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A Proposal for the Tax Treatment of Interest in a Territorial System

Martin A. Sullivan*

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I. BACKGROUND

On October 26, 2011, Ways and Means Committee Chairman Dave Camp, Republican from Michigan, released a discussion draft of a tax reform plan that included a reduction in the corporate tax rate from 35% to 25% and the adoption of a territorial tax system in which most active foreign profits of multinational corporations would be exempt from U.S. tax.¹ In

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1. For the draft statutory language, see COMM. ON WAYS & MEANS, WAYS & MEANS DISCUSSION DRAFT (Oct 26, 2011) (Chairman Dave Camp), *available at* http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf [hereinafter DRAFT LANGUAGE]. For a twenty-seven page technical explanation, see COMM. ON WAYS & MEANS, TECHNICAL EXPLANATION OF THE WAYS & MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A

order to meet the self-imposed constraint of maintaining revenue neutrality for all changes to tax laws relating to the taxation of foreign profits,² the plan included several provisions to offset the revenue cost of exempting foreign profits from U.S. tax. These included: a mandatory 5.25% tax on existing unrepatriated foreign earnings (whether or not repatriated); proposals to tax foreign income in situations where aggressive transfer pricing practices are likely (for example, when intangible assets generate high rates of profit or when profits are booked in low-tax jurisdictions); the taxation of 5% of foreign profit upon repatriation; and thin capitalization rules to disallow U.S. deductions for interest above certain prescribed limits.³ The last two features are the focus of this Article.

Often referred to as the “5 percent haircut,”⁴ the inclusion of 5% of otherwise exempt active foreign source income in taxable profits is similar to provisions in the approach adopted by several other nations with territorial systems, including Japan, Germany, and France.⁵ Chairman Camp’s explanation of the proposal states that it is intended as “a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.”⁶ Many commentators have asserted that in adopting a territorial tax system the United States should adhere to the matching principle and disallow deductions related to foreign profits exempt from U.S. tax.⁷

PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME (Oct. 26, 2011) (Chairman Dave Camp), *available at* http://waysandmeans.house.gov/uploadedfiles/final_te_-_ways_and_means_participation_exemption_discussion_draft.pdf [hereinafter TECHNICAL EXPLANATION]

2. COMM. ON WAYS & MEANS, SUMMARY OF WAYS & MEANS DISCUSSION DRAFT: PARTICIPATION EXEMPTION (TERRITORIAL) SYSTEM (Chairman Dave Camp), *available at* http://waysandmeans.house.gov/uploadedfiles/summary_of_ways_and_means_draft_option.pdf [hereinafter PARTICIPATION EXEMPTION] (“The Committee does not believe that domestic base broadening should be used to finance international tax relief, and vice versa.”).

3. *See* PARTICIPATION EXEMPTION, *supra* note 2.

4. *See, e.g.*, Reuven S. Avi-Yonah, *Vive la Petite Difference: Camp, Obama, and Territoriality Reconsidered*, 66 TAX NOTES INT’L 617, 618 (2012).

5. J. COMM. ON TAX’N, JCX-33-11, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME (2011), *available at* <https://www.jct.gov/publications.html?func=startdown&id=3793> [hereinafter JCX-33-11].

6. *See* TECHNICAL EXPLANATION, *supra* note 1, at 18. Other expenses besides interest incurred in the United States that might be subject to allocation are research and development expense and general and administrative expense. Issues surrounding the allocation of these expenses are not discussed in this article.

7. *See, e.g.*, JCX-33-11, *supra* note 5, at 9 (“A territorial system that permits a deduction for an expense incurred to produce exempt foreign income may not achieve a matching of taxable income items with deductible expense items.”); *Testimony Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 112th Cong. 4 (2011) (statement of Paul W. Oosterhuis, Partner of Skadden, Arps, Slate, Meagher & Flom), *available at* <http://waysandmeans.house.gov/uploadedfiles/oosterhuissrm1117.pdf> [hereinafter *Statement of Oosterhuis*] (“[T]ax policy should be guided by the fundamental matching principle that an expense should be deductible against the tax base that will include revenue arising from that expense.”);

Because it is generally believed that all components of any firm's finances are interdependent (i.e., that money is fungible) and that it is therefore not possible to assign or trace interest costs to a single component of a firm's operations, these commentators have proposed that a multinational's worldwide interest expense paid to third-party lenders be allocated across jurisdictions using assets as an allocation factor.⁸ If the United States adopted such a rule, the location of borrowing would no longer affect the size of the U.S. interest deduction. Furthermore, related-party borrowing from subsidiaries in low-tax jurisdictions would no longer be a threat to the U.S. tax base.⁹

Elsewhere in the Discussion Draft, under the heading of "Prevention of Base Erosion," Chairman Camp includes a two-pronged thin-capitalization

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSAL TO FIX AMERICA'S TAX SYSTEM (2005), *available at* <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html> [hereinafter PRESIDENT'S ADVISORY PANEL] ("Under the Simplified Income Tax Plan, the active business earnings of foreign affiliates would not be subject to U.S. tax at the business level. Accordingly, business expenses that are attributable to these foreign earnings should not be allowed as a deduction against U.S. taxable income."); J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty*, 13 FLA. TAX REV. 397, 448 (2012) ("A general principle of the U.S. income tax is that expenses allocable to exempt income should not be allowed as income tax deductions unless Congress deliberately chooses to increase the exempt activity's tax advantage by reducing the effective U.S. tax rate below zero.").

