand, a prescriptive rule determines *ex ante* what specific conduct is or is not permissible by detailing the treatment of all expected factual situations.[75] For example,

72. Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 363 (Fall 2005) ("The tax system is the quintessential rule-based, as opposed to a standards-based, legal regime.").

73. Lassila et al., *supra* note 23, at 207 (showing that corporations with a higher degree of internationalism had even higher compliance costs).

74. For example, the accounting and securities regulation fields are currently undergoing extensive debate on this topic. *See*, *e.g.*, Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L. J. 1, 1 (2008) ("The significance and wisdom of 'principles-based' securities regulation may be among the most pressing questions facing securities regulators internationally today."); George J. Benston, Michael Bromwich, & Alfred Wagenhofer, *Principles- versus Rules-Based Accounting Standards: The FASB's Standard Setting Strategy*, 42 ABACUS 165 (June 2006). This debate has also been going on for some time in the tax law. *See*, *e.g.*, Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969); Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Weisbach, *supra* note 17; FREDERICK SCHAUER, PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE (Clarendon L. ed., Oxford University Press 1993) (1991).

75. These definitions of principles-based rules and prescriptive rules are similar to those given to the traditional "standards" and "rules" terms as defined by Louis Kaplow. *See* Kaplow, *supra* note 74, at 562. Under his definition, a standard is a provision in which the determination of content is made *ex post* and a rule is a provision in which the determination of content is made *ex ante*. *Id.* Generally speaking, a prescriptive rule will have the characteristics of a "rule" in that its content is determined *ex ante*. In addition, a standard will likely qualify under my definition of a principles-based rule. However, although similar, as I define principles-based rules, there are certain principles-based rules which may be "rules." That is, even though the determination of the content can be made *ex ante*, the underlying principle is in fact articulated as the rule directly in the

in regulating driving speeds, a principles-based rule could provide that drivers are allowed to drive at any speed that is safe and reasonable given the existing traffic and weather conditions and time of day. A prescriptive rule could provide that the speed limit is sixty miles per hour. As another example, in regulating chemical disposal, a principles-based rule could provide that no company can dispose of any chemical waste without the use of specially approved containers if such waste could be harmful to humans, animals or the environment. On the other hand, a prescriptive rule could merely mandate the proper disposal of a specific list of chemicals, which scientists have already pre-determined are harmful.

Advocates of principles-based rules generally believe that these types of rules more adequately convey the underlying policies that the rules are intending to effectuate.[76] For example, it is clear that in the traffic example, lawmakers would like to ensure that drivers are moving at safe speeds, and in the chemical disposal example, that lawmakers want to protect their citizens and the environment from harmful substances. With the prescriptive rules, by contrast, you must deduce what underlying policy the law is intending to implement. You must assume that transportation officials, in studying various relevant factors, have determined that sixty miles per hour is the speed that the majority of drivers can reach without posing a significant danger to themselves and other drivers. In addition, principles-based regulations may provide the regulated entities with more flexibility in choosing their method of compliance. Drivers, for instance, can make their own determination, based on their level of comfort and examination of the facts, as to what speed they deem safe to travel. Principles-based rules are also typically more adaptable to changing circumstances and various factual situations. If a new chemical is developed that is known to be dangerous to humans, that chemical will automatically be covered under the principles-based rule, whereas lawmakers would have to amend the prescriptive rule in order to add the new chemical to the list of covered substances. Relatedly, the cost of implementing principles-based rules is generally lower than that for prescriptive rules, because with prescriptive-based

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applicable provision. Although in certain situations the delineation between prescriptive and principled rules may become blurred, I do not believe that difficulties in labeling on the margin should affect the overall analysis or conclusions regarding the effects of implementing more principles-based rules. Indeed, there has been much debate over what the precise definition of these terms should be, even though the general meaning accorded them is largely the same. *See*, *e.g.*, Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting*, 60 VAND. L. REV. 1411 (2007).

76. *See*, *e.g.*, Surrey, *supra* note 74, at 703; Weisbach, *supra* note 17, at 861-62.

rules, the regulator must work to identify all of the transactions or behaviors that fall within a rule and those that do not.[77]

On the other hand, proponents of prescriptive rules argue that they allow for a much higher certainty of behavioral expectations.[78] For example, drivers under the prescriptive rule would know *ex ante* that in order to comply with the law, they could not drive in excess of sixty miles per hour. On the other hand, even after a driver has assessed all of the relevant conditions and determined his or her appropriate speed, he or she would not be certain that they had complied with the principles-based law until after the fact when a relevant enforcement agency determined otherwise (*e.g.* a state trooper pulls them over). Accordingly, prescriptive rules have the potential to result in significantly lower compliance and enforcement costs. Once the actor is made aware of the prescriptive rule, they may need no further guidance before participating in the regulated behavior, and once they have engaged in the behavior, it will be clear whether or not they have complied. On the other hand, with a principles-based rule, it may take considerable time and cost for an actor to evaluate whether the anticipated behavior will be "reasonable" or "safe" or otherwise comply with whatever principled rule has been enunciated. Similarly, in order for the applicable enforcement entity to be able to sanction the actor, it must again compile all of the relevant facts and circumstances and conclude that its determination of the content of the principles-based rule is meaningfully different from the actual activity engaged in by the actor. Prescriptive rules also are considered to have the advantage of ensuring more consistency in behavior and enforcement across firms or individuals. A driver can be assured that even though he or she cannot drive over sixty miles per hour without violating the law, no one else can either.

B. Factors Affecting the Use of Principles-Based Rules in U.S. Tax Law

In actuality, the pros and cons of either approach to regulation are not so easily delineated. Generalizations about the utility and attributes of principles or prescriptive rules can depend greatly on the actors in—and content, dynamics, and regulatory goals of—the specific area of law.

77. *See*, *e.g.*, Kaplow, *supra* note 74, at 562 ("Rules are more costly to promulgate than standards because rules involve advance determinations of the law's content. . . .").

78. The "big three" justifications for prescriptive rules are certainty, predictability, and reliance in the system. Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 10 (2001).

With respect to corporate tax law in particular, I believe the effectiveness of either form of rule is highly influenced by any number of factors, including: (i) the relative complexity of prescriptive rules, (ii) the absolute level of complexity of the regulatory regime, (iii) the prevalence of the regulated behavior and pace of change in the underlying regulated field, (iv) the desirability of uncertainty, (v) the frequency and availability of up-to-date guidance, (vi) the level of complexity actually employed by the enforcers of the rules, and (vii) the possibility for the regulatory system to overlap and interact with a distinct set of rules from an entirely different regime.[79]

1. The Relative Complexity of Prescriptive Rules

In order to be able to achieve the goal of reducing complexity, it must first be accepted that principles-based rules are systematically less complex than prescriptive rules. Stanley Surrey first posited that standards would allow the tax law to be simpler than rules. He believed that broader principled anti-abuse provisions would "save the tax system from the far greater proliferation of detail than would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of [rules]."[80] Weisbach expanded on this proposition and definitively concluded that rules are "systematically more complex than standards."[81] I agree with these assessments in relation to principles-based rules.[82]

The essence of a prescriptive rule is that it must be able to mandate, *ex ante*, the proper treatment for a particular transaction. It attempts to prescribe the appropriate treatment of all expected factual situations. A prime example of this phenomenon can be found in the passive-activity loss rules under Section 469 of Code and the accompanying Treasury Regulations.[83] In an attempt to account for every conceivable scenario

79. Although in the context of standards (rather than principles-based rules), factor (i) has been analyzed in depth by Weisbach, and factors (ii) through (vi) have previously been considered by Louis Kaplow. Weisbach, *supra* note 17; Kaplow, *supra* note 74. Factor (vii) is an additional consideration that I believe is also relevant in assessing the use of principles-based rules in the regulation of international transactions.

80. Surrey, *supra* note 74, at 707 n.31.

81. Weisbach, *supra* note 17, at 867.

82. A notable contrary opinion is Kaplow who believes that a rule and a standard that lead to identical outcomes necessarily have an equal level of complexity. Kaplow, *supra* note 74, at 586-88.

83. I.R.C. § 469 (2006). Section 469 generally provides that deductions from passive trade or business activities of a taxpayer, to the extent they exceed income from all such passive activities (exclusive of portfolio income), may not be deducted against other income. § 469(a)(1). Similarly,

that a taxpayer engaged in a passive trade or business could encounter, the IRS initially set forth an extremely detailed and complex series of tests for the determination of the scope of a taxpayer's "activities," which spanned 60 pages.[84] After the regulations were highly criticized by tax practitioners as being "overly long and complex," the Secretary allowed the temporary regulation to expire and ultimately promulgated in the final version of Treasury Regulation Section 1.469-4, a more principles-based facts-and-circumstances test for the determination of the scope of a taxpayer's activities under the passive-income rules.[85] Not surprisingly, these regulations span only eight pages, representing an 87 percent reduction in length.[86] Just as importantly, these final rules have been successful in shutting down abusive passive activity loss transactions.

As evidenced by the passive activity loss rules, given the infinite number of potential transactions that savvy taxpayers and their advisors are able to develop, in order for prescriptive rules to be effective in fulfilling their purpose, they must specify the treatment of a greater number of transactions. Otherwise, gaps in the tax law will emerge. Therefore, prescriptive rules can "less afford to overlook uncommon transactions than can standards."[87] Principles-based rules, on the other hand, are able to encompass a larger subset of transactions, because the articulated principle can apply to even unknown situations. Thus, any given principle has the potential to govern the treatment of both common and uncommon (or yet unknown) transactions. Accordingly, with respect to the tax law, I believe that prescriptive rules will generally be more complex than principles-based rules.

2. The Underlying Complexity of the U.S. Corporate Tax System

There is a general belief that prescriptive rules are easier and less costly to implement because they direct a specific outcome and do not require an assessment of particular facts to a given principle. In fact, however, this argument loses force when the overall regulatory regime is highly complex. Even though the treatment of a given transaction may be predetermined under a prescriptive rule, the taxpayer must still be

credits from passive activities generally are limited to the tax allocable to the passive activities. § 469(g)(1).

