Stimulating the Stimulus: U.S. Controlled Subsidiaries and I.R.C. 965

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Abstract: Recently, there has been much debate about how and when to balance the federal budget. Economists have examined how to safely raise taxes without stifling crucial growth in a fragile economic climate. This Note argues that a method already exists for tapping additional, secure sources of funding, namely the taxation of repatriated earnings from foreign subsidiaries. The Note explores the advantages and disadvantages of reenacting a tax break on foreign profits returning to the U.S. and concludes that the reenactment of this tax break coupled with major revision of the tax code will improve the taxation of U.S. businesses with subsidiaries abroad. These two acts are keys to a more honest and more effectual international tax system.

Introduction

As the economic stimulus bill of 2009 passed through the houses of Congress, there were innumerable attempts to support pet projects and self-righteous causes in the name of fixing the U.S. economy.\(^1\) With the logic of “what’s a few billion more anyway?,” Congress has tried to give more money to schools, alternative energy, and law enforcement, for example.\(^2\) In the midst of these power plays was an idea that may help fund these potential catalysts of economic growth: the resurrection of a tax holiday for repatriation of untaxed income earned by multinational companies.\(^3\)

Like individuals and small businesses, large multinational companies that do business in the United States must pay taxes to the U.S.

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\(^2\) See id.

Due to a strange confluence of corporate and tax law, however, these companies are able to defer taxes on their income earned in foreign-based subsidiaries. Multinationals store their income in countries with low tax rates, enabling them to avoid the higher U.S. rates they should be paying. The amount held in these foreign havens is staggering. For instance, IRS data indicates that there were $804 billion in earnings and profits of controlled subsidiaries in 2005, with only $362 billion actually repatriated and taxed, but at a sharply reduced rate.

Congress has made prior attempts to tax this income at normal rates but instead has settled for a sharply reduced tax rate in the hope that U.S.-based parent companies will create domestic jobs. The recession and subsequent stimulus bills have put the United States government in a financially horrifying position. Some argue that any source of income that has not been utilized thus far should be pursued with alacrity. Others opine that the federal government should begin encouraging businesses to repatriate their income back into the United States by either reducing permanently or eliminating the tax on income earned abroad by subsidiaries, allowing them to finance their own bailouts.

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4 See Letter from Benjamin Franklin to Jean-Baptiste Leroy (Nov. 13, 1789), in 10 The Works of Benjamin Franklin 409, 410 (Jared Sparks ed., Hilliard Gray 1840) (“In this world nothing can be said to be certain, except death and taxes.”).
7 See Lee A Sheppard & Martin A Sullivan, Repatriation Aid for the Financial Crisis?, 53 Tax Notes Int’l 275, 276 (2009) [hereinafter Repatriation Aid].
8 See id.
10 See I.R.C. § 965; see Repatriation Aid, supra note 7, at 276–77 (“Economists concluded that the repatriation holiday produced a windfall gain for companies with large amounts of accumulated earnings in low-tax countries. They found that companies used the funds principally for share repurchases. And they found that companies that benefitted from the holiday were no more likely to spend on growing their businesses than companies that did not benefit.”).
12 See Multinationals Accumulate, supra note 6, at 376.
This Note outlines the problem of taxing income of foreign subsidiaries and why the reenactment of section 965 of the Internal Revenue Code failed. Part I describes the background of the problem and the attempt by members of Congress to reenact section 965. Part II then explores the legal framework and implications of section 965. Part III analyzes the effects of successfully levying taxes on foreign subsidiaries and those of giving up attempts at such taxation.

I. BACKGROUND

A. Why Is There a Problem?

The United States subscribes to a “resident-based” tax system, which taxes corporations either “created or organized in the United States or under the law of the United States or of any State,” or “effectively connected with the conduct of a trade or business within the United States.” According to this definition, corporations organized in the United States with subsidiaries abroad are taxed on income from their business operations worldwide. Their foreign subsidiaries, which have been organized within foreign jurisdictions, are excluded from these U.S. income taxes, however, as long as their income is not realized by the U.S.-based parent. The only vehicle through which the parent company may realize the income of the subsidiary is the stock which is controlled by the parent. Realization of the subsidiary’s income by the parent corporation occurs if the parent either sells its stock in the subsidiary or if the subsidiary pays dividends on that stock.

Such a system of worldwide taxation would result in a double tax on foreign-earned profits, effectively eliminating any chance of U.S. investment abroad; therefore, a tax credit is given to offset the difference between the two rates. The credit is equal to the tax rate applied

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14 I.R.C. § 11 (stating that all corporations are taxed on their income, but that is further limited to domestic corporations by I.R.C. § 882); I.R.C. § 7701(a)(30) (stating that a “United States person” includes any domestic corporation for income tax purposes).
15 I.R.C. § 882(a)(1).
16 See I.R.C. § 882(a)(1) (“A tax is hereby imposed for each taxable year on the taxable income of every corporation.”) (emphasis added); I.R.C. § 882(a)(1) (defining as “taxable income [that income] which is effectively connected with the conduct of a trade or business within the United States”).
17 See Boise, supra note 5, at 667.
18 See id. at 667–68.
19 See I.R.C. § 11(d).
20 See I.R.C. §§ 901, 902 (stating that taxes paid to a foreign state are considered paid to the United States).
in the foreign country in which the subsidiary is organized.\textsuperscript{21} If the foreign tax rate is greater than the U.S. rate, the corporation can use the surplus tax credit to offset other profits; however, if the foreign rate is lower than that of the U.S., as it typically is, then the company must pay the resulting balance to the U.S.\textsuperscript{22}