8. Many prominent authorities have proposed that territorial systems should include interest allocation by assets. *See* J. COMM. ON TAX'N, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 190 (2005); PRESIDENT'S ADVISORY PANEL, *supra* note 7, at 241 ("Interest expense should only be disallowed to the extent that the U.S. operations of a U.S. multinational are more heavily leveraged than the multinational's foreign operations; that is, interest expense should be disallowed to the extent that the ratio of foreign debt to foreign assets is lower than the worldwide ratio of debt to assets."); Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 BULL. FOR INT'L TAX'N 486, 491 (2008) ("A far better policy [than allowing multinationals to deduct interest wherever they borrow] . . . would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place."); Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 781 (2001) ("A system that allocates interest expense first to interest income (whether or not eligible for exemption) with the remaining interest expense allocated to each category of income pro rata based on assets, but taking worldwide assets into account, would be a better starting point than current law.").

9. Like aggressive transfer pricing, related-party debt is used by multinational corporations to shift profits from high-tax to low-tax countries. H. David Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, and Related-Party Debt*, 32 TAX NOTES INT'L 989 (2003); Lee A. Sheppard, *News Analysis: What Hath Britain Wrought?* 61 TAX NOTES INT'L 7 (2011). Rosenbloom calls related-party debt "a principal tool of the tax planner." Rosenbloom, *supra*, at 997. Sheppard refers to it as "the big enchilada of easily manufactured income and expense." Sheppard, *supra*, at 9.

rule.¹⁰ Under this rule, U.S. deductions for interest expense would be disallowed if a multinational corporation exceeds thresholds set in both a “relative leverage test” and a “percentage of adjusted taxable income test.”¹¹ Under the relative leverage test, U.S. interest deductions are disallowed in the same proportion that a multinational’s U.S. debt-equity ratio exceeds its worldwide debt-equity ratio. Under the percentage of adjusted taxable income test, U.S. interest deductions are disallowed to the extent they exceed an unspecified fixed percentage (perhaps, for example, 30%) of “adjusted taxable income.” Adjusted taxable income is taxable income increased by deductible losses, interest, depreciation, and amortization.¹²

Even though the Discussion Draft presents the two provisions separately, it is difficult conceptually and in practice to disentangle interest allocation rules (or a proxy for those rules), on the one hand, and thin capitalization rules, on the other. It might be said that interest allocation rules exist for proper income measurement and thin capitalization rules are designed to prevent high levels of tax-motivated domestic leverage, especially when multinationals achieve an advantageous redistribution of interest expense across jurisdictions through related-party loans. But about the two policy goals—properly measuring income and limiting related-party loans—it should be noted that the latter is only worthwhile if it helps achieve the former. Even if they are unvarnished tax-motivated artificial transactions, related-party loans need not be disdained—and, as shall be discussed below, perhaps should even be encouraged if income measurement goals are met through well-functioning interest allocation rules.

In November 17, 2011, congressional testimony on the Discussion Draft, Paul Oosterhuis argued that if the 5 percent haircut is a proxy for interest allocation rules then the inclusion of both the haircut and the thin capitalization rules are not necessary given that interest allocation rules and thin capitalization have largely the same effect.¹³ In fact, allocation of worldwide interest by gross assets is practically identical to the first prong of Camp’s thin capitalization rule, the relative leverage test.¹⁴ The only difference is that the allocation rule *determines* domestic interest deduction while the relative leverage test *caps* otherwise allowable domestic interest deduction. To illustrate, suppose a U.S. multinational had worldwide assets of \$3,000, worldwide debt of \$1,000, worldwide interest costs of \$100, and

10. See TECHNICAL EXPLANATION, *supra* note 1, at 32.

11. *Id.* at 35.

12. *Id.* Adjusted taxable income is more a measure of cash flow than of income.

13. *Statement of Oosterhuis, supra* note 7.

14. Martin A. Sullivan, *Economic Analysis: Should the Camp Territorial Plan Include a 5 Percent Haircut?*, 136 TAX NOTES 359 (2012).

equal assets at home and abroad. Its interest deductions in the United States under allocation rules would be \$50, computed as 50% of worldwide interest. By the balance sheet identity, the worldwide capital structure consists one-third of debt and two-thirds of equity. Under the relative leverage test, U.S. interest deductions would be capped at \$50, computed as interest attributable to domestic debt that should be equal to one-third of \$1,500 of domestic assets.

Whether originating with the intent of implementing the matching principle, restricting the use of transactions considered abusive, or simply raising revenue, interest allocation rules (or equivalent limitations based on debt-equity ratios) will receive a great deal of attention in the debate about possible adoption of a territorial system by the United States. This Article explores the economic characteristics of interest allocation rules. Part II shows that in a world where all nations have territorial tax systems disparities in effective tax rates can be significantly reduced or eliminated if all nations adopt interest allocation rules with assets as the allocation factor. Part III explains why concerns that the competitiveness of U.S. multinationals will be damaged if the United States unilaterally adopts interest allocation rules are overstated. Part IV argues that replacing gross profits for assets as the allocation factor in an interest allocation rule would yield additional benefits. Part V summarizes and concludes with the proposal that if the U.S. adopts a territorial system it should also adopt, unilaterally if necessary, an interest allocation rule with gross profits as the allocation factor.

II. MULTILATERAL ADOPTION OF INTEREST ALLOCATION BY ASSETS

A. Preliminaries

To quantify the impact of different rules concerning the deductibility of interest, this section and the following section calculate marginal effective tax rates on capital. If marginal effective tax rates on capital are equal, the after-tax return on capital is reduced proportionately and decisions about making new (marginal) investments are not distorted by taxes. Tax rules that do not distort the allocation of capital are called “neutral.” In the absence of externalities, neutral taxes are considered economically efficient because they do not change the allocation of capital from what would exist in a world without taxes. It is important to distinguish marginal effective tax rates on capital used here from other effective tax rates, in particular from effective tax rates that appear in financial statements and are widely reported

in the financial press. Those tax rates measure the level of tax on all income from all capital (not just marginal investment), and they do not take into account returns on capital financed by debt.