84. Treas. Reg. § 1.469-4T, 54 Fed. Reg. 20,527 (1989).

85. Preamble to Treas. Reg. § 1.469-4, 57 Fed. Reg. 20,802, 20,803 (1992).

86. Notwithstanding the reduction of rules relating the definition of "activity," the final regulations still contain one of the most complex and voluminous set of regulations in the Code.

87. Weisbach, *supra* note 17, at 867.

able to determine what that outcome is. As discussed above, with the nearly 100,000 pages of existing Code and Treasury regulations that exist in the current tax system, the task of figuring out the tax consequences of a particular transaction can be more than daunting. This is particularly true as transactions become increasingly complex. Overlapping or overriding provisions may or may not be applicable, making the determination of the appropriate treatment of any given transaction potentially a timely and expensive endeavor. Thus, even though a given rule, or set of rules, may prescribe a particular outcome, deciding which, if any, provision is appropriate to apply can require the same, or even more, work than a principles-based regime.[88] Accordingly, because of the highly intricate nature of the current U.S. corporate tax provisions, the assumption that compliance with prescriptive rules is less timely and expensive is not necessarily accurate.

3. Regulating Common and Fringe Transactions in an Evolving Marketplace

One of the primary complaints against principles-based rules is that they are too ambiguous and do not provide enough predictability to the regulated entity. Indeed, in the tax law, predictability of application and outcome is extremely important for transactions in which taxpayers frequently engage. However, the assumption that predictability can be best provided by prescriptive rules can be compromised when tax policymakers are working to police complex transactions in a fast-changing marketplace. In these situations, principles may in fact provide better guidance than prescriptive rules.

At a basic level, the tax system should enable taxpayers who engage in commonplace transactions to be relatively certain of the resulting tax costs *ex ante*. Tax considerations often play a pivotal role in assessing whether or not it is advisable for a taxpayer to engage in a particular transaction. The tax system would be impractical and unwieldy if the majority of transactions required subjective determinations to be made by the taxpayers and government. Accordingly, prescriptive rules, and the predictability they provide, are appropriate for regulating rudimentary transactions. Indeed, there are existing simple prescriptive rules that are longstanding, work well, and

88. For example, just determining the proper allocation and apportionment of interest expense for purposes of calculating the foreign tax credit can be an extraordinarily grueling and time consuming process.

do not cause any significant changes in taxpayer behaviors, and these generally should not be replaced or overridden by broader principles.[89]

As the level of intricacy and specialization of the transactions increase, however, and the marketplace in which taxpayers operate evolves, the assumptive predictability of prescriptive rules can be diminished. Prescriptive rules can only be effective in so far as they adequately address the specific transaction at issue. Thus, when trying to regulate behaviors in an environment that is undergoing constant change, principles-based rules may in fact provide better guidance than prescriptive rules.

The pace of global innovation is so rapid that it is impossible for any jurisdiction to keep in lockstep with its development. Accordingly, as transactions evolve and new products are developed, prescriptive rules tend to be either over- or under-inclusive, because it is impossible for the government to effectively anticipate every potential scenario that can be created. As articulated by Kevin Dolan, "[a prescriptive]-based rule can be a rifle shot that hits only one piece of the logical target or hits the wrong target," or "[a]lternatively, it can be a scattershot, hitting many wrong targets and causing collateral damage."[90] On the other hand, even if a particular transaction is not contemplated by the drafters of a principles-based regulation, because the underlying principle is directly articulated in the rule, the applicable principle will nevertheless govern the outcome. In this way, principles-based rules have the advantage of being able to cover a broader range of situations.[91] Therefore, the less prescriptive a regulatory system is, the more easily it will be able to absorb various changes in the markets as they occur.

Principles-based rules will increase the effectiveness of the U.S. tax system in a constantly evolving environment. A principles-based system will be better equipped to deal with the economic transformation that has occurred as a result of globalization by enabling policymakers to build a platform upon which they can more effectively and efficiently administer tax policy. Principles-based rules have the advantage of

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89. *See* Weisbach, *supra* note 17, at 882-83.

90. Kevin Dolan, *Foreign Tax Credit Generator Regs: The Purple People Eater Returns*, 115 TAX NOTES 1155 (June 18, 2007).

91. Kaplow, *supra* note 74, at 616:

> In the present legal system, it is usually believed that standards are easier to keep up-to-date. The reason is that standards are given content in a definitive way only when they are applied to particular conduct. Thus, a standard promulgated decades ago can be applied to conduct in the recent past using present understandings rather than those from an earlier era.

Id. (citations omitted).

being able to cover a broader range of situations, and are thus more effective when trying to regulate behaviors in an environment that is undergoing constant changes. In this sense, they may also provide MNCs with more guidance when dealing with novel issues. Having a cohesive set of principles can enable the MNCs to more accurately predict the application of the law to their proposed transactions.

4. The Potential Exploitation of Loopholes and the Attractiveness of Uncertainty

Certainty of application is often touted as the key advantage of prescriptive rules over principles-based rules. From the government's perspective, however, certainty may not be desirable when it is contending with rules that inevitably create loopholes that can be easily exploited by sophisticated MNCs and their advisors. When the government is attempting to regulate transactions that fall into these gaps not anticipated by the original drafters, its chances for a government-favorable outcome are greatly hampered without the presence of any overarching standard. If the government tries to rely primarily on addressing these situations after the fact by layering prescriptive rules on top of prescriptive rules, then it will inevitably end up on the losing end of a reactive game of catch-up.

With the plethora of derivative and entity forms currently available in taxpayers' arsenals, it would be very unusual for a new product to come into the marketplace that is not at least tax-neutral or more likely tax-advantaged. Tax benefits are typically a huge (and often primary) factor in the development of new structures and products. Thus, the backstop of a principles-based rule would be preferable from the government's perspective because even a miniscule change to the facts can change the outcome under a prescriptive rule,[92] and if the bright-lined requirements of a particular statute or regulation are met, then the government may have a much more difficult time sustaining a contrary position. As noted by Daniel Shaviro, a key reason for using principles-based rules is that the IRS can apply them "even if the government failed to anticipate a particular trick and state in advance that it does not work," and "[t]here are simply too many fault lines in the existing income tax laws and too many clever people laboring behind closed doors to find

92. *See*, *e.g.*, Weisbach, *supra* note 17, at 873 (discussing discontinuous nature of prescriptive rules).

new ways to exploit these fault lines for after-the-fact prospective responses to be adequate."[93]

The exploitation of loopholes can create significant social waste. If the ability of the government to respond to gaps in the tax law is compromised, then "what was a potentially small loophole with relevance to only a few transactions," inevitably becomes "a large loophole as enterprising tax advisors funnel money and clients through such gaps."[94] The better the tax advantage, the more ordinary the extraordinary transaction will become, creating even greater social inefficiencies and costs.[95]

Accordingly, principles-based rules may better enable the United States to neutralize and minimize these distortions that can be created when tax considerations play an undue role in investment decisions, by introducing a level of what I will call "desirable uncertainty." That is, the level of unpredictability caused by the principles-based rule provides an attractive benefit to the government who is trying to prevent taxpayers from taking advantage of the fact that it is impossible for it to adequately predict the future actions of taxpayers.[96]

Because taxpayers will always have the advantage of being able to structure into (or around) particular tax provisions that the government has set forth,[97] it is important to consider the types of incentives or constraints a particular form of rule will provide to the taxpayer when they are at the crossroads of deciding whether or not to enter into a transaction. In this regard, principles-based rules could be a leveling mechanism for a government with inadequate resources to regulate an entity with superior resources and the advantage of not having to act first.[98] The blurry line created by a principle may introduce a level of

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93. DANIEL SHAVIRO, CORPORATE TAX SHELTERS IN A GLOBAL ECONOMY: WHY THEY ARE A PROBLEM AND WHAT WE CAN DO ABOUT IT 23 (2004).

94. Logue, *supra* note 72, at 366.

95. Weisbach, *supra* note 17, at 869.

96. For example, Section 482 of the Code gives the IRS enormous discretion to decide whether taxes are being evaded or income is not being clearly reflected when policing transactions among commonly controlled entities. I.R.C § 482 (2006). As globalization has expanded the opportunities for MNCs to take aggressive positions with respect to their intercompany cross-border transactions, the IRS's powers under Section 482 have become more important. *See*, *e.g.*, Aprill, *supra* note 78, at 26 ("[A]s multinational issues grew, so did the impact of section 482.").

97. *See* Schizer, *supra* note 46, at 334-35 ("[S]helters (and, indeed, all aggressive planning) exploit poorly drafted statutes and regulations. The relevant rules are capable of being read (albeit aggressively) to allow, for example, tax losses with no corresponding economic losses. Drafters need to be more effective in anticipating this sort of misreading.").

98. *See generally id.* at 331 (acknowledging that a contributing factor to aggressive tax planning is the imbalance of resources and experience between the taxpayers and the IRS auditors).

desirable uncertainty that can serve to restrain the taxpayers' behavior.[99] As a result, even though a taxpayer may want to engage in a form of transaction not anticipated by the drafters, an overarching principles-based rule could nonetheless cast a shadow under which the transaction will be structured.[100] A principles-based rule is not as easy to step around as a neatly drawn prescriptive line in the sand. In this way, principles-based rules can more effectively diminish a taxpayer's ability to exploit gaps in the tax law.

5. Timely Regulatory Guidance

A commitment to make up-to-date guidance readily available can also help mitigate the perceived disadvantages of principles-based rules. For example, once the IRS issues a revenue ruling with respect to a particular type of transaction, a prescriptive rule is established for that set of facts.[101] Therefore, the level of uncertainty and cost of compliance with respect to that specific transaction are greatly reduced. Even in the case of the issuance of less formal guidance that does not have any strict precedential value,[102] such guidance will still help to establish

99. *See*, *e.g.*, Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards* 17 ACCT. HORIZONS 91, 99 (2003). It is worthwhile to note that some data that shows that the aggressiveness of positions can sometimes increase with the imprecision of the relevant rule because responders are able to interpret the evidence more liberally. *Id.* at 96-97. However, this latitude of ambiguity will cut the other way when the deterrents and penalties are sufficiently onerous such that the value of certainty becomes augmented. *Id.* at 99.