The problem with taxing income of foreign subsidiaries with U.S.-based parent companies occurs because of the convergence of two basic concepts.\textsuperscript{23} First, in our legal system, corporations are treated as individuals separate from their shareholders.\textsuperscript{24} If a subsidiary is formed outside of the jurisdiction of the United States, it is considered a foreign individual.\textsuperscript{25} The upshot of this principle is that parent companies and their controlled subsidiaries are legally separate individuals despite the fact that their stock is often wholly owned by a U.S.-based corporation.\textsuperscript{26} So long as income is not transferred from subsidiary to parent, the parent corporations are taxed only on the income they earn, not on the income of other companies they control.\textsuperscript{27} The United States only taxes individuals within its jurisdiction, so corporate entities established outside of the country are not U.S. residents and therefore are not taxed.\textsuperscript{28} Even controlled foreign subsidiary corporations whose entire cache of stock is owned by a U.S. parent company are still absolutely

\textsuperscript{21} See I.R.C. § 902(b)(1)(B) (stating that “foreign corporation shall be deemed to have paid the same proportion of such other member’s post-1986 foreign income taxes as would be determined under subsection (a) if such foreign corporation were a domestic corporation”).

\textsuperscript{22} See id. For example, the U.S. tax rate for these companies is typically 35%, and the hypothetical tax rate in Ireland is 25%. I.R.C. § 11(b)(1)(D). A subsidiary of a U.S. company in Ireland would be taxed by the Irish government at its 25% rate and then a credit would be given by the U.S. for that amount. See id. The company would then have to pay the remaining 10% (i.e. 35%-25%). See id.

\textsuperscript{23} See Boise, supra note 5, at 668.

\textsuperscript{24} Black’s Law Dictionary defines a corporation as:

\begin{quote}
[a]n entity (usu. a business) having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely; a group or succession of persons established in accordance with legal rules into a legal or juristic person that has a legal personality distinct from the natural persons who make it up, exists indefinitely apart from them, and has the legal powers that its constitution gives it.
\end{quote}

See BLACK’S LAW DICTIONARY 151 (3rd pocket ed. 2006).

\textsuperscript{25} See id. at 152.

\textsuperscript{26} See id. at 151.

\textsuperscript{27} See I.R.C. §§ 11(a), (d), 882(a).

\textsuperscript{28} See id. (assuming the foreign-based corporations do not engage in trade or business within the U.S. as defined in § 882).
separate foreign juridical persons in the eyes of U.S. law, including the
tax code.\footnote{See id. §§ 11(b), 882.}

Second, shareholders of a company are not obligated to pay taxes on
the profits of the company until those profits are formally realized
through a dividend payment or sale of the stock.\footnote{See id. § 61(a); Eisner v. Macomber, 252 U.S. 189, 219 (1920) ("[N]either under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder.").} Thus, as long as foreign-based subsidiaries do not pay dividends on their stock, no income is reported.\footnote{See I.R.C. § 61(a); Eisner, 252 U.S. at 219.} Because the U.S. parents do not report the income made by their controlled foreign subsidiaries, no taxes are collected.\footnote{See I.R.C. § 61(a); Eisner, 252 U.S. at 219.}

These two concepts when considered together create a gigantic
loophole through which parent companies in the United States with
subsidiaries abroad are able to defer payment of income tax indefi-
nitely.\footnote{See discussion infra Part II A–B.} Given that the foreign subsidiary is not a part of the parent, but merely has the parent as its controlling shareholder, taxes on income made abroad do not have to be paid until a dividend is declared or stock is sold.\footnote{See I.R.C. § 61(a)(3), (7).} Unsurprisingly, these companies have taken to exploiting this loophole and are hoarding over half a trillion dollars in subsidiary profits in countries where taxes are low by not paying dividends and holding on to stock.\footnote{See Multinationals Accumulate, supra note 6, at 377 ("By the end of fiscal 2007 these multinationals had replenished their stash of unrepatriated earnings to $518 billion—a 72 percent increase in two years.").}

B. What Has Congress Done About It?

In 2006 and 2007 there was a 72% increase in unrepatriated in-
come in foreign subsidiaries, swelling the figure from $558 billion to
$958 billion.\footnote{Repatriation Aid, supra note 7, at 281.} These enormous figures mean that the U.S. is being robbed of up to $335.3 billion in unpaid tax revenue.\footnote{See I.R.C. § 11(b)(1)(D). The calculation is done using the 35% tax rate and multiply-
ing it with the possible $958 billion of foreign unrepatriated income. See id.} There has been, however, heated debate about whether the U.S. should be taxing in-
come of foreign corporations at all.\footnote{Compare Desai & Hines, supra note 15, at 957 (arguing that these taxes reduce these companies’ ability to compete in foreign markets), with Multinationals Accumulate, supra note 6.} Unfazed by these disagreements,
Congress has amended the tax code in an effort to access this huge deposit of untaxed income, with mixed results. One of the latest amendments of this type was section 965 of the Internal Revenue Code. Section 965 was enacted by Congress in 2004 as a part of the American Jobs Creation Act. The new provision gave multinational companies in the United States an 85% tax break on income derived from subsidiaries in foreign countries if that income was repatriated through cash dividends to the U.S. parent company within a one-year timeframe.

There were several stipulations to this incredible tax break, the most important of which was the Domestic Reinvestment Plan (DRIP) requirement, which stated that companies had to spend their dividends on job creation measures in the U.S. The DRIP requirements were not as effective at creating American jobs as Congress had hoped, but rather the cash was used to shore up domestic corporate health. The plans were disregarded outright by a number of companies while others were slightly more subtle in their methods, though the result was the same: spending to directly increase their stock value rather than invest in the limited domestic market.

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note 6, at 376 (arguing that U.S. corporations should pay income taxes, but that section 965 was ineffective in compelling them to do so).