The main points will be illustrated by comparing the effective tax rate of two hypothetical multinational corporations, one based in the United States (US MNC), where the federal statutory corporate tax rate is 35%, and the other based outside the United States (Foreign MNC), in a jurisdiction where the statutory rate is 25%. Both multinationals have investments earning \$100 in their home countries and \$100 in a third country (called Source) where the corporate statutory rate is 15% tax rates. Debt incurred by both firms generates interest deductions of \$100. To assess the economic effect of interest deductions, marginal effective tax rates are calculated for these two firms' new investments in Source that generates an additional \$100 of profit and is financed with debt that generates an additional \$50 of interest deductions. For simplicity, it is also assumed there is a uniform rate of interest on all debt and that it is equal to a uniform rate of profit on assets. Later, that latter assumption will be relaxed.

B. US MNC's Choice of Domestic versus Foreign Investment

Allocating interest by assets improves economic efficiency because it narrows the spreads on effective rates compared to what they would be without allocation rules, as the following calculations illustrate.

In a territorial system without interest allocation rules, if US MNC borrows in the United States to invest in the United States, it would generate \$100 of income and \$50 interest deductions in the United States.¹⁵ With taxable income of \$50, and tax of \$17.50, the marginal effective tax rate on capital would be 17.5%.¹⁶

Without interest allocation rules, if US MNC borrows in the United States to invest in Source, it pays \$15 of tax on \$100 of income in Source and deducts \$50 of interest in the United States, reducing US taxes by \$17.50.¹⁷ The net worldwide tax change from the investment is negative 2.5%.¹⁸ Dividing the marginal tax effect by the marginal income yields an effective tax rate of -2.5%.¹⁹ A negative tax rate signifies that a taxpayer is receiving a subsidy from governments rather than being taxed. The 20% difference in marginal effective tax rates provides US MNC with a significant incentive to invest in Source instead of the United States.²⁰

15. See *infra* tbl.1, panel A.1.

16. See *infra* tbl.1, panel A.1.

17. See *infra* tbl.1, panel A.2.

18. See *infra* tbl.1, panel A.2.

19. See *infra* tbl.1, panel A.2.

20. Similar calculations yielding negative effective tax rates on foreign investment in the

If the United States adopted a territorial system with interest allocation rules, the tax advantage for foreign over domestic investment would be reduced. Before the new investment, the domestic share of assets is half, the foreign share is half, and overall interest is \$100.²¹ \$50 of interest is deductible in the US and \$50 is deductible in Source.²² US tax is \$17.5 and foreign tax is \$7.5.²³

With new domestic investment, the domestic share of assets is two-thirds, the foreign share is one-third, and overall interest is \$150.²⁴ \$100 of interest is deductible in the United States and \$50 is deductible in Source.²⁵ Domestic taxable income is \$100 and domestic tax is \$35.²⁶ Foreign tax is unchanged.²⁷ There is \$17.5 of additional tax on \$100 of new investment income.²⁸ The marginal effective tax rate on domestic investment is 17.5%.²⁹

With new foreign investment, the domestic share of assets is one-third, the foreign share is two-thirds, and overall interest is \$150.³⁰ Fifty dollars of interest is deductible US and \$100 is deductible foreign.³¹ Domestic taxable income is unchanged by the new investment. Foreign taxable income is \$100.³² There is \$7.5 of additional tax on \$100 of new investment income. The marginal effective tax rate on foreign investment is 7.5%.³³

For a U.S. multinational corporation, interest allocation rules reduce the tax advantage of foreign over domestic investment. The original differential in effective tax rates of 20% (-2.5% for foreign versus 17.5% for domestic) is reduced to 10% (7.5% for foreign versus 17.5% for domestic). Interest allocation rules cannot erase the tax benefits due to differences in tax rates across countries, but they can significantly reduce the enlargement of these

absence of interest allocation rules are presented by Graetz, *supra* note 8, at 488, and by PRESIDENT'S ADVISORY PANEL, *supra* note 7, at 133 ("Although territorial tax systems are designed to impose no home country tax on active foreign earnings, the goal of these systems is not to subsidize foreign investment.").

21. See *infra* tbl.1, panel B.1.

22. See *infra* tbl.1, panel B.1.

23. See *infra* tbl.1, panel B.1.

24. See *infra* tbl.1, panel B.1.

25. See *infra* tbl.1, panel B.1.

26. See *infra* tbl.1, panel B.1.

27. See *infra* tbl.1, panel B.1.

28. See *infra* tbl.1, panel B.1.

29. See *infra* tbl.1, panel B.1.

30. See *infra* tbl.1, panel B.2.

31. See *infra* tbl.1, panel B.2.

32. See *infra* tbl.1, panel B.2.

33. See *infra* tbl.1, panel B.2.

differentials due to mismatching income and expense. In addition, they remove the specter of the United States government going far beyond merely exempting foreign profits from tax but providing significant subsidies for foreign investment. In this example, the U.S. subsidy of \$17.50 more than offsets additional foreign tax of \$15.

C. The Competitiveness of US MNC versus Foreign MNC

As shown above, without interest allocation rules, a US MNC investing abroad faces a marginal effective tax rate of -2.5%.³⁴ If foreign MNC makes the same investment in Source and borrows at home, it pays \$15 of tax on \$100 of income in Source and deducts \$50 of interest in its home country at 25%, reducing foreign taxes by \$12.5.³⁵ The net worldwide tax change from the investment is \$2.50.³⁶ Dividing the marginal tax effect by the marginal income yields an effective tax rate of positive 2.5%.³⁷ Thus, without interest allocation rules, Foreign MNC has a marginal effective tax rate that is 5% higher than its U.S. competitor.