100. While the increased flexibility of principles-based rules may more effectively eliminate the presence of tax loopholes and opportunities for tax arbitrage, in certain situations MNCs may actually prefer the flexibility that principles-based rules can provide. The attitude of an entity towards the implementation of principles or prescriptive rules may very well depend, among other factors, on whether the underlying rule is intended to be permissive or restrictive. Clearly, if a regulation is attempting to restrict or penalize the behavior of MNCs, they would likely prefer the specificity of a prescriptive rule because it would be easier to avoid its application. On the other hand, if the rule permits the MNC to engage in a behavior that it deems favorable, it may prefer a rule that is principles-based because it would give the MNC the flexibility to comply with the rule in whatever way it deemed most efficient or otherwise desirable. *See*, *e.g.*, I.R.C. § 482 (2006).

101. Kaplow, *supra* note 74, at 577-78.

102. Strictly speaking, IRS administrative guidance such as chief counsel advice, private letter rulings and technical advice memoranda may not be used or cited as precedent. I.R.C. § 6110(k)(3) (2006). Nevertheless, such materials are routinely cited to reveal statutory interpretation by the IRS as the agency charged with administering the revenue laws, and as evidence that a particular construction is compelled by the language of the statute. Hanover Bank v. Comm'r, 369 U.S. 672, 686-87 (1962); Estate of Bongard v. Comm'r, 124 T.C. 95, 162 n.18 (2005); Woods Inv. Co. v. Comm'r, 85 T.C. 274, 281 n.15 (1985). *See also* Dover Corp. v. Comm'r, 122 T.C. 324, 341 n.12 (2004) ("Private letter rulings may be cited to show the practice of the Commissioner."); Estate of Cristofani v. Comm'r, 97 T.C. 74, 84 n.5 (1991) (stating that private letter rulings are not precedential, but reveal the IRS's interpretation of statute); AT&T Corp. v. United States, 62 Fed.

interpretive norms and make the application of the underlying principle more predictable. Thus, in moving towards a more principles-based system, it would be extremely important for the IRS to supply consistent guidance interpreting the underlying principles.[103] This would give the relevant principle more precision and predictability. In such a case, a principles-based rule could have the benefit of more certainty with respect to the transactions on which the IRS or courts have provided guidance, while maintaining the advantage of being able to guide MNCs' behavior on the implementation of novel transactions. Of course, one drawback is that too much additional interpretative guidance for a particular principle can increase the complexity of the principle and thus diminish its benefits of simplicity.[104] Also, the issuance of guidance creates additional administrative costs for the government and potentially incremental compliance costs for the taxpayer who must be able to discover and analyze these precedents. Nevertheless, the issuance of targeted guidance to taxpayers can be a useful tool in enhancing the predictability of principles, a result often welcome by taxpayers.

6. High Level of Complexity Employed by the IRS and Courts

When analyzing the relative advantages of prescriptive rules versus principles-based rules, it is important to take into account the level of detail actually used by the enforcers of the rules.[105] In an era in which the judicially constructed economic substance/business purpose and step-transaction doctrines lurk in the background and are being pursued with invigorated zealousness by the government,[106] for most structured

Cl. 490, 496 (2004) (stating that technical advice memoranda are not precedential, but can be instructive).

103. Detailed examples in any implementing regulations could also have the same effect.

104. *See* Nelson, *supra* note 99, at 96.

105. Kaplow, *supra* note 74, at 565-66.

106. Courts may deny a tax benefit associated with a transaction that might otherwise arise on the basis that the taxpayer does not have a business purpose for entering into a transaction or that there is no economic effect of the transaction other than tax savings. *See generally* Gregory v. Helvering, 293 U.S. 465 (1935), *aff'g*, 69 F.2d 809 (2d Cir. 1934). The step transaction doctrine allows the IRS to disregard a particular step in a transaction only if a taxpayer included the step for no purpose other than tax avoidance. *See*, *e.g.*, Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 213 (D.C. Cir. 2001). This extra-statutory use of common law doctrines has been criticized by several scholars as being unnecessary in a regime with highly articulated standards. *See*, *e.g.*, Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982); John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997); Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX. L. REV. 677 (1996); Lawrence Zelenak, *Thinking About Nonliteral Interpretations*

transactions no matter how seemingly straight-forward the prescriptive rule might be, the analysis nonetheless becomes rather muddled. The recent expansion of Circular 230 has further heightened the attention paid to these issues because tax advisors can no longer provide penalty-protection opinions by assuming that their client has a business purpose or that the transaction has an economic effect other than the creation of tax benefits.[107]

Thus, complaints about uncertainty can have much less relevance when dealing with the regulation of intricately engineered transactions. Even when MNCs and their advisors are able to squarely structure into a gap in the regulatory system, much time and discussion is still devoted to examining the business purpose/economic substance, step transaction, conduit and/or any other relevant anti-abuse doctrines. For example, when attempting to express concerns about ongoing foreign tax credit abuses, the IRS stated that although regulations regarding the particular abuse at issue would not be pursued, that it would continue to challenge transactions generating "inappropriate" foreign tax credit results under "the substance over form doctrine, the step transaction doctrine, debt-equity principles, Section 269, the partnership anti-abuse rules of §1.701-2, and the substantial economic effect rules of §1.704-1."[108] Therefore, in addition to the actual foreign tax rules and regulations under Section 901 that MNCs and tax advisors must contend with, they must also examine the potential application of these other provisions and doctrines as well.

This is not to say that all, or even most, structured transactions are in fact abusive or lacking a business purpose. However, because these kinds of transactions can involve the shifting of income, arbitrage, the exploitation of a loophole and/or achieve results clearly not anticipated by the drafters, such as the double non-taxation of income, there is usually a heightened concern by taxpayers and their advisors that the IRS may attempt to use all of the weapons available in its arsenal to

of the Internal Revenue Code, 64 N.C. L. REV. 623 (1986). However, the judicial use of these extra-statutory standards is well established and endorsed by Supreme Court decisions. *See*, *e.g.*, *Gregory*, 293 U.S. 465.

107. Treas. Dept. Circ. No. 230 § 10.35(c)(1)(ii) (Sept. 26, 2007) ("[I]t is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits."). Circular number 230, which governs the standards of professional practice for tax advisors, was recently modified to expand the gatekeeping role of advisors with respect to aggressive tax planning. T.D. 9165, 70 Fed. Reg. 75839-01 (Dec. 20, 2004) (amended by T.D. 9201, 70 Fed. Reg. 28824-01 (May 19, 2005) and T.D. 9359, 72 Fed. Reg. 54540-01 (Sep. 26, 2007)).

108. Notice 2004-19, 2004-1 C.B. 606 (withdrawing Notice 98-5, 1998-1 C.B. 334).

attack the transaction, including the anti-abuse doctrines. Thus, before executing these transactions, taxpayers are likely to seek opinions from their tax advisors analyzing whether the IRS may be successful in any attempts to disregard or recast their transactions. Accordingly, any incremental time spent examining whether a transaction satisfies the underlying principle of a particular statutory rule may not be as relatively significant because it will only be one additional subjective factor to consider.

7. Interaction of the U.S. Tax Rules with Tax Rules of Other Jurisdictions

The perception regarding the advantages and disadvantages of prescriptive and principles-based rulemaking can also be affected when more than one country's rules apply to a single transaction. Today cross-border transactions are increasingly prevalent, and the interaction of the laws of the relevant jurisdictions can often produce unanticipated results and create opportunities for tax arbitrage. Now, more than ever, large MNCs are engaging in these highly structured deals that can result in double non-taxation.[109] In these transactions, MNCs are able to attain significant tax benefits by exploiting differences or inconsistencies in two or more jurisdictions' tax laws. For example, an opportunity for tax arbitrage can exist when the same items of deduction and income, entities or instruments are treated or classified differently by two or more jurisdictions.[110] Such differences can result in significant tax benefits, such as multiple deductions or credits or deductions with no offsetting inclusion.

At a fundamental level, arbitrage itself may not necessarily be abusive, as it can be the natural result of a global economy that contains

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109. *See* Paulus Merks, *Categorizing Corporate Cross-Border Tax Planning Techniques*, 44 TAX NOTES INT'L 55, 56 (Oct. 2, 2006) ("[I]nstances when particular income is not taxed at all are becoming increasingly frequent.").

110. As a simple example, assume that a U.S.-based MNC issues an original issue discount ("OID") instrument to non-related investors in Country A. Assume further that Country A does not have OID rules, so that a zero coupon bond allows a Country A holder to defer the inclusion of interest income, while the U.S.-based MNC is allowed to deduct the interest on an economic accrual basis under the U.S. tax rules. Because there are no current inclusions for the Country A investors, the OID instruments can be issued at a lower rate of interest than if they were issued to U.S. investors (who would have to currently include the accrued interest in income). For more examples of cross-border arbitrage transactions, see Mark Silverman & Philip R. West, *Law Firm Comments on Leveraged Foreign Investment, Cross-Border Arbitrage Transaction Issues*, 2006 TAX NOTES TODAY 148-28 (July 31, 2006); Yaron Z. Reich, *International Arbitrage Transactions Involving Creditable Taxes*, TAXES, Mar. 2007, at 53.

disparate tax systems.[111] It has long been argued that taxpayers are free to manage their affairs in a way that minimizes their tax liability.[112] However, many view this exploitation by MNCs of differences in tax systems as inappropriate or unfair and the highly engineered and artificial structures that produce some of these arbitrage spreads can have significant economic consequences in one or both of the affected jurisdictions.