41 See id.

42 See I.R.C. § 965.

43 See id. at (b)(4).

44 See Repatriation Aid, supra note 7, at 278–79.

Higher levels of repatriations, however, were not associated with increased domestic capital expenditures, domestic employment, or research and development expenditures. In fact, increased repatriations in response to the [Homeland Investment Act (HIA)] had small negative, but insignificant, effects on each of these measures of activity in instrumental variable specifications. Even firms that increased contributions to congressmen responsible for drafting the HIA and who belonged to a lobbying coalition that asserted that the tax holiday would allow them to increase domestic investment did not significantly increase their domestic expenditures.


45 See id. at 277.
The consequence of section 965 was a 5.25% tax on $315 billion, resulting in $16.5 billion in revenue for the U.S. Treasury. One of the side-effects of this tax holiday was that companies moved even more intangible assets abroad, seemingly biding their time for a second holiday and decreasing their domestic value. The immediately lucrative effects coupled with a renewed call for a tax holiday on offshore assets have brought the reenactment of section 965 to the congressional forefront. Corporations continue their lobbying efforts in the face of a recent setback in which a reenactment was rejected. Despite the U.S. government’s dire need for tax money and the need to bring assets into the domestic, taxable arena, Congress has rejected a second tax holiday.

II. Discussion

A. How Are Corporations Taxed?

The United States has a “resident-based” income tax system. A resident-based tax system is one in which only those who are citizens or residents are taxed; thus, foreign individuals are not within the jurisdiction of the tax code. This concept is codified in section 11 of the Internal Revenue Code (“I.R.C.”). The reach of section 11 to foreign corporations is limited by section 11(d), which limits taxes on foreign corporations to only those allowed by section 882. Section 882 defines taxable income from foreign corporations as the “gross income which is effectively connected with the conduct of . . . business within the United States.”

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46 See id. at 276 (5.25% of $315 billion is $16.5 billion).
47 See Multinationals Accumulate, supra note 6, at 376.
48 See Donmoyer, supra note 3.
49 See id.
50 See id.
51 See I.R.C. § 11 (stating that all corporations are taxed on their income, but limiting its scope to domestic corporations pursuant to I.R.C. § 882); I.R.C. § 7701(a)(30) (stating that a “United States person” includes any domestic corporation for income tax purposes).
52 See id. §§ 11, 882, 7701(a)(30); Restatement (Third) of the Foreign Relations Law of the United States § 412(1)(a) (1987) (explaining that a state may exercise jurisdiction to tax an individual who is a resident of the state, who does business in the state, or who owns property in the state).
53 I.R.C. § 11 (limiting the taxation of individuals to those who either reside in the state or whose income is derived from actions or properties in the state, as codified in later sections of the I.R.C.).
54 See id. § 11(d).
55 Id. § 882(a)(2).
The U.S. Federal Government has made an effort to impose taxes upon foreign companies which are controlled by U.S.-based parents.\textsuperscript{56} A controlled company is defined as:

any foreign corporation if more than 50 percent of—
(1) the total combined voting power of all classes of stock of such corporation entitled to vote, or
(2) the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.\textsuperscript{57}

This means that any foreign corporation which has over 50\% of its stock owned by a U.S. individual, including a corporation, is considered “controlled” for the purposes of taxation.\textsuperscript{58}

A controlled foreign corporation is not subject to United States income taxation due to the residence-based income tax system to which the U.S. subscribes.\textsuperscript{59} Corporations are considered individuals under U.S. law, and their citizenship is based on where they are organized.\textsuperscript{60} Due to this system of legal organization of corporations in the United States, a corporation founded in a foreign jurisdiction is considered a foreign citizen.\textsuperscript{61} Therefore, even if a foreign company is “controlled” according to I.R.C. section 957(a), it is still not taxed on its income due to its status as a non-resident.\textsuperscript{62}

The next logical question is: why does the U.S. government not tax the controlling domestic company? The answer involves a basic principle of the I.R.C.\textsuperscript{63} Section 61(a) of the I.R.C. states that stockholders are obligated to pay any income taxes on the sale of property or gain from dividends, but not valuation increases in the stock they possess.\textsuperscript{64} Instead of a tax on stock valuation changes, the federal government taxes

\textsuperscript{56} See id. §§ 951–964, 1291–1298 (codifying anti-deferral rules for controlled corporations and anti-deferral rules on passive foreign investment).

\textsuperscript{57} Id. § 957(a).

\textsuperscript{58} See id.

\textsuperscript{59} See I.R.C. §§ 11, 882, 7701(a)(30).

\textsuperscript{60} See Black’s Law Dictionary 151, 152 (3rd pocket ed. 2006).

\textsuperscript{61} See id. at 152.

\textsuperscript{62} See I.R.C. §§ 11, 882. This tax treatment is subject to whether the company has participated in business within the United States. See id. § 882(a)(2).

\textsuperscript{63} See id. § 61(a).

\textsuperscript{64} Id. § 61(a)(3), (7).
profits from stock when the income is “realized.”\(^{65}\) For the income to be realized through stock the stock must be sold or a dividend awarded.\(^{66}\)

Consequently, the only way to tax profits from a foreign company with no business in the U.S., but with a U.S. stockholder is to tax the domestic stockholder.\(^{67}\) The U.S. government taxes any dividends distributed or profits from the sale of stock, but these two events do not occur often for large controlled multinational companies.\(^{68}\) Controlled foreign corporations and their U.S. parents are well aware of the government’s limitations and thus do not pay dividends.\(^{69}\) Instead, domestic companies allow their foreign subsidiaries to hold the profits in their local jurisdiction,\(^{70}\) which invariably has a lower tax rate.\(^{71}\) If no dividends are paid, and if the controlling corporation does not sell its stock, the foreign corporation escapes U.S. income taxation.\(^{72}\)

**B. The Problem and the Response**

The problem is that U.S. companies who want to avoid paying U.S. income taxes on their business abroad merely have to set up a foreign subsidiary.\(^{73}\) The result is a legally separate entity that is able to pursue business ventures in foreign nations and enrich the parent company’s stock value while never paying a cent of U.S. income tax on its active profits.\(^{74}\) The United States is left in a conundrum: to continue in its flailing attempts at taxation of foreign subsidiaries, or to rethink the current tax code to take into account the realities of the situation.\(^{75}\)

Congress is well aware of these multinational monies and has enacted provisions of the tax code to tax the profits of U.S.-controlled companies abroad.\(^{76}\) These provisions discuss passive income from highly mobile sources but do not address the general income a company makes in ordinary business.\(^{77}\) U.S. parent companies that control

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\(^{65}\) See Eisner v. Macomber, 252 U.S. 189, 212 (1920).

