INTERNATIONAL TAX POLICY'S HARM TO MANUFACTURING AND NATIONAL INTERESTS

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Two tax regulations that permit U.S. multinational enterprises (MNEs) to use foreign contract manufacturers and to disregard their wholly owned foreign subsidiaries have created significant tax incentives for MNEs to move manufacturing outside the United States. These tax incentives have contributed to the loss of five million manufacturing jobs and the closure of more than 91,000 plants since 1997.

The job losses exacerbated racial and economic inequality and stressed our political system. But the losses arising from offshore manufacturing extend to other areas as well. Offshore manufacturing increases U.S. exposure to supply chain disruptions, threatens national security, and decreases research and development efforts to improve production techniques. Also, as automated manufacturing increases, the use of offshore manufacturing hinders the ability of the U.S. to compete in that sector.

The U.S. implementation of a corporate alternative minimum tax in 2023 and the current Organization for Economic Co-operation (OECD) initiative, Pillar Two, which seeks to impose a global corporate minimum tax, may reduce the incentive to offshore in some instances. But the incentives created by the two tax regulations for U.S. MNEs to offshore clearly remain and should be eliminated given the harms they have inflicted and are likely to inflict in the future.

This Article proposes two amendments to the regulations to further reduce the tax incentives for offshoring. First, MNEs should not be allowed to use foreign contract manufacturers to qualify for the manufacturing exception in Subpart F of the Internal Revenue Code. Second, MNEs should not be permitted to disregard their wholly owned foreign entities. Under the *Chevron* doctrine, both proposals would clearly be valid. The Supreme Court's nascent major question doctrine (MQD), however, creates significant uncertainty about the circumstances in which *Chevron* deference should apply. This Article concludes that even if the MQD applies to eliminate

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Chevron deference, the so-called "weak form" of the MQD should validate the proposed regulations.

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INTRODUCTION

The U.S. lost almost five million manufacturing jobs and more than 91,000 plants from 1997 through 2018.[1] Although service jobs increased at the same time that manufacturing jobs decreased,[2] a significant portion of factory workers, particularly less educated workers, have not shared in that growth.[3] The loss of these jobs has created massive social disruption.[4]

In addition to declining employment in manufacturing, recent studies indicate that the U.S. production of items critical to national security has also declined as U.S. businesses outsource manufacturing.[5] This shift has created several harmful effects. Often, manufacturing has shifted to countries with totalitarian governments and questionable human rights, thereby strengthening governments potentially hostile to democracy.[6] Distant manufacturing also increases U.S. susceptibility to potential supply chain disruption.[7] Offshore manufacturing may also weaken research and development pertaining to production methods because production is remote from research.[8] Lastly, the social disruptions caused by the massive loss of manufacturing jobs adversely affect our democracy because of political fault lines they create.[9]

Our tax system has played a role in encouraging U.S. multinational enterprises (MNEs) to move their manufacturing activities outside the United States.[10] A portion of our tax laws, called Subpart F, seeks to impose the maximum U.S. corporate tax on certain types of income earned in tax havens by foreign subsidiaries of U.S. MNEs.[11] In general,

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1. Robert E. Scott, Econ. Pol'y Inst. Pol'y Ctr., We Can Reshore Manufacturing Jobs, but Trump Hasn't Done It 3 (2020), https://files.epi.org/pdf/202015.pdf [https://perma.cc/HHZ8-J725].

2. *See infra* text accompanying notes 128–30. It is unclear whether the increase in service jobs fully offset the decline in manufacturing jobs. *See infra* text accompanying notes 129–31.

3. *See infra* text accompanying notes 131–45.

4. *See infra* text accompanying notes 140–69. *See generally* Eric D. Gould, *Torn Apart? The Impact of Manufacturing Employment Decline on Black and White Americans* (IZA Inst. of Lab. Econ., Working Paper No. 11614, 2018), https://docs.iza.org/dp11614.pdf [https://perma.cc/TBL6-5Q3T].

5. *See infra* Section II.C.

6. *See infra* text accompanying notes 171–86.

7. *See infra* text accompanying notes 172–94.

8. *See infra* text accompanying notes 209–14.

9. *See infra* Section II.B.

10. *See infra* Sections I.A–B. As discussed in Section I.C, *infra*, several other contributing factors also exist.

11. I.R.C. §§ 951–65.

Subpart F targets the subsidiary's income if the subsidiary resides in the low-tax jurisdiction for tax avoidance purposes. An important exception to the imposition of this tax is the so-called "manufacturing exception."[12] The manufacturing exception allows the income of foreign subsidiaries to avoid current U.S. taxation on a portion of their profits arising from the sale of goods they have manufactured.[13] In other words, the manufacturing exception assumes that there is a legitimate business purpose for the subsidiary to be in the tax haven if the subsidiary is manufacturing goods.