At its core, cross-border tax arbitrage requires inconsistencies between the tax laws of two or more jurisdictions. The prevalence of these transactions is aided by the predominance of bright-lined prescriptive rules. The same way that sophisticated MNCs and their advisors are able to structure around loopholes in the U.S. tax system, they are equally adept at structuring cross-border transactions that take advantage of the differences between the disparate tax rules of two jurisdictions. However, the more demarcated the rules in the tax systems are, the more easily the mismatch between dissimilar rules can be identified and exploited.[113] On the other hand, principles-based rules

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111. *See*, *e.g.*, Lee A. Sheppard, *U.S., U.K. Officials Discuss Cross-Border Tax Planning*, 2005 TAX NOTES TODAY 233-4 (Dec. 6, 2005); Mark J. Silverman & Philip West, *Law Firm Comments on Leveraged Foreign Investment, Cross Border Arbitrage Transaction Issues* 2006 TAX NOTES TODAY 148-28, 6-7 (July 31, 2006):

> [W]e think that there is no serious debate about the fundamental proposition that, absent a law or regulation to the contrary, a tax result is not rendered inapplicable solely because a different or inconsistent result is produced for the same transaction under the laws of a foreign jurisdiction . . . [or] that an enhanced economic return or the prospect of a lower cost of funding before consideration of U.S. taxes constitutes a valid business purpose for adopting a particular structure for a given investment. Taken together, these two propositions suggest that, if a U.S. taxpayer is able to obtain capital through a structure at a lower cost of funds than would be paid without that structure, the tax consequences that otherwise result are not rendered inapplicable, even if the structure yields inconsistent tax results in the U.S. and another jurisdiction . . . .

Id. Even Hal Hicks, Treasury international tax counsel, stated that there is nothing inherently wrong with cross-border tax arbitrage because it is a natural byproduct of the global economy interacting with disparate tax systems and it is hard to delineate what is evil from what is acceptable. Sheryl Stratton, *Tax Arbitrage Not Inherently "Evil," Treasury Official Says*, 2006 TAX NOTES TODAY 9-3 (Jan. 13, 2006).

112. Judge L. Hand argued:

> [A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . .

Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

113. *See*, *e.g.*, Weisbach, *supra* note 17, at 874.

can make the identification of incongruous rules more difficult. The potential gaps between lines that are blurry can be much harder to pinpoint.

In addition, well-enunciated principles can potentially ease the ability of the United States to coordinate its tax rules and policies with those of other countries so as to prevent the unintended results of tax arbitrage transactions. International collaboration with peer jurisdictions can help to produce more harmonized rules among cooperators.[114] Coordinating principles of the involved national regulators would help reduce the opportunities for arbitrage transactions between parties in the cooperating jurisdictions and help to broaden the United States' political reach beyond its borders. Globalization, in a very real sense, limits a nation's sovereign ability to impose any particular policy on an MNC, for example, when that MNC is highly elastic and can easily "opt out" of a regulatory scheme or rule it does not like. By coordinating with other jurisdictions, however, the United States can help influence the policies of other jurisdictions.[115] In essence, the larger the pool of global cooperators, the larger the reach of our political power and the less able the MNCs will be able to opt out of a particular policy.[116]

To that end, it is easier to coordinate and agree to overarching principles with other jurisdictions than it is to attempt to perfectly align competing (or even non-competing) sets of narrowly tailored prescriptive rules.[117] If two taxing jurisdictions are trying to pervasively eliminate opportunities for arbitrage, it is necessary to be able to first identify where the underlying policy gaps exist. However, without the presence of clearly articulated principles, that task can be very difficult, or even impossible. The complexity generated by prescriptive rules can

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114. Former IRS Commissioner Mark Everson stated that "[m]any of [his] counterparts in the international tax community have expressed the need for greater cooperation to fight the proliferation of abusive tax practices." Internal Revenue Serv., *Everson Chairs International Tax Forum, Underscores Enforcement*, 2006 TAX NOTES TODAY 148-10 (Aug. 1, 2006).

115. *See*, *e.g.*, Daniel Shaviro, *Some Observations Concerning Multi-Jurisdictional Tax Competition* (NYU Center for L. & Bus., Working Paper No. CLB-00-001, 2000).

116. Insop Pak, *International Finance and State Sovereignty: Global Governance in the International Tax Regime*, 10 ANN. SURV. INT'L & COMP. L. 165, 197 (2004).

117. Coordination would not necessarily require homogenization. Complete cooperation is not often likely to occur because independent countries must be expected to follow their own interests in developing rules of taxation that best suit them. *See*, *e.g.*, H. David Rosenbloom, Speech at the 59th Annual Federal Tax Conference of the University of Chicago Law School (Nov. 11, 2006); *see also* H. David Rosenbloom, *Cross-Border Arbitrage: The Good, The Bad and The Ugly*, 85 TAXES 115 (2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1012888. It is also not necessarily the case that any compromises away from unilateralism will decrease domestic efficiency and undermine domestic policy concerns, because in many instances the laws did not, *ab initio*, take into account any international impact or result that was intended by the lawmakers.

thus significantly impair the ability of the United States to effectively cooperate with other jurisdictions.[118]

C. The Proper Balance of Principles and Prescription in U.S. Corporate Tax Law

As the preceding analysis shows, the utility of principles-based versus prescriptive rules is not strictly a black-and-white determination. The relative advantages of, and therefore weight given to, either a prescriptive or principles-based rulemaking approach can depend on any number of important factors. In particular, as it relates to the corporate tax system, the preceding examination of the pertinent considerations reveals that: (i) the use of more principles-based rules should help simplify the tax laws; (ii) the use of prescriptive rules in the tax law may not be easier and less costly to apply because of the underlying inherent complexity of the U.S. tax system; (iii) the certainty of prescriptive rules is most necessary and achievable when regulating straight-forward, commonplace transactions; (iv) principles-based rules can provide more guidance to novel transactions and more effectively mitigate the emergence and exploitation of tax loopholes; (v) if targeted, up-to-date guidance is being articulated with respect to commonplace transactions, a principles-based rule can quickly adopt some of the positive characteristics associated with prescriptive rules (*e.g.*, certainty of outcome), while maintaining the advantages of having a regulatory safety net; (vi) when dealing with highly structured transactions, because of the myriad of anti-abuse doctrines that can apply, the application of a substantive principles-based rule may only add accretive complexity to the analysis when compared to applying a prescriptive rule; and (vii) the development and implementation of more principles-based rules can facilitate the ability of the United States to cooperate with its international counterparts to address issues such as the proliferation of abusive cross-border arbitrage transactions.

Accordingly, taking into account these determinations as a whole, and the lessons learned from prior concerted attempts at principles-based

118. For example, a few years ago, the United States had significant issues negotiating with the OECD about the model income tax treaty because the United States, having adopted the check-the-box regulations, had to contend with the ensuing plethora of hybrids. *See* Article 23 of the OECD Model Tax Convention (2003); Lee A. Sheppard, *U.S. Sponsored Double Non-Taxation*, 110 TAX NOTES 196 (Jan. 16, 2006). Even though the United States eventually "persuaded" the OECD to view hybrids in way that would benefit foreign investment in the United States, it did so with great difficulty, and the resulting effects have enabled undesirable double non-taxation that has prompted even more debate. *Id.*

rulemaking, discussed below, I believe that an optimal corporate tax system should contain a tailored combination of both principles-based and prescriptive guidance. An ideal construct would continue to rely on prescriptive rules to govern straightforward, commonplace transactions. However, in other areas, principles-based rules should significantly supplement, and in some instances supplant, these prescriptive rules in order to both simplify the tax law and serve as a backstop to the prescriptive rules to prevent the emergence of loopholes.

1. Prior Attempts at Principles-Based Rules in the Tax Law: Anti-Abuse Provisions

A move away from strict prescriptive rules previously arose in the U.S. tax law in response to the rise of tax shelter development and marketing efforts by major accounting and other tax advisory firms in the 1990s. These tax shelter products typically involved hyper-technical readings of the Code and Treasury regulations. U.S. tax policymakers responded by putting in place any number of quasi principles-based rules, mostly in the form of anti-abuse provisions, in order to combat taxpayers' increasing manipulation of the literal language of the law.[119] The effective use of these anti-abuse rules against tax shelters, however, has been compromised by their infrequent and imbalanced application. In part, this is because the IRS is frequently hampered by issues of uncertainty and invalidity, often inspired by its own vague and overbroad drafting.

Weisbach suggested two general methods for combating the rise of tax shelters: (i) close loopholes once they are determined to be the source of exploitation, and (ii) use broad standards, such as anti-abuse rules, to deny tax benefits in certain loosely specified classes of transactions to prevent exploitations from occurring in the first place.[120] One of the primary arguments against (ii) is that broad standards tend to produce uncertainty for taxpayers who are trying to structure non-abusive, ordinary course transactions.[121] This seems to be the block upon which the IRS tends to stumble.[122] For example, the proposed anti-

119. For a full discussion of these regulatory and judicial efforts to address tax shelters, see generally, Marvin A. Chirelstein & Lawrence Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005); Aprill, *supra* note 78; Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177 (2001).

120. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 247 (2002).

121. *Id*.