Multilateral adoption of interest allocation rules would level the playing field for competing multinationals. As shown above, with interest allocations rules, US MNC faces a marginal effective tax rate of 7.5% on new investment in Source.³⁸ If Foreign MNC makes the same investment, gross profit in Source increases by \$100.³⁹ Interest allocated to its home country remains unchanged (half of \$100 before, one-third of \$150 after) and its deductions in Source increase by \$50 (half of \$100 before, two-thirds of \$150 after).⁴⁰ So additional tax in Source is 15% of the difference between \$100 of additional gross income and \$50 of additional interest deductions.⁴¹ The marginal effective tax rate for Foreign MNC is 7.5%, equal to that of US MNC making the same investment.⁴²

And so in addition to reducing the tax advantages of foreign over domestic investment for multinationals, multilateral adoption of interest allocation would equalize the effective tax rates of multinationals investing in source countries regardless of the multinationals' home jurisdiction.

34. *See infra* tbl.2, panel A.1.

35. *See infra* tbl.2, panel A.2.

36. *See infra* tbl.2, panel A.2.

37. *See infra* tbl.2, panel A.2.

38. *See infra* tbl.2, panel B.1.

39. *See infra* tbl.2, panel B.2.

40. *See infra* tbl.2, panel B.2.

41. *See infra* tbl.2, panel B.2.

42. *See infra* tbl.2, panel B.2.

III. UNILATERAL ADOPTION OF INTEREST ALLOCATION RULES

A. *Multinational Competitiveness*

Despite the wide acceptance of the matching principle in theory, few countries have put it into practice by implementing effective interest limitations.⁴³ The United Kingdom, for example, has a “debt cap” that limits interest deductions in the United Kingdom not to a share of worldwide interest related to U.K. business (as would an interest allocation rule), but to total interest paid by a multinational to external lenders.⁴⁴ And looking to the future, if the United States did adopt interest allocation rules, there is good reason to be skeptical about whether other nations would follow. Coordinating international tax rules is difficult in practice, especially since businesses, anti-tax organizations, and many governments themselves prefer that governments differentiate their tax rules in order to compete for mobile international capital. Therefore, it is important to consider the implications of the United States adopting territorial taxation—as most other major nations have—while implementing strict interest allocation rules that most other nations have shunned. Several commentators have expressed concern that U.S. multinational corporations would suffer a competitive disadvantage relative to foreign multinationals.⁴⁵ Others have stated that, as a matter of

43. Diane Hay, *Introduction*, in *TAXATION OF FOREIGN PROFITS 2009–2010* 12 (Philip Baker ed., 2009) (“Most countries with a territorial system have some form of expense allocation, even though these are not always particularly effective in practice.”).

44. Neil Edwards & Stephen Taylor, *Debt Cap-In General*, in *TAXATION OF FOREIGN PROFITS 2009–2010*, *supra* note 43, at 122 (“[T]he interest deductibility is not restricted to the overall gearing levels of the worldwide group but the total finance cost of the whole group; there is no restriction based in the proportion of profits earned, and there is no specific restrictions on finance cost relating to borrowings used to acquire finance subsidiaries.”).

45. See *Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers Before the H. Comm. on Ways & Means*, 112th Cong. 4 (2011) (submission by National Foreign Trade Council of Written Comments for the Hearing Record), available at <http://www.nftc.org/default/Tax%20Policy/Statement%20for%20the%20Record%20to%20WMs%20Committee%20May%202011.pdf>.

It is also important to note that, in adopting a territorial system, the U.S. should not deny deductions for interest or other expenses allocated to foreign income. Such a limitation would be inconsistent with the tax systems of every major industrialized country and would put worldwide American companies at a competitive disadvantage in both the U.S. and foreign markets.

Id.; *Tax Reform Options: International Issues: Hearing Before the S. Comm. on Fin.*, 112th Cong. 12 (2011) (testimony of Scott M. Naatjes, Vice President and General Tax Counsel, Cargill, Incorporated), available at <http://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Scott%20Naatjes.pdf>.

principle, interest should be deductible somewhere, and have asserted that this principle would be violated if the United States denied deductions for interest incurred in the United States, given that countries where foreign income is earned rarely allow deductions for such expense.⁴⁶

The first row of Table 3 shows the effect on US MNC in a territorial system where, because the United States unilaterally adopts an expense allocation rule, some of its interest expense is not deducted anywhere.⁴⁷ As previously, US MNC invests in Source, earns \$100 of gross income, and borrows in the United States, but the \$50 of interest incurred in the United States on debt used to finance that investment is not deductible in the United States because the allocation formula does not increase the allowable interest deduction. And Source does not allow deductions for interest expense on debt not incurred by a business inside its borders. So \$100 of income in Source is taxed at that country's 15% rate. This puts the U.S. multinational at a competitive disadvantage vis-à-vis Foreign MNC that can deduct expense at its home country tax rate of 25%, as shown by comparing the first and last rows of Table 3.⁴⁸

Some have proposed keeping the U.S. expense allocation rules even if the United States adopts a territorial tax system, and then making the allocated expenses permanently non-deductible. Not surprisingly, that could actually raise U.S. tax revenue relative to our current system. But it would do so with a tax cost based upon rules unrelated to non-U.S. income or business performance, making business planning more difficult and U.S. MNCs even less competitive.

Id.; BUS. ROUNDTABLE, TAKING ACTION FOR AMERICA: A CEO PLAN FOR JOBS AND ECONOMIC GROWTH 18 (2012), available at http://businessroundtable.org/uploads/studies-reports/downloads/20120307_BRT_Taking_Action_for_America.pdf ("The U.S. system should not deny domestic deductions for expenses not directly allocable to foreign earnings."); Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, 35 INT'L TAX J. 5, 52 (2009) ("Other OECD member countries have to date, either deliberately or accidentally, opted for a system that reduces the residence country tax burden on foreign business activity (competitiveness) rather than perfect matching of expense and intended income.").