A major loophole, however, which became more certain to withstand Internal Revenue Service (IRS) challenge after surviving two court challenges, is that the subsidiaries need not have produced the goods themselves to qualify for the manufacturing exception. Instead, they can contract with foreign manufacturers in other countries to produce their goods. Since our current rules impute the contract manufacturer's production activities to the subsidiary, the subsidiary is able to avoid current U.S. taxation, while continuing to pay little or no tax to the tax haven. This is true even though the subsidiary often has no real presence in the tax haven—it is usually just a paper "shell." For example, a U.S. MNE can form a shell corporation in a tax haven. The tax haven subsidiary can then contract with a foreign manufacturer to produce a good, and then sell the good back in the U.S. at a significant profit with minimized U.S. tax.[14] In 1997,[15] the IRS issued a revenue ruling that many practitioners viewed as giving a green light to employ this scheme.[16]

Another important development, also occurring in 1997, was the adoption of the check-the-box (CTB) regulations.[17] These regulations, which were supposed to simplify the tax classification of entities, allow U.S. MNEs to create foreign entities that are disregarded for U.S. tax purposes, but treated as separate entities for foreign tax purposes. The CTB regulations enable U.S. parent corporations, in certain circumstances, to avoid the application of Subpart F to sales by its foreign subsidiaries. These corporations sidestep Subpart F by electing to disregard the separate existence of foreign subsidiaries. The combination

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12. *See infra* notes 39–41 and accompanying text.

13. *See infra* note 40 and accompanying text.

14. As discussed in Part III, *infra*, although this strategy will avoid the tax imposed by Subpart F, it is possible that the so-called "GILTI" tax of 10.5 percent or the corporate AMT will apply to a portion of that income.

15. Rev. Rul. 97-48, 1997-2 C.B. 89.

16. *See infra* text accompanying notes 59–62.

17. Treas. Reg. §§ 301.7701-1 to -3 (1997).

of the contract manufacturing exception and the check-the-box regulations created numerous opportunities to avoid or minimize U.S. taxes by shifting manufacturing overseas beginning in 1997.[18]

Although tax is not the only reason that manufacturing employment began to plummet in 1997, it was likely a contributing factor to the steep downward trajectory shown in Figure 1 below.

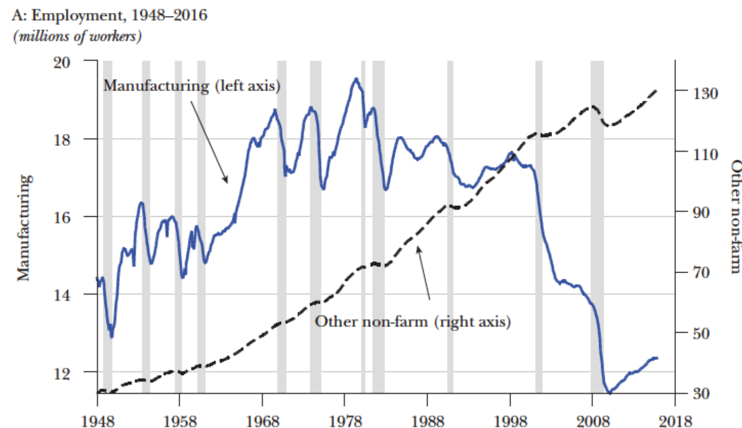

Figure 1. US Employment within and outside Manufacturing.[19]

This Article argues that we should amend Treasury regulations to eliminate the tax incentives to shift manufacturing outside the U.S. As discussed herein, the implementation of the corporate alternative minimum tax (AMT) in 2023 and the Organization for Economic Co-operation's (OECD) ongoing initiative to adopt a global fifteen percent minimum tax,[20] may reduce (but clearly will not eliminate), the

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18. For an overview of the check-the-box regulations and their impacts, see, for example, Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation After the Check-the-Box Regulations*, 7 FLA. TAX REV. 186, 195–203 (2005); Heather M. Field, *Checking In on "Check-the-Box,"* 42 LOY. L.A. L. REV. 451, 489–90 (2009), and Paul Oosterhuis & Moshe Spinowitz (Mar. 15, 2013), Tax Incentives to Conduct Offshore Manufacturing Under Current Law, *in* TAX POLICY AND U.S. MANUFACTURING IN A GLOBAL ECONOMY, 15–16 (2013).

19. Teresa C. Fort, Justin R. Pierce & Peter K. Schott, *New Perspectives on the Decline of US Manufacturing Employment*, J. ECON. PERSPS., Spring 2018, at 47, 48 fig.1.A.

20. *See* OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – ADMINISTRATIVE GUIDANCE ON THE GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO) 6 (2023), https://www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two-july-2023.pdf [https://perma.cc/3BRL-H93U] [hereinafter GLOBAL ANTI-BASE EROSION MODELS].

incentive to shift manufacturing outside the U.S. Our international tax policy should not include any incentives that favor foreign manufacturing over U.S. manufacturing.

An important legislative objective of Subpart F is to restrict favorable tax treatment to situations where a U.S. MNE has a legitimate business reason for locating a subsidiary in a tax haven. Consequently, this Article proposes that we either amend regulations or adopt legislation in Subpart F to limit the manufacturing exception to situations where the foreign subsidiary manufactures goods itself, and not through the use of contract manufacturers. If an MNE's foreign subsidiary in a tax haven is not actually manufacturing products, there is no reason for our tax system to subsidize its existence there. In addition, this Article suggests that we amend the CTB regulations to disallow the disregard of foreign entities. The CTB regulations' goal of simplification does not justify the harm this provision has inflicted on U.S. manufacturing.

The advantage of amending regulations, as opposed to seeking legislative solutions, is that the corrections can be made quickly and legislative deadlock can be avoided. However, as discussed herein, the developing major question doctrine (MQD),[21] which eliminates judicial deference for regulations that present major political or economic issues, may apply to the regulations proposed in this Article. This Article concludes that courts should validate amendments to the contract manufacturing and CTB regulations, even if the major question doctrine applies.