122. The U.K. government in 2005 passed anti-cross-border arbitrage legislation which targeted the use of hybrid entities and instruments in double-dip structures in which a tax deduction

abuse rules in the check-the-box regulations, a regime widely acknowledged as being directly responsible for a great many of the existing arbitrage structures, was withdrawn in 2003 due to concerns of uncertainty.[123] In its withdrawal notice, the IRS stated that "[m]ost commentators criticized the approach adopted in the proposed regulations as overly broad and expressed concern that [they] would mitigate the increased certainty promoted by the entity classification regulations. . . ."[124]

I agree with Weisbach, however, that notwithstanding any uncertainty concerns "[prescriptive] rules-based responses to shelters tend to make the law more complicated" and are less effective.[125] The problem frequently encountered with the principle-driven rules to date is that they often suffer from overly broad drafting. I believe implementing more precise and focused principles into the Code and regulations can abate this issue. For instance, rather than have vague, broad-based anti-abuse standards that are intended to cover an expansive spectrum of transactions that are already subject to a bevy of other rules,[126] it would be more effective to have a more tailored

is achieved in the United Kingdom and in another jurisdiction on the same matter or payment. Avoidance Involving Tax Arbitrage, Finance (no.2) Act 2005, §§ 24-31. The United Kingdom's tax authority, Her Majesty's Revenue and Customs ("HMRC"), has clarified that the provisions of this anti-abuse rule will not apply if the tax benefit could have been otherwise achieved absent the structure in question. *See* Andy Newsome et al., *New U.K. Finance Provisions Bring Uncertainty*, 16 INT'L TAX REV. 56 (Mergers & Acquisitions 2005). The IRS and Treasury balked at the United Kingdom's broad stroke attempts to curb tax arbitrage abuses, raising concerns that the breadth of the rules would unduly damper cross-border transactions entered into by U.S. and U.K. MNCs that were "legitimately" structured to minimize their tax burdens. Robert Goulder, *Treasury Official Questions U.K. Antiavoidance Approach*, 2005 TAX NOTES TODAY 98-7 (May 20, 2005).

123. Notice 2003-46, 2003-2 C.B. 53, announced that the IRS would withdraw former Prop. Treas. Reg. § 301.7701-3(h), 64 Fed. Reg. 66691 (1992). That former regulation was withdrawn by 68 Fed. Reg. 60,305 (Oct. 22, 2003) (to be codified at 26 C.F.R. pt. 301), and Announcement 2003-78, 2003-2 C.B. 1172.

124. Notice 2003-46, 2003-2 C.B. 53. The IRS did say that it would "continue to pursue the application of other principles of existing law (such as the substance over form doctrine) to determine the proper tax consequences in such cases." *Id.* In addition, opponents of the proposed partnership anti-abuse regulations argued that "they are so broadly and vaguely worded, and the examples are so limited, that it is almost impossible to determine what transactions will be covered." Richard M. Lipton, *Controversial Partnership Anti-Abuse Prop. Regs. Raise Many Questions*, 81 J. TAX'N 68 (Aug. 1994).

125. Weisbach, *supra* note 120, at 247.

126. The IRS has anti-abuse provisions that are intended to apply to an entire set of provisions in the tax law. For example, under Treasury regulation Section 1.446-3(g)(1), the IRS can recharacterize all or part of a transaction (or series of transactions) if the effect of the transaction (or series of transactions) is to avoid the application of the notional principal contract regulations. Treas. Reg. § 1.446-3(g)(1) (1993, as corrected at T.D. 8491, 59 Fed. Reg. 9411, Feb. 28, 1994;

implementation of principles, such as in the form of "catch-all" provisions.[127]

In other areas, such as with respect to the partnership anti-abuse rule, attempts to effectively administer the principled regulations also have been dampened or overshadowed by underlying concerns that the rule is invalid because it exceeds the IRS's regulatory authority given by Congress.[128] The Partnership Committee of the American Bar Association Section on Taxation argued that the partnership anti-abuse rules are invalid on the basis that they do "not interpret the language or meaning of Section 701 under which it is being promulgated."[129] Most likely because of the IRS's cognizance of its shaky regulatory ground, the Treasury continues to require a field agent to receive approval from the National Office before asserting the partnership anti-abuse

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T.D. 8554, 59 Fed. Reg. 36358, July 18, 1994). *See also* the broad partnership anti-abuse rules discussed below.

127. For example, under the notional principal contract regulations, the term "termination payment" includes (i) a payment made between the original parties to the contract (an extinguishment), (ii) a payment made between one party to the contract and a third party (an assignment), and (iii) any gain or loss realized on the exchange of one notional principal contract for another. Treas. Reg. § 1.446-3(h)(1). However, as a "catch-all" provision, the regulations provide that even in the absence of an actual termination payment, that any other economic benefit that is given or received by a taxpayer in lieu of a termination payment is treated as a termination payment. Treas. Reg. § 1.446-3(h)(4)(ii).

128. In *Jade Trading, LLC v. United States*, 65 Fed. Cl. 443 (2005), the taxpayers asked the court to invalidate the partnership anti-abuse regulation on the grounds that it was inconsistent with judicial precedent, contrary to statute, and unduly vague. *Id.* at 447. *See also* Shop Talk, *Will the Court of Federal Claims Invalidate the Partnership Anti-Abuse Rule?*, 102 J. TAX'N 379 (June 2005); Comments to IRS from Sheldon I. Banoff, *Partnership Antiabuse Regs Should Be Rescinded, Banoff Asserts*, 63 TAX NOTES 1256 (June 6, 1994); Comments to IRS from Sheldon I. Fink, Louis S. Freeman, Richard M. Lipton, and Thomas M. Stephens, *Partnership Antiabuse Reg will have 'Chilling Effect' on Legitimate Transactions, Attorneys Say*, 94 TAX NOTES TODAY 115-16 (June 15, 1994). *Cf.* RLC Indus. Co. v. Comm'r, 58 F.3d 413 (9th Cir. 1995) (the court invalidated a timber-depletion anti-abuse rule in Treas. Reg. § 1.611-3(d)); Stephenson Trust v. Comm'r, 81 T.C. 283 (1983) (finding that the IRS invalidly inserted an anti-abuse rule (neither contained in the statute nor contemplated by Congress) relating to an entire portion of the Code (subchapter J)). Lack of statutory authority is also mentioned in the foreign tax credit separation structure regulations. Definition of Taxpayer for Purposes of 901 and Related Matters, 71 Fed. Reg. 44,240 (proposed Aug. 4, 2006) (codified at 26 C.F.R. pt. 1). Several bills have been proposed which would give explicit prescriptive authority to the IRS to address separation structures. *See, e.g.*, *To offset the costs of defense spending in the supplemental appropriation*, S. Amdt. 3715, § 8112 (Apr. 2006) to *Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Katrina*, H.R. 4939, 109th Cong. (2006). Hicks, however, has stated that it does not see this legislation as any indication that the Treasury presently lacks the authority to rewrite the technical taxpayer rule, but rather is mere "confirmation to round out [their] authority." Lee A. Sheppard, *Offshore Investments: Don't Ask, Don't Tell*, 108 TAX NOTES 171 (July 11, 2005).

129. William H. Caudill, *ABA Tax Section Members Say Anitabuse Rule is Not a Valid Exercise of IRS Authority*, 94 TAX NOTES TODAY 146-50 (July 1, 1994).

regulations.[130] This problem of attacks on grounds of invalidity would be lessened where the underlying principles were clearly enunciated in the Code provision itself because Congress' objectives would be made clear.

Thus, although these existing principles-based anti-abuse provisions can be somewhat useful to the IRS as currently constructed and applied, they often fall short of effectuating their goals of deterring MNCs from engaging in highly structured transactions that take advantage of gaps in the tax law, and suffer from often legitimate attacks of over-breadth and invalidity.[131] However, rather than merely adding more anti-abuse rules, I am proposing a more focused and systematic use of principles in the actual Code and Treasury regulations.

2. Proposed Use of Principles-Based Tax Rules

Taking into account the problems with the existing uses of principles-based rules and the prior examination of the various factors that can impact the effects of principles in the tax law, I believe that principles can be most useful in corporate tax law when one or both of the following characteristics are present: (i) the line drawn by the prescriptive rule relates to a change in form only, and not in behavior or economic consequences of the taxpayer, and the distinctions made by the rule create significant differences in the potential tax liability of the taxpayer; and (ii) subtle changes to, or evolutions of, the form of the targeted transaction can easily avoid application of the law.[132] In addition, principles-based rules can serve as effective stopgap measures for prescriptive rules, particularly when there is a clear underlying principle intended to be implemented by Congress or Treasury.

130. Announcement 94-87, 1994-27 I.R.B. 124 (1994). In total, 140 requests were made within the IRS between 2003 and 2007 to apply the partnership anti-abuse regulation, and all but twelve were approved. *Id.* In March of 2007, the National Office granted blanket approval for agents to use the regulation in the case of seven specific transactions. *IRS Gives Agents Blanket Authority to Apply Partnership Anti-Abuse Reg*, 2007 TAX NOTES TODAY 51-5 (Mar. 14, 2007).

131. Congress has grappled on at least four occasions with the codification of an "economic substance" standard, which would be a broad-based standard that would apply to all transactions, and, in each instance, could reach no conclusion. CARE Act, S. 476, 108th Cong. § 701 (2003); Jobs and Growth Tax Relief Reconciliation Act, S. 1054, 108th Cong. § 301 (2003); Taxpayer Accountability Act, H.R. 1555, 108th Cong. § 101 (2003); The Heartland, Habitat, Harvest, and Horticulture Act of 2007; S. Rep. No. 110-206, 110th Cong., 1st Sess. (Oct. 25, 2007).

132. *Cf.* David A. Weisbach, *Corporate Tax Avoidance* (John M. Olin Program in L. & Econ., Working Program No. 202, at 14, 2004) ("Standards [] should apply when the rules (or the drafters) fail to anticipate a rare transaction and when mis-taxation of the transaction would lead to the problem of a proliferation of the mis-taxed transactions.").

First, the implementation of principles-based rules may be appropriate when the line drawn by the prescriptive rule relates merely to a change in form only, and the potential changes in tax liability to the taxpayer as a result of these changes are significant.[133] In light of the extreme elasticity of most MNCs, providing taxpayers with clear options that do not result in any substantive effects to their economics or business structure but provide them with varying tax consequences, only gives them a greater number of options when structuring transactions. Thus, when MNCs can effectively decide to opt-in or opt-out of a particular tax treatment with no significant accompanying real-life consequences, it just engenders frictionless tax planning. The incentives for MNCs to capitalize on these options are only magnified when these changes in form can create large changes in tax liability. In these situations, principles-based rules could be helpful in making the distinctions between alternatives more substantive than procedural in order to ensure that taxes are not motivating otherwise non-economical transactions. Alternatively, when differences in tax treatment are accompanied by real behavioral or economic consequences, taxpayers are less likely to change their structures solely for tax-motivated reasons.[134] Furthermore, if the difference in tax treatment is not meaningful, then MNCs are less likely to spend the time and resources necessary to manipulate the most economically efficient form of the transaction (from a purely business perspective).