46. Ways and Means Committee Counsel Ray Beeman stated that there was concern that interest allocation rules could create "stateless expenses." KPMG TAX GOVERNANCE INSTITUTE, A DISCUSSION OF CHAIRMAN CAMP'S TERRITORIAL TAX REFORM DRAFT 5 (2011) available at <http://www.kpmginstitutes.com/tax-governance-institute/insights/2011/pdf/tgi-exec-sum-territorial-tax.pdf>; see also JCX-33-11, *supra* note 5, at 9 ("Disallowing a deduction for the expense may, however, cause the expense not to be deductible in any country (because the country in which the income is derived also may not permit a deduction."); *Statement of Oosterhuis*, *supra* note 7, at 18 ("[A]ll interest expense represents a real cost of earning income and should be deductible against taxable income in some jurisdiction."); Paul W. Oosterhuis, *The Evolution of U.S. International Tax Policy: What Would Larry Say?*, 112 TAX NOTES 87, 94 (2006).

47. See *infra* tbl.3, row 1.

48. See *infra* tbl.3.

TABLE 3
Various Response of US MNC to Unilateral Adoption
of Interest Allocation Rules by the United States

Investor	Location of Net Debt	Location of Deduction	Rate at Which Interest Deducted	Tax Value of Deduction	Marginal Effective Tax Rate
US MNC	US	nowhere	-	\$0	15.0%
US MNC	Source	Source	15%	\$7.50	7.5%
US MNC	Other	Other	20%	\$10.00	5.0%
US MNC	Other	Other	25%	\$12.50	2.5%

Compare to:

Foreign MNC	Foreign Home	Foreign Home	25%	\$12.50	2.5%
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But just as water runs downhill, it is only natural to expect that US MNC will seek to minimize its taxes, especially if tax planning does little to interfere with business operations. US MNC could qualify for foreign deductions by having its affiliate in Source borrow instead of the U.S. parent company doing the borrowing. This, however, may raise US MNC's overall financing costs.⁴⁹ Alternatively, US MNC could itself lend to a foreign affiliate and then the foreign affiliate could deduct the \$50 of interest at Source's 15% rate. Intra-company lending has no impact on the calculation of allowable deductions in the United States, so U.S. taxes are not affected.⁵⁰ Tax in Source is 15% of \$50 of net taxable income.⁵¹ The effective tax rate is 7.5%, as shown in the second line of Table 3.⁵² That is not as favorable as the 2.5% effective rate faced by Foreign MNC when it was not subject to interest allocations, but it is a considerable improvement over the 15% rate when US MNC did not respond to the changing rules.

US MNC could even further improve its tax situation in the face of U.S. unilateral adoption of interest allocation rules by shifting debt used to finance investment in Source to another jurisdiction where it has operations

49. See *Statement of Oosterhuis*, *supra* note 7, at 19 ("For a variety of reasons, it is frequently easier, more efficient, and more affordable for a U.S. company to borrow on behalf of its entire worldwide group than for its [foreign affiliate] to borrow on its own behalf."); Graetz, *supra* note 8, at 491 n.29 ("While corporations may have considerable control over where they locate their borrowing, that control may not be absolute: [a source country], for example, may not have well-developed capital markets for corporate borrowing. And there may be economies of scale from concentrating borrowing in one or a few places.")

50. See I.R.C. § 1031(f)(1)(B) (2006). If a taxpayer exchanges property with a related person (*i.e.*, two corporations that are members of the same group), gain or loss is not recognized.

51. See *supra* tbl.3.

52. See *supra* tbl.3, row 2.

and the tax rate is higher than in Source.⁵³ As before, US MNC borrows in the United States to partially finance investment in Source. As before, the borrowing generates \$50 of non-deductible interest in the United States and \$100 of income taxed at 15% in Source. If US MNC makes a related-party loan to an affiliate in a country with a 20% tax rate, its effective tax rate on marginal investment is reduced to 5%.⁵⁴ Related-party lending that shifted the interest cost to a country with a 25% rates (the statutory rate in the home country of Foreign MNC) would entirely eliminate US MNC's tax advantage.⁵⁵ Related-party loans to affiliates can be used to shift interest deductions outside the United States, ensuring that the interest is deductible somewhere and reducing—perhaps even eliminating—the tax advantage Foreign MNC enjoys over US MNC with respect to investment in Source.⁵⁶

B. Possibility of a Double Dip

If the United States adopts interest allocation rules, neither issuance of related-party debt nor changes in the location of third-party debt will affect interest deductions in the United States. On the other hand, if other countries do not adopt interest allocation rules, they generally will continue to allow interest to be deducted on borrowing by affiliates operating inside their borders. This is an opportunity for tax arbitrage. Multinationals operating in the United States will have a powerful incentive to shift borrowing into foreign jurisdictions.

To see this, consider US MNC in its “before” state, where it had equalized operations in both the United States and Source.⁵⁷ Under U.S. allocation rules, 50% of the \$100 in worldwide interest is deductible in the United States, no matter where net debt is located. Assuming no foreign thin capitalization rules, every dollar of worldwide interest expense in excess of \$50 that US MNC locates outside of the United States is deducted twice.⁵⁸ For example, if US MNC locates \$80 of its \$100 of net interest outside the United States, it can deduct \$50 in the United States and \$80 in foreign jurisdictions. So, contrary to fear that less than \$100 of a multinational's interest will be deductible anywhere if interest allocation rules are adopted

53. See Graetz & Oosterhuis, *supra* note 8, at 781 n.18.

54. See *supra* tbl.3, row 3.

55. See *supra* tbl.3, row 4.

56. In his congressional testimony, Oosterhuis emphasizes the importance of related-party loans to minimize the impact of proposed U.S. interest limitations: “[A]n interest disallowance provision should allow domestic corporations that borrow from unrelated parties to lend to their foreign affiliates with the same consequence as if the [foreign affiliate] borrowed directly from a third party with a parent guarantee.” *Statement of Oosterhuis, supra* note 7, at 19.