\(^{66}\) See id.

\(^{67}\) See I.R.C. §§ 11, 61(a), 882, 7701(a)(30); Eisner, 252 U.S. at 212.

\(^{68}\) See I.R.C. § 61(a)(3), (7); Multinationals Accumulate, supra note 6, at 376.

\(^{69}\) See Multinationals Accumulate, supra note 6, at 376.

\(^{70}\) See id.

\(^{71}\) See Repatriation Aid, supra note 7, at 276.

\(^{72}\) See I.R.C. § 61(a).

\(^{73}\) See id. §§ 11, 882.

\(^{74}\) See id. §§ 11, 882, 951–964, 1291–1298 (codifying that domestically-controlled foreign companies are taxed only on their passive income, if at all).


\(^{77}\) See id. §§ 1291–1298.
foreign subsidiaries are subject to taxation on all profits from passive to active income.\textsuperscript{78} They are able to defer taxation on the profits of controlled companies until they repatriate the income from those subsidiaries in the form of dividends.\textsuperscript{79} The deferred income taxes owed by U.S. parent companies on profits made in their controlled foreign subsidiaries continue to be out of reach unless Congress amends the tax code in order to take this practice into account.\textsuperscript{80}

In another attempt at effective worldwide taxation, Congress passed the American Jobs Creation Act in 2004, section 271 of which added new section 965 of the Internal Revenue Code (section 965).\textsuperscript{81} Section 965 granted a temporary tax holiday for U.S. multinational companies holding profits and intangible assets abroad.\textsuperscript{82} The section allowed dividends paid by controlled foreign companies to their U.S. parent shareholders to be taxed at a sharply reduced rate if they paid those dividends within a limited timeframe.\textsuperscript{83} Congress’ goal was to lessen the burden of taxation on foreign profits as a means of encouraging corporations to repatriate their profits in dividends and bring in at least a portion of the tax revenue.\textsuperscript{84}

Section 965 “allowed as a deduction an amount equal to 85 percent of the cash dividends” received during the year the section was active by shareholders “from controlled foreign corporations.”\textsuperscript{85} The original rate of income taxation for the majority of these multinational corporations was 35%, making the 85% reduced rate equal 5.25%.\textsuperscript{86} The maximum amount allowed to be repatriated was the greatest of: (1) $500 million; (2) the amount listed on a financial statement as permanently reinvested outside the United States; or (3) failing sufficient information on the financial statement, the amount of tax liability attributable to earn-

\textsuperscript{78} See U.S. Const. amend. XVI; I.R.C. § 11.
\textsuperscript{79} See I.R.C. § 61(a)(7).
\textsuperscript{80} See Weiner, supra note 75, at 290–91.
\textsuperscript{82} See I.R.C. § 965.
\textsuperscript{83} See id.

The Committee observes that the residual U.S. tax imposed on the repatriation of foreign earnings can serve as a disincentive to repatriate these earnings. The Committee believes that a temporary reduction in the U.S. tax on repatriated dividends will stimulate the U.S. domestic economy by triggering the repatriation of foreign earnings that otherwise would have remained abroad.

\textsuperscript{85} I.R.C. § 965(a)(1).
\textsuperscript{86} See id. § 11. The calculation is made by multiplying the applicable tax rate of 35% by the remaining tax of 15% (100%-85%) to get 5.25%. See id.
nings reinvested outside the United States divided by 35%.\footnote{Id. § 965(b)(1)(A)–(C).} Pfizer repatriated more income than any other U.S. parent company, totaling a whopping $37 billion itself, which was more than 10% of the entire amount repatriated by all companies under section 965.\footnote{See Multinationals Accumulate, supra note 6, at 376, 379 (stating that $362 billion was repatriated, and Pfizer alone repatriated $37 billion).} The amount Pfizer would have paid without the tax break is nearly $13 billion.\footnote{See I.R.C. § 11 (multiplying Pfizer’s repatriated $37 billion by the 35% original tax rate).} Instead, the company paid only about $2 billion under the auspices of section 965’s holiday.\footnote{See id. §§ 11, 965 (multiplying Pfizer’s repatriated $37 billion by the 5.25% reduced tax rate).}

Rather than freely allowing corporations to gain the benefit of decreased tax rates, Congress included stipulations as to what companies must do with their tax savings.\footnote{See id. § 965(b)(4).} Section 965 required the corporations that wished to take advantage of the tax holiday to do so within the applicable year and also required to enact an investment plan referred to as a DRIP.\footnote{See id.} The DRIP had to be approved by the president, CEO, or other equivalent company official and was supposed to map out how the dividend would be spent.\footnote{See id.} The dividend was allowed to be spent on reinvestment in the United States, including workers, infrastructure, research and development, capital investments, or financial stabilization for job retention or creation.\footnote{See I.R.C. § 965(b)(4).} Expenditures on executive compensation were specifically disallowed.\footnote{See American Jobs Creation Act § 271; Multinationals Accumulate, supra note 6, at 379 (demonstrating that corporations had been withholding billions prior to the tax holiday).}