An example of this is the U.S. residence rules. The U.S. tax treatment of a corporation depends greatly on whether the ultimate or "top-tier" parent is incorporated in the United States. The stakes of this determination can be quite high. A U.S. resident is taxed on its worldwide income. In contrast, a foreign corporation is only taxed in the United States on its income that is derived from U.S. sources. The current U.S. residence rules base the determination solely on the place of organization. Accordingly, a corporation is treated as domestic if it is created or organized in the United States, and all other corporations are treated as foreign.[135] Thus, the status of a corporation as domestic or

133. *Cf.* Weisbach, *supra* note 17, at 882-83 (observing that prescriptive rules work well, "particularly where avoiding the rule requires real change in behavior rather than just a change in form.").

134. For example, differences in treatment can create real "frictions" that the taxpayer must take into account. *See*, *e.g.*, David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) (providing a detailed analysis of when "frictions," or constraints on tax planning other than tax law, such as transaction costs, financial accounting, regulatory treatment credit risk, etc. may adequately curtail wasteful tax planning).

135. I.R.C. § 7701(a)(4) (2006).

foreign is purely elective in most cases. In this regard, "[t]he present-law test of determining corporate residency based solely on where the company is incorporated is artificial, and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations."[136] This problem was made evident with the flurry of corporate inversion transactions, where merely the place of incorporation, but not activities of the MNCs, changed. A more principled approach could base residence on the corporation's primary place of management and control, which could take into account other factors that affect a corporation's substantive residence, including the location of the corporation's management activities, employees, shareholders, business assets, operations and revenue sources.[137] This would provide a more meaningful standard and could reduce the avoidance of tax by corporations who are effectively managed in the United States, notwithstanding their parent's foreign address.[138]

In addition, the use of principles-based rules may be more appropriate when subtle changes to, or evolutions of, the form of the targeted transaction can easily avoid the application of the law. When the number of potential iterations of a particular transactional form is extremely high, it is not productive to use a prescriptive rule, the efficacy of which depends on it being able to determine the tax treatment of a specific transaction *ex ante*. In dealing with derivative transactions, tax policymakers seem to be more aware of this issue. As an example, for purposes of qualifying for the dividends-received deduction, a taxpayer's holding period is reduced for periods when it holds offsetting positions that reduce its risk of loss on the underlying stock.[139] In order to determine when the holding period has been reduced, the statute lists several concrete, prescriptive examples (*i.e.*, being the grantor of a call

136. JOINT COMMITTEE OF TAXATION, OPTIONS TO IMPROVE COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05, 179 (Jan. 27, 2005).

137. *Id*. This approach is already used by some taxing jurisdictions, including the United Kingdom and Canada. Reuvan S. Avi-Yonah, *Tax Reform in the (Multi)National Interest*, 2009 TAX NOTES TODAY 141-16 (July 27, 2009); S. Foreign Relations Comm., *Senate Foreign Relations Committee Issues Report on Canada Tax Treaty Protocol*, 2008 TAX NOTES TODAY 182-45 (Sept. 17, 2008).

138. Similarly, many hedge funds use these residency rules to be structured in a way that reduces or eliminates the tax to U.S. investors. *See* Sheppard, *supra* note 128. They are able to form partnerships in traditional tax haven jurisdictions, even though they are effectively run out of the United Sates, because the partnership residence rules, like the corporate residence rules, use place of organization rather than place of management or control. *Id.*

139. IRC § 246(c)(4) (2006).

option or having a short sale open with respect to the stock).[140] Congress, however, was aware that any number of other derivative structures could be created that also have the effect of reducing a taxpayer's risk of loss and did not endeavor to enumerate them. Instead, it included a principles-based catch-all category, which provides that the holding period will also be tolled if "a taxpayer has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property."[141] Accordingly, a taxpayer, which otherwise has a high level of flexibility in structuring its hedging transactions, is nevertheless constrained by this overarching principle (*i.e.*, they cannot diminish their risk of loss).

Many other areas of corporate tax law suffer from similar problems, but tax lawmakers fail to take a similar approach. With the availability of the check-the-box regime, sophisticated derivatives and a growing level of mobile assets, MNCs, in a sense, have a limitless number of structures they can create to circumvent or exploit the corporate tax provisions.[142] There are many areas of the corporate tax regime where because of the intricacies and under-inclusiveness of the existing prescriptive provisions,[143] mere subtle changes can allow the taxpayer to alter their tax treatment, for example by avoiding the application of an undesirable rule.[144] The introduction of more principles would make this type of avoidance more difficult.

Furthermore, because these are often the provisions where the proliferation of detail is highest, they should also be the areas in which the benefits of simplification are most profound (*e.g.*, the foreign tax credit rules). These provisions are often very complex because the IRS is trying to engage in the impossible task of trying to anticipate all of the potential structures that can be developed by taxpayers and their

140. IRC § 246(c)(4)(A) (2006).

141. I.R.C. § 246(c)(4)(C) (2006). Under the implementing regulations, a taxpayer is considered to diminish its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely. Treas. Reg. § 1.246-5(b)(2) (1995).

142. *See*, *e.g.*, Erika W. Nijenhuis, *NYSBA Report on Certain Administration International Tax Proposals*, 2009 TAX NOTES TODAY 232-75 (Dec. 4, 2009) (discussing failed attempts to stop a number of abuses involving the check-the-box rules); Michael J. McIntyre, *A Program for International Tax Reform*, 2009 TAX NOTES TODAY 34-46 (Jan. 12, 2009) ("The indefensible check-the-box rules need to be revised to prevent widespread abuses, including the avoidance of many antiavoidance rules and the taking of inconsistent tax positions in different countries); Lee A. Sheppard, *Behind the Eight Ball on Check-the-Box Abuses*, 101 TAX NOTES 437 (Oct. 27, 2003) (noting that the check-the-box rules facilitate the process of abuse).

143. *See*, *e.g.*, the discussion in Part III.C.3.

144. *See supra* note 140 and text.

advisors. In addition, abuses of these rules often result in the addition of even more rules, as tax policymakers attempt to "fix" the law by piling on yet more prescriptive provisions. Accordingly, not only could the use of principles-based rules in these circumstances help the IRS more adequately regulate the future generation of existing transactions, but they could also result in significant simplification. An example of the type of regulatory provision where principles-based rules could be more ideal is contained in the case study of recently promulgated foreign tax credit generator regulations in Part IV.C.3 below.

Finally, I believe that it is useful for the drafters of the Code and Treasury regulations to include the underlying principle in the actual tax provision, where appropriate,[145] rather than not articulating them at all or just referencing them in the accompanying legislative history of the Code or preamble to the Treasury regulation, where their utility can be rather limited.[146] Having direct statements of the applicable principles in the governing provision will help to ensure that any new structures, or derivations of old structures, can be covered by the applicable principle. Not only could this expand the reach of the existing laws, but it could also reduce the necessity for regulators to supplement the existing rules when new transactional structures inevitably arise.

There are any number of commonly understood general principles in the corporate tax regime area that are found nowhere in the actual operative provisions. For example, it is often asserted that foreign tax credits should not be separated from the related foreign income on which the tax is imposed.[147] Although many provisions in the Code and regulations try to effectuate this underlying principle, it is not directly articulated in the law and, accordingly, can often be violated by mere application of the prescriptive rules, particularly with the use of hybrid entities and instruments.[148] In that sense, prescriptive rules falter relative

145. It is understood that some rules are implemented merely for administrative convenience and there may be no broader principle at play.

146. *See*, *e.g.*, Preamble, Regulations Enabling Elections for Certain Transactions Under Section 336(e), Notice of Proposed Rulemaking, 73 Fed. Reg. 49,965 (Aug. 25, 2008); Preamble, Transfers by Domestic Corporations That Are Subject to Section 367(a)(5), Notice of Proposed Rulemaking, 73 Fed. Reg. 49,278 (Aug. 20, 2008).

147. For example, IRS and Treasury announced that, notwithstanding the withdrawal of Notice 98-5, they would continue to scrutinize transactions that generate inappropriate foreign tax credit results, such as transactions that "effectively separate foreign taxes from the related foreign income, including transactions that create a mismatch in the timing of recognition for U.S. tax purposes of foreign taxes and the related foreign income." *See*, *e.g.*, Notice 2004-19, 2004-1 C.B. 606 (withdrawing Notice 98-5, 1998-1 C.B. 334).

148. Indeed, in order to combat the rising prevalence of foreign tax credit separation structures, in August of 2006, Treasury and the IRS issued proposed regulations attempting to restrict

to the comparable principles-based rule "when a particular application of a rule generates a result divergent from that which would have been generated by direct application of the rule's justification."[149] Because it is impossible for legislators and regulators to fully anticipate the potential activities of the taxpayers, it is less likely that the intended original purpose of a provision will be realized when only the existing prescriptive rule is applicable to a given factual situation.

In addition, when the underlying justification and purpose of a rule is not easily deduced or can only be found in the legislative history or preamble, it may or may not be adequately taken into account by the taxpayer or the enforcing legislative body or court. This can happen when the IRS is faced with a textualist judge who focuses on whether the taxpayer complied with the literal words of the statute and not whether they circumvented the underlying purpose of the law.[150] On the other hand, if a judge or regulator does take the legislative history or preamble into account, the articulation of the principle in the rule itself may benefit unsophisticated taxpayers who may not be aware of the rule's historical purpose. Indeed, the Supreme Court has observed, "the plain meaning of the statute should be conclusive except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'"[151] In order to protect against these events, where feasible, the underlying principle

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taxpayers' ability to separate foreign income taxes from the underlying income on which such taxes are imposed. 71 Fed. Reg. 44,240 (Aug. 4, 2006) (to be codified at 26 C.F.R. pt. 1). According to Treasury and the IRS, this type of separation is "contrary to the general purpose of the foreign tax credit to relieve double taxation of foreign-source income." *Id.* pmbl. Although this general principle is articulated in the Preamble, it is not contained in the underlying regulatory provision, which consists of a detailed set of rules relating to foreign consolidated groups and reverse hybrid entities. *Id.* at 44,243-47.