57. See *infra* tbl.2, col. 1.

58. Martin A. Sullivan, *Economic Analysis: The Effect of Interest Allocation Rules in a Territorial System*, 136 TAX NOTES 1098, 1100 (2012) [hereinafter *Interest Allocation Rules*].

unilaterally, there is a strong possibility that some multinational interest will be deducted twice.⁵⁹ In our example, US MNC can reduce its foreign taxes without increasing its overall leverage simply by lending to its foreign affiliate. U.S. taxes are unchanged.

Of course, the opportunity for double dipping would provide a significant incentive for foreign governments to adopt their own interest allocation rules or other thin capitalization rules to prevent debt dumping that eats away at their tax base.⁶⁰ Related-party loans, no longer a threat to the U.S. tax base, are now a heightened threat to foreign countries because debt formerly attracted to the United States for tax reasons will now be attracted to affiliates in their jurisdictions.

IV. GROSS PROFITS AS AN ALLOCATION FACTOR

Up until now it has been assumed for computational ease that the rate of return on assets has been equal for all assets. Under this assumption, because assets and gross income remain in strict proportion to each other, using assets as the allocation factor is exactly the same as using gross profits, defined as profits before interest deductions. In the real world, however, there are two distinct benefits to using gross profits as an allocation factor instead of assets.

A. Simplification Benefits

Measuring assets for purposes of allocating interest can be problematic.⁶¹ It is generally believed that using the market value of assets is more accurate than using tax basis, but determining market value can be costly and nevertheless still lead to disputes with the Internal Revenue Service.⁶² Current allocation rules, used for computing foreign tax credit limitations, allow multinationals the option of using market value or tax basis.⁶³

In addition to issues of valuation, assets must be valued at a point in time.⁶⁴ In many cases, particularly where a multinational has experienced

59. *Id.*

60. *Id.*

61. Martin A. Sullivan, *An Automatic Brake on Profit Shifting in a Territorial System*, 67 TAX NOTES INT'L 502, 504 (2012) [hereinafter *An Automatic Brake*].

62. *Id.*

63. Treas. Reg. § 1.861-9T(g)(ii) (as amended in 2012).

64. *An Automatic Brake*, *supra* note 61, at 504.

large changes—for example, after an acquisition—valuing assets at a single point in time can lead to misleading result if that value is assumed to hold for the entire year.⁶⁵ This problem can be ameliorated by using averages at multiple points in time, but this increases compliance costs.⁶⁶

If gross interest is used to allocate interest instead of assets, neither valuation problems nor problems of dating valuation arise.⁶⁷ So, if only for purposes of reducing complexity and opportunities for manipulation of asset totals used in allocation formulas, interest allocation by gross profits is preferable to interest allocation by assets.

B. Reduction of Incentive for Aggressive Transfer Pricing

Under normal circumstances, any multinational that shifts profits out of the United States reduces its worldwide taxes by:

$$(t_{us} - t_f) * X$$

where X is the shifted amount, t_{us} is the U.S. statutory rate, and t_f is the foreign statutory rate.⁶⁸

Under rules where interest is allocated in proportion to gross profit, profit shifting through transfer pricing adjustment has a direct effect on domestic interest deductions.⁶⁹ For example, if a U.S. manufacturer shifts profits to Ireland by raising the transfer price of goods manufactured in Ireland and sold to its U.S. parent, it will reduce deductible interest in the United States. The benefit of shifting profits to a low-tax jurisdiction is offset by a reduction in interest expense allocated to the United States.

In algebraic terms, if interest is allocated using gross profits, the amount of deductible domestic interest is:

$$(GP_{us}/GP_{ww}) * r * D_{ww}$$

where GP_{us} is domestic profits, GP_{ww} is worldwide gross profits, r is the interest rate on borrowing, and D_{ww} is a multinational's worldwide external debt.⁷⁰ Worldwide intra-company debt nets to zero.⁷¹ This expression can be re-arranged to:

$$GP_{us} * (r * D_{ww} / GP_{ww})^{72}$$

The term in parentheses is the ratio of worldwide interest expense to gross profits, which we will call v .⁷³ It follows that U.S. tax can be expressed as:

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* at 502.

69. *Id.* at 502–03.

70. *An Automatic Brake*, *supra* note 61, at 503.

71. *Id.*

72. *Id.*

73. *Id.*

$$T_{us} = t_{us} * (1-v) * GP_{us}$$

where t_{us} is the U.S. statutory corporate tax rate.⁷⁴ In this case, a shift of profit out of the United States changes U.S. tax by:

$$-t_{us} * (1-v) * X$$

The effect on foreign tax depends on whether foreign jurisdictions have adopted similar rules.⁷⁵ If there is multilateral adoption of these interest allocation rules, the effect of profits shifting on the amount of foreign taxes is:

$$t_f * (1-v) * X$$

where t_f is the foreign statutory corporate tax rate.⁷⁶ In this case, the overall effect of profits shifting on multinational taxes is:

$$[t_{us} - t_f] * (1-v) * X^{77}$$

As is the case without allocation rules, the benefit of profit shifting is a function of the difference between the U.S. and foreign statutory, but now that benefit is reduced as the multinational's interest expense increases. Returning to the example of the prior section (where v is 0.5),⁷⁸ if US MNC shifts profit into Source, the tax benefit per \$100 of shifted profit is reduced from \$20 without allocation rules to \$10 with allocation of interest by gross profits.⁷⁹