This Article is organized as follows: Part I describes the two key tax regulations that created an unintended tax incentive for U.S. MNEs to shift manufacturing outside the United States. Part II then explores the harms suffered by the U.S. due to manufacturing's flight. Part III describes new provisions that became effective as part of major revisions of the tax system in 2017 and 2022 that have not eliminated, and in some instances have exacerbated, the problem. It also briefly describes another developing OECD initiative, Pillar Two, which seeks to impose a global corporate minimum tax and which also will not eliminate the problem. Part IV offers a solution to correct this problem that may be accomplished through regulatory amendments.

21. *See, e.g.*, *West Virginia v. EPA*, 142 S. Ct. 2587, 2605 (2022).

I. Two Tax Provisions That Created Incentives for U.S. Multinationals to Offshore Manufacturing

A. Subpart F and Controlled Foreign Corporations

To understand the biases in our international tax system that have encouraged U.S. MNEs to shift manufacturing overseas, it is necessary to explore some of the mind-numbing nuances of Subpart F. At the outset, it is important to note that Congress did not intentionally design our tax system to encourage offshore manufacturing. Rather, the intention was to allow U.S. MNEs to compete effectively with local producers in foreign countries.[22] Our system sought to accomplish this by allowing the controlled foreign corporations (CFCs)[23] of U.S. corporations to avoid U.S. tax on their foreign earnings until such earnings were distributed to the U.S. parent. As the subsidiary earned income in the foreign country and retained those earnings, it would only pay the foreign country's tax.[24] This allowed the MNE's CFC to carry the same tax burden as its competitors with respect to its retained earnings in the foreign country and to reinvest those earnings in its operations to stay competitive.

This system created an obvious incentive to accumulate income in low-tax jurisdictions. For example, a U.S. parent corporation might create a CFC in a country, such as the Isle of Jersey, which imposes no corporate tax.[25] The U.S. parent would then cause the CFC to purchase goods from a third party outside the U.S. and then sell those purchased

22. *See, e.g.*, OECD, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 19 (2000), https://home.treasury.gov/system/files/131/Report-SubpartF-2000.pdf [https://perma.cc/92CJ-A3L3].

23. CFCs that are subject to Subpart F are foreign corporations in which more than fifty percent of either the total combined voting power of all classes of stock entitled to vote or of the total value of all stock are owned by "United States shareholders." I.R.C. § 957(a). A "United States shareholder[]" is a U.S. person owning directly or by attribution ten percent of the vote or value of the CFC's stock. I.R.C. § 951(b).

24. The deferral of U.S. tax was, in effect, a form of "[c]apital import neutrality," which seeks to impose the same aggregate tax burden on foreign corporations operating in a country as is borne by the country's domestic corporations. *See* James R. Repetti, Diane M. Ring & Stephen E. Shay, Introduction to United States International Taxation 105 (Aspen Treatise Series 7th ed. 2022). For an insightful criticism of the use of capital import neutrality in international tax analysis, see David A. Weisbach, *The Use of Neutralities in International Tax Policy*, 68 Nat'l Tax J. 635 (2015).

25. *See Jersey, Channel Islands: Corporate – Taxes on Corporate Income*, PwC, https://taxsummaries.pwc.com/jersey/corporate/taxes-on-corporate-income [https://perma.cc/WG4Z-ZYUE].

goods for a large profit to the U.S. parent. The U.S. parent would now have a high tax basis in the goods and would incur only a small U.S. tax liability when it sold the goods in the U.S.[26] At the same time, the CFC would have a large profit from its sale to the U.S. parent at a high price, but its large profit would not be subject to U.S. tax (absent rules discussed below to discourage this strategy) and no foreign tax would be owed to the tax haven.

The U.S. would eventually collect a tax if the CFC distributed its income to the parent,[27] but many MNEs permanently kept the income of the CFCs overseas. For example, in 2017, U.S. companies reported $4.2 trillion in earnings accumulated offshore, $3 trillion of which were in tax havens.[28] It is also estimated that in 2017 the various methods that U.S. MNEs used to shift income to low-tax countries reduced U.S. corporate tax revenues by about $100 billion annually.[29] This represented about one third of federal corporate tax revenues.[30] As discussed in Sections IV.A and B, recent tax acts[31] have introduced new provisions that attempt to reduce incentives to shift manufacturing and allocate profits to tax havens.[32] These provisions, however, are expected to reduce the amount

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26. I.R.C. § 482 curtails this practice with only partial success by allocating some of the gain arising from the CFC's subsequent sale of the product back to the U.S. parent so that the amount paid by the tax haven subsidiary to the U.S. parent reflects a price that would have been paid in an arms-length transaction. *See* REPETTI, RING & SHAY, *supra* note 24, at 200–01.

27. Recent tax acts have introduced new tax regimes that may impose a reduced U.S. tax on a portion of the income earned by a CFC overseas even if it is never distributed to the U.S. parent. Nevertheless, there is still a significant incentive to accumulate income in tax havens and to shift manufacturing overseas. *See infra* Sections III.A–B.

28. Kimberly A. Clausing, *5 Lessons on Profit Shifting from U.S. Country-by-Country Data*, 169 TAX NOTES FED. 925, 927 (2020).

29. Kimberly A. Clausing, *Profit Shifting Before and After the Tax Cuts and Jobs Act*, 73 NAT'L TAX J. 1233, 1253 (2020).

30. Kimberly A. Clausing, How Big Is Profit Shifting? 15 (May 17, 2020) (unpublished research note).

31. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017); Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818 (2022).