149. Schauer, *supra* note 74, at 72.

150. Codification of the principle should "give the government an edge in any litigated matter" because "[c]ourts give much greater deference to a position clearly incorporated in regulations than the same position supported only by an interpretation of case law." Joseph Bankman, *The New Market In Corporate Tax Shelters*, 83 TAX NOTES 1775, 1788 (June 21, 1999). *See also* Karen C. Burke, *Black & Decker in the Fourth Circuit: Tax Shelters and Textualism*, 111 TAX NOTES 315 (Apr. 17, 2006) (in discussing the Fourth Circuit's textualist approach in *Black & Decker Corp. v. U.S.*, 436 F.3d 431 (4th Cir. 2006), *rev'g in part and aff'g in part*, 340 F. Supp.2d 621 (D. Md. 2004), in which they resolved the statutory issues in favor of the taxpayer, having concluded that the statutory language was unambiguous and did not need to examine the purpose of the statute in light of legislative history and relevant case law); Aprill, *supra* note 78, at 19 ("[C]odifying a standard would be expected, at the very least, to have some effect on the calculus employed by judges acting as presumptive positivism in deciding whether to resort to these common law doctrines. It would make the standard more salient.").

151. United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242 (1989) (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)).

should take the form of a direct statement of the principle in the statute or regulation either as the operative baseline provision, followed by any requisite prescriptive carve-outs, or as a catch-all provision.

I believe that this tailored use of principles-based rules would provide the best of both regulatory approaches. Taxpayers would have certainty and predictability with respect to non-abusive, ordinary course transactions. At the same time, the government would be better equipped to deal with the emergence of new market technologies and to combat the inherent advantage that MNCs have in being able to exploit the cracks in the regulatory construct that will inevitably materialize. In addition, highly detailed portions of the Code could be streamlined by implementing their principled counterparts. Accordingly, I believe that a more balanced use of principles-based rules and prescriptive rules in the corporate tax laws could result in significant improvements to the overall system.

3. Case Study: The Foreign-Tax Credit Generator Regulations

The utility of a more comprehensive use of principles-based rules is evidenced in the ongoing issues that have arisen with respect to the foreign tax credit regime, an area that is among the IRS's top compliance concerns for large corporate taxpayers.[152] U.S.-based MNCs have been engaging in highly structured cross-border transactions with foreign counterparties in order to generate foreign tax credits. Of particular concern are transactions in which ordinary-course financing and portfolio investments, either of which would typically result in little or no foreign taxes, are elaborately engineered to create structures which purportedly generate foreign tax and permit the U.S. taxpayer to claim a credit for the foreign tax payments while also allowing the foreign counterparty to claim a foreign tax benefit.[153] The U.S. taxpayers then

152. Internal Revenue Serv., *IRS Announces Release of Guidance on Foreign Tax Credit Generator Transactions*, 2007 TAX NOTES TODAY 62-13 (Mar. 29, 2007).

153. The preamble to Prop. Treas. Reg. § 1.901-2(e)(5) reads:

> [The transactions convert these ordinary transaction into] some form of equity ownership in a foreign special purpose vehicle (SPV). The transaction is deliberately structured to create income in the SPV for foreign tax purposes, which income is purportedly subject to foreign tax. The parties exploit differences between U.S. and foreign law in order to permit the U.S. taxpayer to claim a credit for the purported foreign tax payments while also allowing the foreign counterparty to claim a foreign tax benefit. The U.S. taxpayer and the foreign counterparty share the cost of the purported foreign tax payments through the pricing of the arrangement.

use these foreign tax credits to shelter unrelated foreign source income. Enforcement efforts against these structures had been limited in part because, as acknowledged by the IRS and Treasury, there is often a business purpose for the financing or portfolio investment underlying the otherwise elaborately engineered transactions.[154]

The IRS responded to these perceived abuses by issuing a series of proposed and temporary regulations over the last two years that would disallow foreign tax credits for these highly engineered structures.[155] In fact, in a recent IRS industry director memorandum to field specialists, the director emphasized that foreign tax creditor generator transactions were given Tier I issue status because of the "significant drain on the U.S. Treasury that these transactions are causing."[156] The problem with the new foreign tax credit generator regulations, however, is that they further complicate the already absurdly detailed regulatory landscape by using narrowly constructed prescriptive rules in order to combat an MNC's ability to engage in highly engineered transactions (which are structured to take advantage of other narrowly constructed prescriptive rules), without providing the backstop of an underlying principle or basis of credit disallowance.

Section 901 generally allows a credit for foreign income taxes paid or deemed paid by qualifying taxpayers who elect the credit in lieu of deducting the taxes. The credit is intended to alleviate the double taxation that results when income earned in a foreign country is taxed by both the United States and the country of source. A payment to a foreign government is considered a creditable tax, however, only if it is "compulsory."[157] Treasury regulation Section 1.901-2(e)(5), which provides that an amount paid is not a "compulsory" payment, and thus is

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Preamble to Prop. Treas. Reg. § 1.901-2(e)(5), 72 Fed. Reg. 15,081, 15,802 (Mar. 30, 2007). *See also* Lisa Nada, *Korb Discusses International Tax Developments, Praises IRS's Success*, 2006 TAX NOTES TODAY 220-3 (Nov. 15, 2006).

154. Preamble to Prop. Treas. Reg. § 1.901-2(e)(5), 72 Fed. Reg. 15,081.

155. Prop. Treas. Reg. 1.901-2(e)(5), 72 Fed. Reg. 15,081; Temp. Treas. Reg. § 1.901-2(e)(5), 73 Fed. Reg. 40,727 (July 16, 2008) (effective for foreign payments that, if they were an amount of tax paid, would be considered paid or accrued by a U.S. or foreign entity in taxable years ending on or after July 16, 2008). Interestingly, Treasury tried to provide some guidance with respect to the foreign tax credit area in Notice 98-5. *See* Notice 2004-19, 2004-1 C.B. 606 (withdrawing Notice 98-5, 1998-1 C.B. 334). In particular, the notice contemplated regulations that would apply an economic profit test to disallow credits for foreign taxes generated in certain arrangements if the reasonably expected economic profit were determined to be insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement. *Id.* This project, however, was withdrawn in Notice 2004-19. *Id.*

156. *IRS Alerts LMSB Field Specialists to Abusive Foreign Tax Credit Generator Transactions*, 2008 TAX NOTES TODAY 55-10 (Mar. 20, 2008).

157. Treas. Reg. § 1.901-2(a)(2) (2008).

not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law, is intended to "ensure that a taxpayer will make reasonable efforts to minimize its foreign tax liability even though the taxpayer otherwise may be indifferent to the imposition of the foreign tax due to the foreign tax credit."[158]

The regulations are intended to refine Treasury regulation Section 1.901-2(e)(5) by enunciating a set of six factually descriptive criteria defining certain "structured passive investment arrangements" that the IRS and Treasury believe are abusive, and with respect to which the payments would be "noncompulsory" and therefore not eligible for the foreign tax credit.[159] Although the regulations provide this laundry list of offensive attributes, it fails to identify what underlying principle is evidently not upheld.

As noted by Kevin Dolan,[160] the "government's problem with the described transaction is left unstated," and by resorting to prescriptive rules, the proposed regulation "obscures the problem it is intended to address."[161] All we can glean from the regulation itself is that the

158. Richard Lipton, *Proposed Regulations on Foreign Tax Credits Use Mechanical Tests to Target Abuses*, 107 J. TAX'N 4 (July 2007). For purposes of determining whether an amount paid exceeds the amount of liability under foreign law for tax, Treasury regulation Section 1.901-2(e)(5) provides that:

> An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment).

Treas. Reg. § 1.901-2T(e)(5)(iv)(B).

159. *Id.*

160. Kevin Dolan, a senior vice president at Merrill Lynch & Co., Inc., in 1978 was a docket attorney for the foreign tax credit regulations project that ultimately resulted in the regulations that would be amended by the proposed regulation. Dolan, *supra* note 90, at 1155 (summary).

161. *Id.*, stating:

> One can review the attributes and not find a single one that has previously been considered objectionable. The government's problem with the described transaction is left unstated. For there to be a problem, the foreign tax credits arising from the transaction must be considered not to be paid. If at some point the regulation were challenged, how would the government answer a judge's question: If a transaction has the six attributes, the reason a foreign income tax has not been paid is because . . . because what? . . . [T]he proposed regulation itself does not state a principle or rule but instead identifies a transaction that it wishes to proscribe without stating why that transaction is bad. . . . It does not govern by principle but by a set of prescriptive rules.

government does not like excess foreign tax credits that result from structured transactions. The obvious problem with this is that "there is no tax policy and certainly no authority that would suggest that a transaction that results in excess foreign tax credits is problematic *per se*."[162] The regulation itself does not even disallow excess foreign tax credits *per se*, because it requires that six enumerated criteria be satisfied.[163]

According to the standard I articulated above, this type of situation is ideal for implementing a principles-based rule. The taxpayer is able to change the form of its transaction while maintaining the underlying economics, in order to achieve significant tax benefits. In addition, in light of the highly engineered structures involved, it is evident that the evolution of subsequent iterations that escape the provisions will be impossible to control. Indeed, because, as promulgated, the regulations will only apply if this series of six requirements are met, it is no surprise that there are already in fact transactions being implemented that are substantially identical to the targeted structures, but manage to avoid the regulations.[164] There are likewise transactions that have no tax avoidance purpose, but nevertheless are arguably subject to the regulations because they happen to meet the six prescriptive criteria.[165]

Accordingly, a much more effective result would be to promulgate a rule specifically articulating the underlying principle at the heart of the government's concern. For example, the IRS may want to implement a more general rule limiting the ability of U.S. taxpayers to claim credits for foreign tax payments relating to passive investments when the foreign counterparty is also allowed to claim a foreign tax benefit with respect to the same arrangement.[166] Not only would this force the IRS to

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Id.