If the foreign jurisdictions do not adopt the allocation rule, the effect on foreign tax of profits shifting is:

$$t_f * X^{80}$$

And the overall effect of shifting profits on a multinational's tax is:

$$[t_{us} * (1-v) - t_f] * X^{81}$$

Allocation by gross profits adopted unilaterally is an even better deterrent to aggressive transfer pricing than allocation by gross profit adopted multilaterally.⁸² With unilateral adoption of interest allocation rules by gross profits, the tax benefit of less profit in the United States is reduced and the tax burden of new profit in a foreign jurisdiction is left unchanged. Again, returning to the example of the prior section, if US MNC shifts profit into Source, the tax benefit per \$100 of shifted profit is reduced from \$20

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *See supra* Part II.

79. *See infra* tbl.4, col. 3.

80. *An Automatic Brake, supra* note 61, at 503–04.

81. *Id.* at 504.

82. *Id.*

without allocation rules to \$2.5 with unilateral adoption of allocation rules by gross profits.⁸³ Other examples are shown in Table 4 below.⁸⁴ Among the results, the table shows that adoption of the interest allocation rule by gross assets on a unilateral basis can in certain circumstances actually turn the tide and create an incentive for multinational corporations to shift profits into the United States from low-tax jurisdictions—even if the United States has the highest corporate tax rate in the world.⁸⁵

TABLE 4
Incentive for Profit Shifting without Interest Allocation and
with Interest Allocation by Gross Profits

Worldwide Ratio of Interest to Gross Profit (v)	0	0.25	0.5	0.75
	Tax Reduction per \$100 Shifted out of the United States			
Foreign Statutory Tax Rate = 15%				
Without allocation rule	20.00	20.00	20.00	20.00
Multilateral allocation by gross profit	20.00	15.00	10.00	5.00
Unilateral allocation by gross profit	20.00	11.25	2.50	-6.25
Foreign Statutory Tax Rate = 25%				
Without allocation rule	10.00	10.00	10.00	10.00
Multilateral allocation by gross profit	10.00	8.00	6.67	5.00
Unilateral allocation by gross profit	10.00	3.00	-1.67	-7.50

C. Comparison to Allocation by Gross Assets

Interest allocation by assets could share some of the salutary effects on transfer pricing of interest allocation by gross assets. That is, allocation by assets in some circumstances may also blunt some of the advantages of transfer pricing relative to a system without interest allocation. This will occur if outbound profit shifting causes an increase in foreign assets.

Probably the most important example of this is the transfer of valuable intangible assets outside the United States in order to shift profits out of the United States. It is unlikely, however, that the transferred asset will have a tax or book basis commensurate with its real value, given that the initial buy-in payments (with which the foreign affiliate acquires the asset from the parent) are generally small and subsequent payments for maintaining and

83. See *infra* tbl.4.

84. See *infra* tbl.4, col. 3.

85. *An Automatic Brake*, *supra* note 61, at 504.

enhancing the assets routinely are not capitalized. Therefore, the reduction in domestic interest deductions from shifting intangible assets when assets are the allocation factor will be less than the reduction when gross profits is used as the allocation factor.

More generally, while there is always a tight relationship between transfer pricing and the amount of deductible interest when the allocation factor is gross profits, there may be no relationship when assets is the allocation factor. For example, a foreign subsidiary charging a U.S. parent for services need not result in any shift in foreign assets.

V. SUMMARY AND POLICY RECOMMENDATION

In a world where all nations employ territorial systems of taxation, the absence of interest allocation rules enlarges the incentive for multinationals domiciled in high-tax countries to invest in low-tax countries.⁸⁶ It also gives competitive advantage to multinationals located in high-tax countries relative to multinationals from low-tax countries to invest outside their home jurisdiction.⁸⁷

Interest allocation rules reduce (but do not eliminate) multinationals' incentives to invest abroad.⁸⁸ In addition, multilateral adoption of interest allocation rules equalizes effective tax rates of all multinationals with identical financial structures investing in the same jurisdiction.⁸⁹ In other words, multinationals face a level playing field wherever they compete with multilateral adoption of interest allocation rules.

If the United States unilaterally adopts interest allocation rules, U.S. multinationals can restore much of the economic value of interest limited in the United States by shifting borrowing outside the United States, particularly if borrowing is shifted to another high-tax jurisdiction.⁹⁰ In fact, U.S. corporations will seek to locate as much debt and deduct as much interest as possible outside the United States because the relocation of debt will reduce foreign taxes without having any adverse effect on U.S. taxes. This is a favorable outcome for U.S. multinationals. It will, however, likely drive other nations to adopt interest allocation rules (or thin capitalization rules with similar effects).⁹¹ Because multilateral adoption of interest

86. See Graetz & Oosterhuis, *supra* note 8, at 771; see also *supra* Part II.

87. See *infra* tbl.1; see also *supra* Part III.A.

88. See *supra* Part II.B.

89. See *supra* Part II.C.

90. *Interest Allocation Rules*, *supra* note 58, at 1100; see also *supra* Part III.A.

91. *Interest Allocation Rules*, *supra* note 58; see also *supra* note 60 and accompanying text.

allocation rules has many favorable economic features and because usually it is difficult to get nations to coordinate their tax policies, the catalytic effect of unilateral adoption on other nations is a welcome development.