32. In addition, the 2017 Tax Act has encouraged MNEs to repatriate their prior offshore earnings by subjecting them to U.S. taxation over a period of time. I.R.C. § 965 imposes a one-time U.S. income tax on U.S. MNEs with respect to income accumulated by their CFCs through the end of 2017. It applies a reduced U.S. tax with favorable payment terms that may be spread over eight years. Any actual subsequent repatriation of those accumulated earnings is then tax free. See REPETTI, RING & SHAY, *supra* note 24, at 120–21, for a description of I.R.C. § 965. It is reported that U.S. MNEs repatriated $777 billion in 2018. Michael Smolyansky, Gustavo Suarez & Alexandra Tabova, *U.S. Corporations' Repatriation of Offshore Profits: Evidence from 2018*, BOARD GOVERNORS FED. RSRV. SYS.: FEDS NOTES (Aug. 6, 2019),

of profits shifted to tax havens by small amounts[33] because significant incentives still exist to accumulate income in tax havens.

The ability of U.S. parents to defer tax on the foreign income of their CFCs has always been controversial. In 1961, President Kennedy requested that Congress end deferral for all the income of CFCs earned in developed countries and tax havens.[34] However, instead of ending deferral for all, Congress adopted Subpart F as a means to prevent abuses of deferral while allowing CFCs to remain competitive in foreign countries.[35]

The general approach of Subpart F is to end tax deferral in certain potentially abusive situations. Subpart F taxes the U.S. parent immediately on the earnings of their CFCs[36] in low-tax foreign countries that are not derived from "legitimate" business operations in that low-tax country at the regular corporate tax rate of twenty-one percent.[37] Subpart F imposes this tax on the parent corporation regardless of whether the CFC distributes the earnings to the parent. Rather than apply a general standard that would determine whether a CFC had a legitimate business purpose for operating in the low-tax jurisdiction, Subpart F defines specific categories of transactions that are viewed as "illegitimate" and, consequently, result in immediate taxation to the U.S. parent. Collectively, the income from these categories of transactions is called "Subpart F income." One of the categories of a CFC's Subpart F income

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https://www.federalreserve.gov/econres/notes/feds-notes/us-corporations-repatriation-of-offshore-profits-20190806.html [https://perma.cc/FQA5-MJN3].

33. Clausing, *supra* note 29, at 1253; Martin A. Sullivan, *Post-TCJA U.S. Multinational Profit in Ireland Surges Past $100 Billion*, 173 TAX NOTES FED. 1053 (2021) [hereinafter *Post-TCJA U.S. Multinational Profit*]; Martin A. Sullivan, *Little Progress on Pharma Profit Shifting Back to the United States*, 174 TAX NOTES FED. 1474 (2022) [hereinafter *Little Progress of Pharma Profit Shifting*].

34. JOHN F. KENNEDY, MESSAGE FROM THE PRESIDENT OF THE UNITED STATES RELATIVE TO OUR FEDERAL TAX SYSTEM, H.R. DOC. NO. 87-140, at 7–8 (1961).

35. *See* Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960. *See also* STAFF OF S. COMM. ON FIN., 87TH CONG., BRIEF SUMMARY OF PROVISIONS IN H.R. 10650 THE "REVENUE ACT OF 1962" 9 (Comm. Print 1962).

36. The CFCs subject to this tax regime are foreign corporations in which more than fifty percent of either the total combined voting power of all classes of stock entitled to vote or of the total value of all stock are owned by "United States shareholder[s]." I.R.C. §§ 951(a), 957(a). A "United States shareholder[]" is a U.S. person owning directly or by attribution ten percent of the vote or value of the CFC's stock. I.R.C. § 951(b).

37. *See* I.R.C. § 954(b)(4) (allowing a U.S. shareholder to elect out of the application of Subpart F where the effective tax rate in the CFC's country is greater than ninety percent of the maximum marginal U.S. rate). *See also* Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

that is immediately taxable to the U.S. parent is "foreign base company sales income."[38]

In general, "foreign base company sales income" is income from property manufactured and sold outside the CFC's country of incorporation that the CFC did not manufacture itself and that the CFC purchased from or sold to a related person.[39] Thus, in the above example, where the Isle of Jersey CFC purchased goods from a third party outside the Isle of Jersey and sold the goods at a large profit to its U.S. parent, the CFC's income would be treated as Subpart F income that is immediately taxable to the parent and subject to U.S. tax. The logic behind foreign base company sales income is that deferral should only be available for a CFC in a low-tax country that has a legitimate business reason for being in that country. Legitimate reasons for being in a country include, for example, manufacturing goods there, selling goods to consumers there, or buying goods manufactured there. If the CFC is merely using the tax haven as a base for operations by purchasing goods from an unrelated party outside its country and then selling those goods to a related party outside its country, or purchasing goods from a related party and selling those goods outside the CFC's country, it lacks a legitimate business reason for being in the tax haven. It solely operates there to save taxes.

An important exception to the foreign base company sales income rule is the manufacturing exception. It provides that when the CFC itself manufactures goods, the sale of those goods to a related party will not result in Subpart F income.[40] The manufacturing exception even applies when the CFC purchases materials from its U.S. parent so long as the transformation of the products is substantial in nature.[41]

The manufacturing exception allows a CFC to manufacture a product anywhere and then sell the product to a related party, such as its U.S. parent, for a large profit and avoid a U.S. tax. There is often a problem with this strategy, however. The CFC's tax-haven country may not welcome the CFC's construction of a smokestack factory in the tax haven or may not have the infrastructure to support the operation of such

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38. I.R.C. §§ 951(a), 952(a)(2), 954(a).