The result was not the titular “American Jobs Creation,” but rather the enrichment of large multinationals who had deferred paying billions.\footnote{See Repatriation Aid, supra note 7, at 277.} Since money is fungible, the repatriating companies merely had to move money out of an area like research and development, move in some of the dollars from repatriation, and then spend the money formally marked for R&D on stock buybacks and executive compensation.\footnote{See id.} For instance, a company could be initially spending $100 million on workers and infrastructure and then choose to repatriate $100 million from a foreign controlled subsidiary. In accordance with section
965, the company enacts a DRIP stating that it will spend the $100 million from repatriation on workers and infrastructure, and then it shifts the original $100 million to executive compensation. The result is no net increase in the areas of job creation targeted by Congress, but with no recourse possible by the Internal Revenue Service since the company technically did follow the letter, albeit not the spirit, of the law.

These large multinational companies avoided the DRIP requirement by merely moving around their money. Only a few stated outright that they were using the repatriated funds for stock buybacks and executive compensation, but an analysis of other corporations’ finances revealed that such a practice was widespread. The companies merely took money out of areas in which the DRIP required them to invest and then replaced that money with funds from the repatriated dividends. Many of the companies even cut jobs after they repatriated billions. Despite these well-known results, some members of Congress proposed reenacting section 965 in February 2009 as a part of the $819 billion economic stimulus package. Such practices fulfilled the requirements of the DRIP, but dodged Congress’ intended effects on stimulating domestic investment.

On its face, such activity looks like intentional misuse of the funds Congress intended for certain explicit purposes; however, some tax writers see the effects of section 965 as desirable. The debate between those that viewed section 965 as a success and those that saw it as a failure is directly related to whether those individuals believe there should be a reenactment of the provision. The proposal was voted down on February 4, 2009, but the discussion of what to do about foreign subsidiaries’ profits continues. It is informative to apply each side of the de-

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98 See id.
99 See id.
101 See Repatriation Aid, supra note 7, at 277.
102 See Clemons & Kinney, supra note 100, at 761.
103 See Repatriation Aid, supra note 7, at 277.
105 See Repatriation Aid, supra note 7, at 277.
106 See Weiner, supra note 75, at 284–85, 291.
107 Compare Repatriation Aid, supra note 7, at 281 (stating that repeated tax holidays would increase profit-shifting to offshore subsidiaries, moving more investment dollars outside the U.S.), with Weiner, supra note 75, at 286 (stating that the current system of taxation actively discourages corporations from bringing income back into the U.S., which would be at least temporarily relieved by another tax holiday).
108 See Donnoyer, supra note 3; Weiner, supra note 75, at 283.
bate’s reasoning, along with the practices in Canada, in assessing whether the reenactment of section 965 was rightfully voted down or if it should have been given closer consideration by Congress and passed.109

C. The Debate

On one hand, the stated original purpose of section 965, to boost American job creation, effectively failed.110 The argument on this side of the debate focuses on how the repatriating companies have taken advantage of a flaw in the tax code111 and have circumvented the stated goal of Congress: to grow American jobs as emphasized in the DRIP requirement.112 There has been an increase in unrepatriated earnings since the enactment of section 965, indicating that companies are preparing to take advantage of a new wave of tax breaks.113 Some state that corporations have benefited hand over fist and that they should not be allowed to do so at the expense of American jobs and investment.114

On the other hand, the U.S. Treasury saw a tax revenue increase of $16.4 billion.115 The increase is attributable to the federal government at least temporarily adopting a competitive worldwide taxation strategy.116 This side argues that without such a change, the “reduced” revenue of $16.4 billion would have been $0.117 Furthermore, the only way to permanently increase the tax revenues from controlled foreign subsidiaries is to remove the repatriation disincentive from multinational business.118

In addition, Canada has installed a permanent tax “holiday” in that its Income Tax Act does not impose taxes on dividends received from controlled foreign corporations as long as a tax treaty has been established with the country of the subsidiary.119 The various treaties

109 See Donmoyer, supra note 3.
110 See Repatriation Aid, supra note 7, at 277.
111 See id. at 276–78.
112 See id. at 277.
113 See Multinationals Accumulate, supra note 6, at 377.
114 See Repatriation Aid, supra note 7, at 281, 283.
115 See Weiner, supra note 755, at 283.
116 See id. at 289–90.
117 See id. at 283.
with foreign countries currently amount to an exemption on 90% of all repatriated profits. The Canadian government is planning an overhaul of its system with a possible result of the complete exemption of foreign profits from taxation. A recent government-appointed advisory board has recommended that the Canadian government “[b]roaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.”

Even considering the current system of taxation, there are major advantages to the Canadian model in that taxes on dividends received from foreign corporations controlled by Canadian citizens (including corporations) are reduced, provided there is a treaty with the applicable country. If Canada completes its overhaul, it will have an increased advantage over the U.S. system, which will result in less investment in the U.S. and greater disincentive for controlled foreign subsidiaries to repatriate their earnings to the U.S.

III. Analysis

A. Going Forward

Section 965 did not spur American job creation as Congress intended in enacting it. Instead of investing in the prescribed areas

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120 See Weiner, supra note 755, at 284. The Canadian tax code states:

“tax-exempt income” means income of a taxpayer from a source in a country in respect of which

(a) the taxpayer is, because of a tax treaty with that country, entitled to an exemption from all income or profits taxes, imposed in that country, to which the treaty applies, and

(b) no income or profits tax to which the treaty does not apply is imposed in any country other than Canada;


121 See Weiner, supra note 75, at 284.


123 See I.T.A., § 91(5).

124 See Weiner, supra note 75, at 290 (quoting Michael Mundaca, Deputy Assistant Treasury Sec’y for Int’l Tax Affairs, Address at the George Washington University/IRS International Tax Conference (Dec. 8, 2008)) (“Our international tax system is out of step now. While other countries have been cutting their corporate tax rates, the United States has stood still.”).