Allocating interest by gross profit will produce largely the same favorable effects as interest allocation by assets, but with two added benefits: (1) a reduction in administrative and compliance costs and (2) a reduction in the incentive to shift profits out of the United States.⁹² This latter effect will reduce revenue losses from shifting due to aggressive transfer pricing.⁹³ This effect is in addition to increased revenue from reduced profit shifting due to borrowing by U.S. parents from their foreign affiliates.⁹⁴

All of this leads to the policy recommendation that if the United States moves to a territorial system, it should adopt an interest allocation rule with gross profits as the allocation factor. This eliminates the policy justification for the 5 percent haircut in the Camp plan. And in general, no additional thin capitalization rules would be needed. The exception might be for foreign multinationals investing in the United States when it is difficult for the Internal Revenue Service to gain access to records necessary to allocate interest on a worldwide basis.

What about a limitation on interest similar to the percentage of adjusted taxable income test in the Camp plan? Except as a substitute for an interest allocation rule for foreign multinationals in the United States, there is no *international* tax policy justification for this limit once a meaningful interest allocation rule is in place. There may be, however, a good reason to limit interest deductions generally, especially if revenue gained from limiting deductions is used to lower rates, in order to eliminate the corporate taxes favoritism of debt over equity.⁹⁵ Following this line of reasoning, however, would lead to the imposition of a percentage of taxable adjusted income limitation on all firms, both purely domestic and multinational. That is a topic for another article.

92. *An Automatic Brake*, *supra* note 61, at 504; *see also supra* Parts IV.A–B.

93. *See supra* Part IV.B

94. *See supra* Parts IV.B–C.

95. The Obama Administration has suggested limits on the deduction of interest as one of a menu of options of a corporate tax reform plan that would reduce the corporate tax rate to 28%. THE WHITE HOUSE AND THE DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 10 (2012) ("Additional steps like reducing the deductibility of interest for corporations should be considered as part of a reform plan."); *see also* Martin A. Sullivan, *Treat Corporate Interest Deductions Like Any Tax Expenditure*, 136 TAX NOTES 631 (2012); Robert C. Pozen & Lucas W. Goodman, *Capping the Deductibility of Corporate Interest Expense*, 137 TAX NOTES 1207 (2012).

VI. APPENDICES

TABLE 1
Effect of Interest Allocation Rules on US MNC's Choice of
Domestic versus Foreign Investment

A. Without Interest Allocation Rules

	US MNC			US MNC		
	New Domestic Investment			New Foreign Investment		
	Before	After	Change	Before	After	Change
Total Gross Profit	200	300	100	200	300	100
Total Interest	100	150		100	150	
Domestic						
Gross Profit	100	200		100	100	
Allocation Fraction						
Interest Deduction	50	100		50	100	
Taxable Profit	50	100		50	0	
Tax @ 35%	17.5	35		17.5	0	
Foreign						
Gross Profit	100	100		100	200	
Allocation Fraction						
Interest Deduction	50	50		50	50	
Taxable Profit	50	50		50	150	
Tax @ 15%	7.5	7.5		7.5	22.5	
Total Tax	25	42.5	17.5	25	22.5	-2.5
Marginal ETR			17.5%			-2.5%

B. With Interest Allocation Rules

	US MNC			US MNC		
	New Domestic Investment			New Foreign Investment		
	Before	After	Change	Before	After	Change
Total Income	200	300	100	200	300	100
Total Interest	100	150		100	150	
Domestic						
Gross Profit	100	200		100	100	
Allocation Fraction	0.5	0.67		0.5	0.33	
Interest Deduction	50	100		50	50	
Taxable Profit	50	100		50	50	
Home Tax Rate	0.35	0.35		0.35	0.35	
Tax @ 35%	17.5	35		17.5	17.5	
Foreign						
Gross Profit	100	100		100	200	
Allocation Fraction	0.5	0.33		0.5	0.67	
Interest Deduction	50	50		50	100	
Taxable Profit	50	50		50	100	
Tax @ 15%	7.5	7.5		7.5	15	
Total Tax	25	42.5	17.5	25	32.5	7.5
Marginal ETR			17.5%			7.5%

TABLE 2
Effect of Interest Allocation Rules on
Competitiveness of US versus Foreign MNC

A. Without Interest Allocation Rules

	US MNC			Foreign MNC		
	New Source Country Investment			New Source Country Investment		
	Before	After	Change	Before	After	Change
Total Gross Profit	200	300	100	200	300	100
Total Interest	100	150		100	150	
Home Country						
Gross Profit	100	100		100	100	
Allocation Fraction						
Interest Deduction	50	100		50	100	
Taxable Profit	50	0		50	0	
Tax @ 35%	17.5	0		12.5	0	
Source Country						
Gross Profit	100	200		100	200	
Allocation Fraction						
Interest Deduction	50	50		50	50	
Taxable Profit	50	150		50	150	
Tax @ 15%	7.5	22.5		7.5	22.5	
Total Tax	25	22.5	-2.5	20	22.5	2.5
Marginal ETR			-2.5%			2.5%

B. With Interest Allocation Rules

	US MNC			Foreign MNC		
	New Source Country Investment			New Source Country Investment		
	Before	After	Change	Before	After	Change
Total Income	200	300	100	200	300	100
Total Interest	100	150		100	150	
Home Country						
Gross Profit	100	100		100	100	
Allocation Fraction	0.5	0.33		0.5	0.33	
Interest Deduction	50	50		50	50	
Taxable Profit	50	50		50	50	
	0.35	0.35		0.25	0.25	
Tax @ 35%	17.5	17.5		12.5	12.5	
Source Country						
Gross Profit	100	200		100	200	
Allocation Fraction	0.5	0.67		0.5	0.67	
Interest Deduction	50	100		50	100	
Taxable Profit	50	100		50	100	
Tax @ 15%	7.5	15		7.5	15	
Total Tax	25	32.5	7.5	20	27.5	7.5
Marginal ETR			7.5%			7.5%