39. I.R.C. § 954(d)(1). If the CFC purchases property from a related party but sufficiently transforms the property to constitute "manufacturing" by the CFC, then the sale of that property to a related party does not result in foreign base company sales income. Treas. Reg. § 1.954-3(a)(4) (as amended in 2011).

40. Treas. Reg. § 1.954-3(a)(4)(i) (as amended in 2011). For an excellent description of the manufacturing exception, see JOEL D. KUNTZ, ROBERT J. PERONI & JOHN A. BOGDANSKI, U.S. INT'L TAX'N ¶ B3.05[3][d], RIA Checkpoint (database updated Sept. 2023).

41. Treas. Reg. §§ 1.954-3(a)(4)(ii)–(iv) (as amended in 2011).

a factory. As a result, the CFC will often look elsewhere to manufacture the goods. The CFC will not use a U.S. manufacturer because that might cause it to be viewed as conducting business in the U.S. and subject it to U.S. tax.[42] Similarly, the CFC may be reluctant to build a factory in a different industrialized country because to do so may subject it to tax in that country.[43] Instead, the CFC will arrange with a contract manufacturer, located outside the U.S., to produce goods with minimal oversight by the CFC's employees. This will allow the CFC to claim the manufacturing exception for the foreign base company sales income rule and avoid taxes in the U.S. and in the tax haven. At the same time, the CFC will usually not be subject to any tax in the contract manufacturer's country.

In Revenue Ruling 75-7, the IRS ruled the activities of the contract manufacturer will be imputed to the CFC for purposes of satisfying the manufacturing exception if the CFC controls the method of production, bears the risk of loss for raw materials used in production that may be destroyed, and sends employees to the production site.[44] Revenue Ruling 75-7 did not result in an immediate departure of manufacturing from the U.S., however, because the IRS sought to limit its scope. The IRS warned that it would apply the so-called "branch rule" to the contract manufacturer with the result that the CFC's use of a contract manufacturer might generate foreign base company sales income in some instances, thereby subjecting the CFC to U.S. taxation.[45]

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42. *See infra* text accompanying note 72.

43. Such an action may also result in unfavorable U.S. tax results due to the "branch rule." *See infra* text accompanying notes 45–52.

44. Rev. Rul. 75-7, 1975-1 C.B. 244. The role of employees was often not significant. *See infra* text accompanying notes 68–71.

45. A "branch" in a foreign country, in very general terms, is a business operation that the taxpayer conducts directly in rather than indirectly through a separate juridical entity, such as a subsidiary. *See generally* Temp. Treas. Reg. § 1.367(a)-6T(g)(1) (1986) (defining "branch" for purposes of I.R.C. § 367). For example, if an Irish CFC owns and operates a factory in Germany without creating a separate juridical entity to hold that factory, the factory would be a "branch" of the Irish CFC.

In general, the "branch rule," when applicable, treats a CFC's branch that manufactures goods for the CFC in another foreign country as a separate related subsidiary of the CFC. The branch rule's treatment of the manufacturing branch as a separate related subsidiary causes the CFC to recognize foreign base company sales income when it sells the manufactured products, since the products are treated as having been acquired by the CFC from a related party. *See* REPETTI, RING & SHAY, *supra* note 24, at 114 n.66 (describing the branch rule and discussing *Whirlpool Fin. Corp. v. Comm'r*, 19 F.4th 944 (6th Cir. 2022), which is the most recent case to apply the branch rule). Such foreign base company sales income is immediately taxable to the U.S. parent under Subpart F.

The IRS suggested in Revenue Ruling 75-7 that the branch rule could apply to treat contract manufacturers as a related subsidiary and subject the CFC to U.S. tax even though the contract manufacturers were separately incorporated entities that were not related to the CFC.[46] Many practitioners agreed with the conclusion in Revenue Ruling 75-7 that a CFC should be able to impute the activities of a contract manufacturer to itself for purposes of applying the manufacturing exception, and the IRS had reaffirmed this conclusion in private letter rulings.[47] Practitioners disagreed, however, with the statement in Revenue Ruling 75-7 that a contract manufacturer could be treated as a branch of a CFC for purposes of applying the branch rule. In 1990, the Tax Court rejected the applicability of the branch rule to contract manufacturers in two cases: *Ashland Oil, Inc. v. Commissioner of Internal Revenue*[48] and *Vetco, Inc. v. Commissioner of Internal Revenue*.[49] In those cases, the Tax Court held that the branch rule could not apply to an unrelated contract manufacturer that a CFC hired to manufacture goods.[50] The Tax Court determined that a separately incorporated entity that was unrelated to a CFC could not be characterized as a branch of the CFC.[51] The court reached this decision, even though the CFC maintained a significant amount of control over the manner in which the contract manufacturer produced the goods.

When does the branch rule apply to trigger foreign base company sales income? The branch rule treats the manufacturing branch as though it were a separate related entity if the foreign tax rules applicable to the foreign branch and to the CFC would result in lower foreign taxes than the foreign taxes that would have applied had the CFC formed a subsidiary to hold the manufacturing facility. I.R.C. § 954(d)(2); Treas. Reg. § 1.954-3(b)(1)(ii) (as amended in 2011). The effect of this test is to require a comparison of the actual foreign taxes imposed on the income of the CFC's branch with the hypothetical foreign taxes that would have been imposed had the branch operation been organized as a subsidiary in the country where it is located. *See* LOWELL D. YODER, DAMON M. LYON & DAVID G. NOREN, CFCS — FOREIGN BASE COMPANY INCOME (OTHER THAN FPHCI) VII.H.4.b, Bloomberg Tax 6240 T.M.. The concern for the U.S. is that the branch is aiding the CFC's accumulation of low-tax income in the tax haven because the branch is subject to foreign taxes that are less than would have applied had the branch been formed as a separate subsidiary.