Pfizer, for example, which took advantage of the DRD and repatriated the largest amount (around $37 billion), started a number of layoffs in its U.S. workforce (around 3,500 jobs) and closed U.S. factories in 2005. Ford Motor
listed in the DRIP requirement, companies shifted around their new capital in order to fund share repurchases. Some companies even cut jobs in the United States after repatriating billions in cash dividends. American workers are left wondering where the DRIP requirement of reinvestment has gone and what has happened to their jobs.

It is enlightening to learn what types of companies decided to take advantage of the tax break provided by section 965. According to the IRS’s Statistics of Income Bulletin, the two types of companies that benefited most from the holiday were pharmaceutical and computer/electronics companies. These two types of companies accounted for about 50% of the total repatriated income qualifying under the requirements of section 965. Additionally, one particular company, Pfizer, accounted for 10% of the total repatriated earnings itself. Other companies like Ford and Eli-Lilly repatriated large amounts and then cut jobs while using their money for share buybacks.

While it is true that the steeply reduced tax revenues from repatriated earnings are better than nothing, the gift of a tax holiday to corporations for avoiding their taxes is not a solution. Nevertheless, this attempt by Congress to break into offshore tax strongholds was widely criticized as too much on one hand and not enough on the other. There has been a significant amount of debate as to whether the United

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125 See Repatriation Aid, supra note 7, at 277.
126 See Nadal, supra note 125, at 1230.
127 See Clemons & Kinney, supra note 100, at 762 (showing the breakdown of repatriating companies by industry).
128 See Melissa Redmiles, The One-Time Received Dividend Deduction, 27 IRS STATS. INCOME BULL., No. 4, 102, 104 (2008) (showing that pharmaceutical companies accounted for 31.6% of total repatriated dividends qualifying for the holiday and that computer/electronics companies accounted for 18.4% of the total repatriated dividends qualifying for the holiday).
129 See id. (illustrating in Figure A, column 6 that “computer and electronic equipment” and “pharmaceutical and medicine” companies repatriated 18.4% and 31.6%, respectively).
130 Multinationals Accumulate, supra note 6, at 376, 379 (demonstrating that Pfizer repatriated $37 billion of the total $362 billion repatriated under the Jobs Act).
131 See id.; Clemons & Kinney, supra note 100, at 760; Nadal, supra note 101, at 1230.
132 Compare Desai & Hines, supra note 15, at 957 (arguing for a permanent tax decrease or elimination), with Multinationals Accumulate, supra note 6, at 376 (arguing against another tax holiday and for more effective taxation).
States should be attempting to tax these foreign corporations at all. Some argue that an effective tax on these revenue streams would give the U.S. Treasury a meaningful boost of income, which could then be used to jumpstart the economy through government stimulus legislation. Others contend that such a tax may also impede the competitiveness of U.S.-based companies, further harming the domestic economy.

B. The Pro-Reenactment Argument

A number of tax writers maintain a much more positive story about the effects of 2004’s American Jobs Creation Act, specifically in reference to section 965. They argue that the title of the act was a red herring and distracts from a more objective view of the substantial benefits of the act. Writers such as Joann M. Weiner of Tax Notes International view the repatriation tax holiday through the lens of previous experience and see a net gain overall instead of focusing solely on the act’s title.

Looking at the amount of repatriation that would have occurred if the American Jobs Creation Act had not been passed versus the amount that subsequently did occur makes the picture look a little less grim. Instead of viewing the results as $128 billion in taxes that should have been raised, but only $16 billion actually raised, the act should be evaluated considering that $16 billion in income came into the U.S. Treasury as opposed to $0 in income. From this perspective, it seems

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135 Compare Repatriation Aid, supra 7, at 281 (stating that repeated tax holidays would increase profit-shifting to offshore subsidiaries, moving more investment dollars outside the U.S.), with Weiner, supra note 75, at 286 (stating that the current system of taxation actively discourages corporations from bringing income back into the U.S., which would be at least temporarily relieved by another tax holiday).

136 See Repatriation Aid, supra note 7, at 276.

137 See Michael C. Durst, International Tax Reform and a Corporate Rate Cut for Stimulus, Efficiency, and Fairness, 53 Tax Notes Int’l 313, 313 (2009) (detailing how the high rate of tax in the U.S. coupled with taxation abroad makes U.S. companies less competitive than their foreign counterparts).


139 See Weiner, supra note 75, at 286 (“To be blunt, creating jobs in the United States was not a requirement of the Jobs Act.”).

140 See id. at 283–84.

141 See id. at 283.

142 See id.
much stranger for there to be as much argument against such a measure.143

Opponents of a reenactment of section 965 focus too much on the name of the act and not enough on the actual effects.144 There has been much wailing and gnashing of teeth about how companies did not follow the DRIP requirements but rather took their money and did what they wanted with it.145 From a corporation’s perspective, however, it followed the instructions and requirements of section 965 to the very letter and used its tax savings to solidify its financial position.146 Section 965 did not categorically ban any type of spending because Congress knew it could not be the judge of what was best for any individual company, especially with legislation as sweeping as the American Jobs Creation Act.147

Because banks have become more reluctant to lend credit during this recession, it makes sense for companies to utilize their own cash invested abroad rather than borrow from creditors domestically.148 It is inherently cheaper for corporations to use money they already have rather than pay someone else to borrow, which is a major principle bolstering the pro-reenactment argument.149 Since companies are in dire financial straits and are trying to stem the freefall of their stock, they should be able to use their money any way they see fit.150