162. *Id.*

163. Treas. Reg. § 1.901-2T(e)(5)(iv).

164. Diana Wollman has observed that the proposed regulations surprisingly would not prevent foreign tax credit claims in four recent internal legal memoranda that deal with situations similar (and in one case, nearly identical) to those addressed by the proposed regulations. *Ships Passing in the Night? The Proposed Foreign Tax Credit Regulations Seem to Sail Right By The Foreign Tax Credit Arbitrage that the IRS Has Challenged in Audits - Was That Intentional?*, 2007 TAX NOTES TODAY 171-8 (Aug. 31, 2007). *See also* Lipton, *supra* note 158.

165. *See*, *e.g.*, *Overbroad FTC Antiarbitrage Regulations Enter Into Force*, 120 TAX NOTES 495 (Aug. 4, 2008) ("We are concerned, however, that the regulators may be overinclusive, because the identifying features as drafted in the regulations may be found in joint ventures and other business arrangements not involving tax arbitrage.").

166. For these purposes, I will assume that the requisite regulatory authority exists for the IRS to promulgate such a rule. However, there is considerable dispute on this matter. Treasury, after failing to get explicit legislative authority from Congress allowing it to attack transactions that are intentionally structured to generate foreign taxes in a manner that allows the parties to obtain

be more explicit as to the behavior it finds objectionable, but it would also help prevent further violations of the currently unstated principle.

As evidenced by these new foreign tax credit generator regulations, U.S. tax policymakers are increasingly enacting transaction-specific prescriptive rules that serve to draw subtle distinctions as to what is allowed and what is disallowed.[167] In fact, "most of the amendments to the international rules over the last two decades have been stop-gap responses to perceived abuses without significant consideration of underlying policies."[168] The resulting U.S. corporate tax system is a complex and ever-growing labyrinth of gap-filling prescriptive rules that are enacted as tax lawmakers try to react to these engineered tax-advantageous structures. Rather than continuing down this road of accretive complexity, a commitment to implementing more principles-based rules would yield a simpler and more effective corporate tax regime.

4. Principles-Based Rules and Corporate Tax Rates

For the reasons already discussed, I believe that having an increased focus on implementing principles-based rules in the U.S. corporate tax system will yield any number of other concrete improvements to both MNC taxpayers and the government. As an additional benefit, I believe that the implementation of principles-based rules could allow the United States to lower its high statutory corporate rates.[169]

Because principles should help close loopholes and provide a more effective constraint against highly engineered transactions, they would have the effect of reducing the number of opportunities for MNCs to engage in self-help measures to minimize their effective tax rate. Our relatively high corporate tax rates produce enormous incentives for MNCs to proactively pursue aggressive strategies to reduce their tax burden. Indeed, "[t]he tax savings that may be realized under the current

duplicate benefits, stated in the Preamble to the proposed regulations that additional legislative authority is not needed to address foreign tax credit abuses. 71 Fed. Reg. 44,240 (Aug. 4, 2006) (to be codified at 26 C.F.R. pt. 1). *But see* Dolan, *supra* note 90, (stating that because the proposed regulation does not appear to enforce any existing or stated statutory purpose, it is invalid). *Compare* the U.K. government's anti-cross-border arbitrage legislation, which targets the use of hybrid entities and instruments in double-dip structures, discussed *supra* note 122.

167. *See*, *e.g.*, Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 GEO. MASON INDEP. L. REV. 319 (1994).

168. ABA INT'L TAX REFORM REPORT, *supra* note 6, at 659.

169. *See* discussion, *supra*, Part II.B.

rules justify the additional investment of resources to evaluate elective alternatives and engage in tax planning."[170] Accordingly, so long as the fault lines created by our current prescriptive rules create loopholes that can be exploited by taxpayers, the intricate tax system that is created may have what Steven Dean refers to as "attractive complexity."[171] That is, a rational taxpayer will always prefer "a complex tax rule when its economic costs (*e.g.* $100 in time and legal fees) are more than offset by tax benefits the rule facilitates (*e.g.* $101 in tax savings)."[172]

No matter how "attractive" complexity may be to certain MNCs now, a more principles-focused corporate tax regime could be just as economically desirable to MNCs if their implementation is combined with a lowering of the overall statutory rate. Even though opportunities to engineer a lower effective rate would be lost, not only could those costs be offset by a lower statutory rate, but significant savings could also be realized through lower compliance costs. It is estimated that billions of dollars are spent each year by taxpayers in compliance costs, and these costs are relatively larger for taxpayers that are subject to the United States' corporate tax provisions.[173] Not surprisingly, MNCs become frustrated with (and less profitable by) trying to untangle the intricate web that our U.S. tax system has created, and a simpler Code could help mitigate these costs.

From the tax lawmakers' perspective, any base-broadening tactics, such as the proposed movement towards more principles-based regulations, should be welcome as they try to push through a lower corporate tax rate through Congress, because it would allow the measure to be implemented in a revenue-neutral way. The United States' current position of having the second-highest corporate tax rate among the OECD countries is becoming politically untenable. Not surprisingly, the President and lawmakers on both sides of the aisle have reiterated their desire for the United States to drop its statutory corporate rates to be more in line with those of other industrialized countries.[174]

170. *See* ABA INT'L TAX REFORM REPORT, *supra* note 6, at 717.

171. *See* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 409 (2005) (distinguishing attractive complexity from burdensome complexity).

172. Unfortunately, even though the rule's complexity may be attractive to taxpayers, it still consumes $100 of society's resources. *Id.* at 417.

173. *See* Logue, *supra* note 73 and accompanying text.

174. In President Barack Obama's remarks during the Fiscal Responsibility Summit in February 2009, he reiterated his commitment to making significant changes to our corporate tax system, including the lowering of corporate tax rates. President Barack Obama, Remarks by the

The inherent benefits of a principles-based approach would become significantly more evident to MNCs (who may otherwise resist the shutting down of corporate loopholes) if they were implemented in a revenue-neutral way. As between the current U.S. corporate tax system and an economically equivalent principles-based alternative, it must be the case that it would be preferable to choose a system that is simpler, more effective, promotes fairness and least encourages distorted behavior and the arbitrary shifting of economic activity. In fact, a revenue-neutral implementation of principles-based rules that results in simplification not only should be more competitive, but could also result in a net positive societal benefit. While the tax on MNCs and U.S. revenue collection would remain constant, the extraordinarily high costs of taxpayer compliance and Treasury enforcement costs could be greatly reduced. With respect to the MNCs, any resulting higher profits could lead to lower costs of goods and services for U.S. residents and increased investment of residual capital in the United States. Similarly, decreased administrative costs for the government could result in more available funds for domestic programs. Accordingly, an optimal use of the proposed systematic implementation of principles-based rules may be as part of a broader, revenue-neutral, tax reform effort that involves the lowering of the statutory corporate rate.

IV. CONCLUSION

The consequences of globalization, such as the proliferation of cross-border activity, multi-jurisdictional organizational structures and increases in tax arbitrage transactions, continue to challenge U.S. tax administrators. Furthermore, the pressure to resolve these challenges while protecting the U.S. tax base is particularly difficult given the level of sophistication and elasticity of the MNCs that they are trying to regulate. Nevertheless, the development of a simple and efficient corporate tax system that will not unduly burden U.S.-based MNCs is a worthwhile tax policy objective. The overwhelming complexity of the U.S. corporate tax regime and its high statutory corporate rates are two significant challenges that should be addressed in any significant corporate tax reform effort. Highly sophisticated MNCs often find ways to use the complexities of the U.S. tax system to create intricate transactional structures that serve to reduce their U.S. tax liability (and

President and the Vice President at the Opening of the Fiscal Responsibility Summit (Feb. 23, 2009) (transcript available at http://www.whitehouse.gov/).

help overcome the otherwise high statutory rate), but produce significant social waste in the process.

I believe that a transition towards a regulatory system that is more structured around principles-based rules will lead to simplification of our corporate tax rules, make the system more adaptable to changes in the market, and increase efficiency by reducing the social cost of highly engineered transactions. Furthermore, because the introduction of more principles-based rules would limit the opportunities available for taxpayers to engage in beneficial tax planning by narrowing tax planning loopholes, the implementation of more principles-based rules could serve an important role in reducing our high statutory corporate rates in a revenue-neutral way.

While a reliance on prescriptive rules to govern straightforward, commonplace transactions may continue, in other areas, principles-based rules should significantly supplement, and in many instances supplant, these prescriptive rules in order to both simplify the tax law and serve as a backstop to the prescriptive rules to prevent the emergence of loopholes. In particular, the use of principles would be most efficacious when one or both of the following characteristics are present: (i) the line drawn by the prescriptive rule relates to a change in form only, and not in behavior or economic consequences of the taxpayer, and the distinctions made by the rule create significant differences in the potential tax liability of the taxpayer; and (ii) subtle changes to, or evolutions of, the form of the targeted transaction can easily avoid application of the law.

In the end, one of the ironic problems of being a country with a rich legal history is that we are often so wedded to our current system that despite its numerous admitted flaws, we are reluctant to embrace change. Our current prescriptive corporate tax provisions reward aggressive tax planning and can create incentives to encourage the movement of capital out of our tax system, and otherwise distort the behavior of MNCs. MNCs are able to be opportunistic in many of their decisions regarding their utilization of particular markets, with respect to location, structure and form, and are thus more easily able to maximize their after-tax returns and minimize their regulatory burdens. As such, globalization is steadily reducing the margin of error that the United States has historically enjoyed, and U.S. lawmakers should evaluate the elements of our system that we know are failing, yet have the power to change, before we fall further behind.