46. Rev. Rul. 75-7, 1975-1 C.B. 244.

47. *See, e.g.*, YODER, LYON & NOREN, *supra* note 45, at VII.E.3.

48. 95 T.C. 348 (1990).

49. 95 T.C. 579 (1990).

50. *Ashland Oil*, 95 T.C. at 358; *Vetco*, 95 T.C. at 593.

51. The Tax Court held a "separately incorporated manufacturing entity operating pursuant to an arm's-length agreement, with the CFC having no direct or indirect stock interest in that entity (and vice versa), does not fall within any customary meaning of 'branch' of which we are aware." *Ashland Oil*, 95 T.C. at 360. For the definition of a "branch," see *supra* note 45.

The IRS finally capitulated at the end of 1997 in Revenue Ruling 97-48, stating that it would follow *Ashland Oil* and *Vetco* and not treat a contract manufacturer as the branch of a CFC.[52] But, in an attempt to discourage the use of contract manufacturing, the ruling also stated that it would not allow CFCs to use contract manufacturers to satisfy the manufacturing exception.[53] The IRS proposed regulations a few months after issuing Revenue Ruling 97-48 that addressed several abuses of Subpart F that involved the use of hybrid entities and that also would have required that a CFC itself perform the manufacturing process in order for the manufacturing exception to apply.[54] The proposed regulations were withdrawn, however, one year later in 1999.[55] Treasury's withdrawal was at least, in part, attributable to a non-binding "sense of the Senate" vote that Treasury should withdraw the regulations.[56] Notably, the discussion in the Senate Finance Committee Report that accompanied the sense of the Senate vote did not refer to the repeal of the contract manufacturing exception.[57] Instead it focused on abuses involving hybrid entities and foreign tax credits.[58]

The result was that, by the end of 1997, many practitioners felt that Revenue Ruling 97-48 gave MNEs the green light to use contract manufacturers and reduce U.S. taxation.[59] Commentators agreed with the IRS that the branch rule should not apply, but disagreed with the IRS view that the manufacturing exception would not apply if the CFC sought

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52. Rev. Rul. 97-48, 1997-2 C.B. 89 (revoking Rev. Rul. 75-7).

53. *Id.*

54. Guidance Under Subpart F Relating to Partnerships and Branches, 63 Fed. Reg. 14,669 (Mar. 26, 1998) (to be codified at I.R.C. pts. 1, 301) *withdrawn*, Issuance of New Guidance Under Subpart F Relating to Certain Hybrid Transactions, 64 Fed. Reg. 37,727 (July 13, 1999) (to be codified at I.R.C. pts. 1, 301).

55. Withdrawal of Guidance Under Subpart F Relating to Partnerships and Branches and Issuance of New Guidance Under Subpart F Relating to Certain Hybrid Transactions, 64 Fed. Reg. 37,727 (July 13, 1999) (to be codified at I.R.C. pts. 1, 301).

56. Internal Revenue Service Restructuring and Reform Act of 1998, H.R. 2676, 105th Cong. § 3713 (as reported with an amendment, April 22, 1998); S. REP. NO. 105-174, at 110–14 (1998). The conference committee deleted the "Sense of the Senate" vote in the final bill because Treasury had withdrawn the regulations in response to the "Sense of the Senate" vote. Internal Revenue Service Restructuring and Reform Act, H.R. REP. NO. 105-599, at 318 (1998) (Conf. Rep.).

57. *See* S. REP. NO. 105-174 110–14 (1998).

58. *Id.*

59. *See, e.g.*, Stephen R. A. Bates & Derrick A. Kirkwood, *Contract Manufacturing: Is the War Over?*, TAX NOTES INT'L 61, 66 (2008) (stating that after the issuance of Rev. Rul. 97-48, "taxpayers and practitioners continued to believe that a CFC engaging a contract manufacturer should not be treated as earning" Subpart F income).

to use contract manufacturers.[60] For example, one group of prominent attorneys wrote that they believed that neither the negligence penalty nor the substantial understatement penalty should apply to the use of contract manufacturers to satisfy the manufacturing exception, and that disclosure of such an arrangement would not be required on a tax return.[61] A treatise explained:

> [T]ax practitioners and other commentators were generally of the view that there was strong support under the law for a position contrary to the IRS position expressed in Rev. Rul. 97-48 [that contract manufacturing could not be imputed to the CFC]. Commentators pointed out that there is no rule in the Code prohibiting the attribution of a contract manufacturer's activities to a hiring CFC for purposes of the CFC manufacturing exception to § 954(d) . . . [foreign base company] sales income. Nor is there any rule in the Code that explicitly requires that only the activities of a CFC's own employees be taken into account for purposes of meeting that exception. Moreover, the courts interpreting other areas of tax law *where the Code and regulations are silent with respect to what constitutes manufacturing*, generally treat the hiring party as the manufacturer where such person supervises and controls the manufacturing process, provides the manufacturing intangibles, and takes the entrepreneurial risks and benefits.[62]