It is certainly not coincidental that the only one of the Big Three U.S. automakers not to request bailout money, Ford, took major advan-

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143 See id.
144 See id. at 286.
145 See Repatriation Aid, supra note 7, at 277.
146 See Weiner, supra note 75, at 286.
147 See I.R.S. Notice 2005-10, 2005-1 C.B. 474, § 5.01 (Feb. 7, 2005) (noting that “th[e] list of permitted investments is not an exclusive list, [and therefore] other investments in the United States made pursuant to a domestic reinvestment plan may also be permitted investments”).
148 See Weiner, supra note 75, at 287.
149 See id.
150 See id.
tage of the section 965 tax holiday. Ford was then able to use that money to invest in its domestic operations and foreign subsidiaries, allowing it to continue the fight for survival. The fact that the company cut jobs is not necessarily a product of poor spending of its tax savings, given that it is entirely possible that even more jobs would have been cut otherwise.

Indeed, the only major change that should be made to section 965 prior to reenactment is a complete elimination of the DRIP requirement. The results of 2004 verify this conclusion, noting that the requirement was ineffective and that companies are in the best position to assess their financial situation and spend their tax savings accordingly. Moreover, the reenactment of the tax holiday should herald a redevelopment of the international corporate taxation system in the United States. Congress should enact a reduced level of taxation more commensurate with other industrialized nations, eliminate the foreign earned income tax, and close the loopholes, collectively allowing for more effective enforcement of existing taxation principles.

C. The Anti-Reenactment Argument

Other tax scholars have taken the questionably extreme position that section 965 was an abject failure and that the only worse course of action would be to reenact the legislation to repeat the process. These writers argue that the title of the act, the American Jobs Creation Act, was wholly instructive in how to judge the results of all portions of the act, including those of section 965 repatriations. Writers like Tax Notes International’s Lee A. Sheppard and Martin A. Sullivan view the

151 See id. at 284; Bill Vlasic, Major Issue in Big 3 Is Financial Cost, N.Y. Times, Dec. 8, 2008, at B1 (discussing the “Big Three” as General Motors, Chrysler, and Ford).
155 See id. at 286.
157 See Weiner, supra note 75, at 290–91.
159 See Kornberg, supra note 158, at 15 (“Now that the monetary effects of § 965 are recorded, it is appropriate to evaluate them against the early criticisms of the deduction. The predictions that § 965 would not fulfill its stated purpose, appear to have come to fruition.”); Repatriation Aid, supra note 7, at 277.
effects of section 965 through the frame of the American Jobs Creation Act.\textsuperscript{160} From their viewpoint, the unalienable purpose of the legislation was to create additional jobs for Americans or at least maintain the current number of jobs, ignoring the dire economic environment.\textsuperscript{161}

When examining the effects of the section 965 repatriations, these scholars examine strictly how the repatriated dividends were used.\textsuperscript{162} Unsurprisingly, they are disappointed when they find that the vast majority of multinational companies who took advantage of the tax holiday effectively used the cash for purposes other than employee wages and research and development.\textsuperscript{163} Because the dividend cash was fungible, the DRIP requirements were neatly skirted by the corporations, and thus, they argue, the legislation failed.\textsuperscript{164}

They further contend that companies neither were then, nor are now, in need of the additional liquidity provided by section 965 and, rather, have a problem with excessive debt.\textsuperscript{165} Such a debt problem, or debt overhang, is the actual key to the financial crisis and the very reason why access to cash stored in foreign subsidiaries is not the solution, nor is it even particularly helpful.\textsuperscript{166}

As a response to this debt overhang problem in the private sector, the public sector has purchased that debt and, additionally, has allowed these companies to gain access to foreign-held capital at bargain-basement cost.\textsuperscript{167} The idea is that companies will be able to use their newfound liquidity to inflate their own stock prices through stock buybacks, which in turn will create a more stable market and fuel demand.\textsuperscript{168}

The problem with this simplistic approach, the anti-reenactment camp contends, is that it incentivizes the very behavior it purports to prevent: the hoarding of income abroad in anticipation of the next holiday.\textsuperscript{169} Some contend that the solution involves directly dealing with

\textsuperscript{160} See Repatriation Aid, supra note 7, at 277.
\textsuperscript{161} See id.
\textsuperscript{162} See Multinationals Accumulate, supra note 6, at 377–78.
\textsuperscript{163} See Repatriation Aid, supra note 7, at 277.
\textsuperscript{164} See id. at 277, 279.
\textsuperscript{165} See id. at 275–76.
\textsuperscript{166} See id.
\textsuperscript{167} See id. at 276; supra notes 88–90 and accompanying text.
\textsuperscript{168} See Repatriation Aid, supra note 7, at 276.
\textsuperscript{169} See Nadal, supra note 101, at 1231 (“The bottom line is that the entire system needs an overhaul, and the [dividends received deduction] is just an example of a quick fix disguised as something else because the task at hand is monumental.”); Repatriation Aid, supra note 7, at 281.
the debt by minimizing it or writing it down. They admit that such an approach will hurt and likely anger the creditors of these toxic assets, but insist that it is a far superior way of handling the crisis.

They conclude that a reenactment of section 965 will again allow large multinational companies to repatriate assets at extremely low prices, but the influx of cash into their coffers will only falsely inflate their stock prices with share buybacks, which would result in a set of circumstances uncomfortably similar to those immediately preceding the present credit crisis. Since the original enactment of section 965 in 2004, multinational companies have had increased rates of profit-shifting to controlled foreign subsidiaries. These increases have been particularly evident in companies with considerable amounts of intangible assets, such as pharmaceutical companies or bank-holding companies, which were big players in the initial repatriation tax holiday. A second wave of repatriation will disincentivize any further repatriation during periods of normal taxation, encouraging companies to lie in wait for the next tax holiday and also shift lucrative intangible assets to subsidiaries in low tax-base countries.