Recognizing that "the horse was already outside the barn," the IRS vindicated the 1997 perspective of practitioners in 2008 when it issued regulations that allowed a CFC to use the manufacturing exception for the work performed by a contract manufacturer so long as the CFC made a "substantial contribution" to the production process.[63] The "substantial contribution" requirement is not very onerous. For example, the regulations state that oversight and direction is not a prerequisite for

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60. *See, e.g.*, Howard J. Levine & Peter A. Glicklich, *FSA 200220005: IRS Again Attempts to Void Contract Manufacturing Arrangements Under Subpart F*, J. TAX'N GLOB. TRANSACTIONS, Winter 2003, at 5; Gregg D. Lemein & John D. McDonald, *FSA 200220005: The IRS Attacks Contract Manufacturing*, TAXES, July 2002, at 5.

61. Howard J. Levine, Peter A. Glicklich & Michael J. Miller, *Accessing the Manufacturing Exception to Subpart F Through Contract Manufacturing Arrangements*, J. TAX'N GLOB. TRANSACTIONS, Fall 2001, at 37, 43 n.13.

62. YODER, LYON, AND NOREN, *supra* note 45, at VII.E.3.d (emphasis added) (footnotes omitted).

63. T.D. 9438, 2009-5 I.R.B. 387 *as corrected at* Guidance Regarding Foreign Base Company Sales Income and Correction, 74 Fed. Reg. 11,843 (Mar. 2009).

satisfying the substantial contribution test, and may not even be necessary in certain industries.[64] Also, some law firms have suggested that there is no minimum level of oversight or direction required in order to satisfy this requirement.[65] Treasury explained its rationale for the generally toothless approach of the regulations:

> [G]lobal economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.[66]

While U.S. MNEs were pleased with these results, others warned that the foreign base company sales rules had now become elective. The New York State Bar Association stated:

> On the basis of this . . . policy of competitiveness, the Proposed Regulations generally liberalize the . . . [foreign base company sales income] rules as applied to contract manufacturing . . . . [T]he regulations will, as a practical matter, permit the elimination of . . . [foreign base company sales income] for most taxpayers.[67]

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64. Treas. Reg. § 1.954-3(a)(4)(iv)(d) (as amended in 2011).

65. *See, e.g.*, Jonathan A. Sambur, Kenneth Klein, Patricia Anne Rexford, John T. Hildy & Rafic H. Barrage, *Final and Temporary Contract Manufacturing Regulations Issued by US Treasury Department and IRS*, MAYER BROWN (Jan. 7, 2009), https://web.archive.org/web/20210924210633mp_/https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2009/01/final-and-temporary-contract-manufacturing-regulat/files/updatecontract-manufacturing0109pdf/fileattachment/update_contract-manufacturing_0109.pdf ("[T]he final regulations removed the potentially confusing word 'regularly' in the phrase 'regularly exercise oversight and direction' . . . . Therefore, the final regulations clarify that there is no minimum level of oversight and direction required in order to satisfy this requirement.").

66. Guidance Regarding Foreign Base Company Sales Income, 73 Fed. Reg. 10,716, 10,718 (proposed Feb. 28, 2008).

67. N.Y. STATE BAR ASS'N, REPORT ON THE PROPOSED CONTRACT MANUFACTURING REGULATIONS 12 (2008),

As mentioned earlier,[68] the regulations require that the CFC's employees make a "substantial contribution" to the manufacturing process in order for the activities of the contract manufacturer to be imputed to the CFC.[69] This test is not difficult to satisfy. Although the regulations set forth several activities to determine whether employees have made a substantial contribution, they do not require that a minimum number of those activities be satisfied or that the activities rise to a certain level before they are considered. Rather, the determination is based on all the facts and circumstances. Some have suggested that the role of the CFC's employees will be insignificant and that the MNE's employees in the U.S. will play a greater role in monitoring production.[70]

The result is that the "substantial contribution" requirement is relatively easy to satisfy. Moreover, given the lack of resources available to the IRS in the past decade,[71] one has to wonder to what extent the IRS

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https://archive.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2008/1161_report.html [https://perma.cc/6NUY-6BMJ]. *See also* Julie A. Roin & Julia Skubis Weber, *"Subpar" F? The Role of Anti-Deferral in a Post-GILTI (and Maybe Pillar Two) World*, TAXES, March 2023, at 59, 65–66 (describing how the manufacturing exception allows U.S. MNEs to avoid Subpart F).

68. *See supra* text accompanying notes 63–65.

69. Treas. Reg. § 1.954-3(a)(4)(iv) (as amended in 2011).

70. *See* Letter from Jeffrey N. Kadet and David L. Koontz to the Internal Revenue Service (Jan. 16, 2020), https://digitalcommons.law.uw.edu/cgi/viewcontent.cgi?article=1579&context=faculty-articles [https://perma.cc/U6QD-3CPC]. In this letter, Kadet and Koontz write:

> Yes, often there will be production-related personnel at the site of a contract manufacturer, but often their principal functions will be liaison and quality control. There may also be some foreign-based personnel involved in sourcing raw materials and components from foreign suppliers and undoubtedly in some cases performing other important production functions such as controlling raw material and component inventory levels. However, even if the production functions of these foreign-based personnel are broader than liaison, quality control, and sourcing raw materials and components, they will often be few in number compared with the U.S.-based production-related personnel who conduct the full gamut of production activities.

Id. (footnotes omitted).