These writers would argue that since the vast majority of companies who took advantage of section 965 did not create jobs in the United States and a reenactment to increase liquidity would not help the economic crisis, Congress was correct in rejecting the reenactment of section 965. They maintain that reenactment of section 965 would distract from the problems of the international taxation system in the United States. The writers believe that the tax system should be overhauled in order to end deferral and capture the taxes on profits of foreign subsidiaries more effectively.

170 See Repatriation Aid, supra note 7, at 275.
171 See id. at 275, 276.
172 See Nadal, supra note 101, at 1230. Compare Repatriation Aid, supra note 7, at 276 (stating that companies used their repatriated dividends to repurchase shares and inflate stock prices), with George Cooper, Op-Ed., When Will the Recession Be Over?: An Ordinary Crisis, N.Y. Times, Mar. 1, 2009, at 12 (stating that the credit crisis was preceded by asset inflation and credit creation).
173 See Multinationals Accumulate, supra note 6, at 376–77.
174 See id. at 376.
175 See id. at 377–78.
176 See Repatriation Aid, supra note 7, at 276–77.
177 See id. at 283.
178 See id.
D. Canada Offers Guidance

As both the anti-reenactment and pro-reenactment camps agree, the international corporate taxation system in the United States needs serious reform.\(^\text{179}\) As noted above, Canada has a system of international corporate taxation closely resembling that of the United States.\(^\text{180}\) Canada is currently overhauling its tax system in order to tax international subsidiaries more effectively while encouraging investment back into their domestic operations.\(^\text{181}\) As one of the United States’ two bordering countries and the country’s top trade partner, Canada’s experiment with international corporate tax reform can prove especially useful as the United States seeks to improve its system.\(^\text{182}\)

The Canadian system currently exempts from taxation any income derived from foreign operations in countries with which there is an information-sharing treaty.\(^\text{183}\) The Canadian system has an overall exemption of over 90% for foreign-earned corporate income; thus, less than 10% of all income from foreign subsidiaries is derived from countries with which Canada has not developed a treaty.\(^\text{184}\) An advisory panel has recommended a complete exemption for all foreign-earned corporate income, not limited to treaty countries.\(^\text{185}\) Such a system, if implemented in the United States in combination with a similarly lower corporate tax rate, could make investment in the United States much more lucrative.\(^\text{186}\)

The United States should adopt several features of the Canadian international corporate tax reform.\(^\text{187}\) First, the need for overhaul of the system of United States taxation on foreign-earned corporate income is an immediate one, as shown by Canada’s action.\(^\text{188}\) Furthermore, a lower base tax is called for if the United States is to compete with other in-

\(^{179}\) See id.; Weiner, supra note 75, at 290–91.
\(^{180}\) See supra Part IIC.
\(^{181}\) See Boidman, supra note 122, at 359.
\(^{182}\) See Foreign Trade Department U.S. Census Bureau, Top Trading Partners—Total Trade, Exports, Imports (2008), available at http://www.census.gov/foreign-trade/statistics/highlights/top/top0812yr.html.
\(^{183}\) See, e.g., U.S.-Canada Tax Treaty art. XXIV, § 2(b).
\(^{184}\) See Weiner, supra note 75, at 284.
\(^{185}\) See id.
\(^{186}\) See U.S. Dep’t of the Treasury, Background Paper on Treasury Conference on Business Taxation and Global Competitiveness 1, 35 (Jul. 23, 2007) (unpublished research paper), available at http://www.ustreas.gov/press/releases/reports/07290%20r.pdf (indicating the effective 2005 U.S. corporate tax rate of 39% is higher than any European Union member in that year and much higher than the average of 27.3%).
\(^{187}\) See Weiner, supra note 75, at 284, 289–91.
\(^{188}\) See Boidman, supra note 122, at 353–54.
dustrialized nations in attracting foreign investment. Corporations will not repatriate earnings if the cost of doing business is radically greater in the United States than other desirable countries. Third, a major exemption for the bulk of foreign-earned corporate profits is necessary to stay relevant in the business world. The United States and Canada are two of the last industrialized countries to attempt worldwide taxation and Canada is prudently in the process of abandoning it after finding it uncompetitive and unwieldy. Finally, tighter enforcement of the tax provisions, coupled with closing loopholes, will give greater efficacy to and respect for the United States taxation system.

Conclusion

The United States Congress should learn from both the domestic debate and the Canadian experiment regarding international corporate tax reform, since a change in tax policy could bring a meaningful stream of revenue to our country in its time of crisis. It is better for the United States to abandon taxation on foreign subsidiaries than to continue the farce of stated taxation that does not actually occur. With the advent of the global economic crisis, the time is ideal for an overhaul of our taxation system to close loopholes, encourage growth, and spur the global economy without hollow threats of impossible taxation.

Section 965 was helpful as a herald for change in the taxation of international controlled corporations, but that call was ignored in 2004. Now with the economic crisis in full force, the United States Congress has a duty to reevaluate the international corporate taxation system, beginning with a reintroduction of section 965. The financial gains from repatriations will then fuel a more complete overhaul of the system, closing loopholes which allow transfer of assets abroad and eliminating taxes that other developed nations have abandoned. These steps will ensure a more effective taxation system and more robust competition by U.S.-based multinationals.

189 See U.S. Dep’t of the Treasury, supra 186, at 35.
190 See Repatriation Aid, supra note 7, at 280, 283.
191 See U.S. Dep’t of the Treasury, supra note 186, at 35.
192 See Weiner, supra note 75, at 289–91; Repatriation Aid, supra note 7, at 282–83.
193 See Repatriation Aid, supra note 7, at 280, 282, 283.