71. The Congressional Budget Office reported that appropriations for IRS enforcement activities decreased by twenty-nine percent in inflation-adjusted dollars between 2010 and 2018. CONG. BUDGET OFF., TRENDS IN THE INTERNAL REVENUE SERVICE'S FUNDING AND ENFORCEMENT 10 (2020), https://www.cbo.gov/publication/56422 [https://perma.cc/5NPC-Q845]. Similarly, the Inspector General for Tax Administration reported that the IRS budget for fiscal year 2020 was sixteen percent less in inflation adjusted dollars than the budget for fiscal year 2010. TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2020 3 (2022), https://www.tigta.gov/sites/default/files/reports/2022-06/202230033fr.pdf [https://perma.cc/9U75-YHCB].

is auditing the extent of a CFC's interactions with its contract manufacturer that is located thousands of miles away from the U.S.

In summary, the contract manufacturing exception creates an uneven playing field for U.S. manufacturers. It encourages U.S. MNEs to form CFCs in low-tax countries and then to employ foreign contract manufacturers in other countries to produce goods. The CFCs are reluctant to employ U.S. contract manufacturers. If the CFC uses a U.S. manufacturer related to it, the foreign base company sales income rules will apply to any gain realized by the CFC upon the subsequent sale of the goods acquired from the related U.S. manufacturer. If, instead, the CFC uses an unrelated contract manufacturer in the U.S. and "substantially contributes" to the manufacturing process, the foreign subsidiary runs the risk that its "substantial contribution" will create a sufficient nexus that will subject the foreign subsidiary to U.S. taxation.[72]

B. The Start of the Check-the-Box Regulations

At approximately the same time that practitioners had determined that the contract manufacturing rules allowed MNEs to circumvent Subpart F following the release of Revenue Ruling 97-48, Treasury adopted another regulation that became effective in 1997 that also made it easy to escape U.S. taxation.[73] These CTB regulations allow taxpayers who own an entity that qualifies as a partnership for federal tax purposes to elect (or "check the box") whether that entity will be taxed as a corporation or a partnership.[74]

The purpose of the CTB regulations was to simplify the tax classification of entities.[75] Prior to the CTB regulations, the classification of an entity as a corporation or partnership for income tax purposes depended upon the application of a multi-factored test.[76] As states developed new entities, such as limited liability companies (LLCs), taxpayers had significant flexibility in classifying such an entity as a partnership or corporation simply by drafting the entity's operating agreement to satisfy the multifactor test. In effect, classification of many entities had already become elective. Thus, the elective approach of the

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72. Oosterhuis & Spinowitz, *supra* note 18.

73. Treas. Reg. § 301.7701-3 (as amended in 2020).

74. Treas. Reg. § 301.7701-1 to -3 (as amended in 2020).

75. *See* T.D. 8697, 1997-1 C.B. 215, 216 ("[T]his document replaces [prior] rules with a much simpler approach that generally is elective.").

76. Treas. Reg. § 301.7701-2(a)(1) (1993) (before amendment by T.D. 8697, 1997-1 C.B. 215).

CTB regulations with respect to classifying domestic entities, such as LLCs, made some sense.

What makes less sense, however, is that CTB regulations also allow a taxpayer, which wholly owns another entity, to elect to disregard that entity as a separate entity for federal tax purposes. This option is only available if the wholly owned entity is an "eligible entity," an entity that is not automatically treated as a corporation under the CTB regulations.[77] Many non-publicly traded foreign entities that have limited liability qualify as eligible entities. Consequently, it is easy for a U.S. MNE to establish a lower tier foreign subsidiary that will be treated as though it is not separate from its sole owner.[78] For example, a "private compan[y] limited by shares" formed under Irish law, which is the most common type of company used in Ireland,[79] is an eligible entity. Thus, if a corporation wholly owns an Irish private company limited by shares, it may elect for U.S. tax purposes to disregard the separate existence of that company. This results in the parent corporation being treated for tax purposes as though it conducted all the activities engaged in by its subsidiary.

The adoption of the CTB regulations created entirely new opportunities to avoid the foreign base company sales income rules of Subpart F that were not contemplated by the regulation's drafters.[80] Recall that, if the contract manufacturing and other exceptions do not apply, Subpart F imposes an immediate U.S. tax on income that is attributable to a CFC's sale of goods to a related corporation outside the CFC's country. A parent corporation with several CFCs that are eligible entities may now check the box to disregard the separate existence of these related CFCs. The result is that sales among the disregarded entities are treated as not having occurred among several entities, but rather as having occurred internally within a single entity, resulting in no U.S tax. It is ironic that prior to the CTB regulations, taxpayers did not have flexibility to disregard any CFC, regardless of whether it was an eligible entity or not. Indeed, case law effectively created a strong presumption

77. Treas. Reg. § 301.7701-3(a) (as amended in 2020).

78. Treas. Reg. § 301.7701-2(b)(8) (as amended in 2019) lists foreign companies that cannot qualify as an "eligible entity."

79. KPMG LEGAL SERVICES, COMPANY SECRETARIAL, TYPES OF IRISH COMPANIES (2015), https://assets.kpmg/content/dam/kpmg/pdf/2016/01/company-secretarial-types-of-irish-companies.pdf [https://perma.cc/M7ZC-LHEL].

80. *See, e.g.*, sources cited *supra* note 18.

that a corporation would be treated as an entity separate from its stockholders up to the time the CTB regulations were adopted.[81]

A 2013 memorandum from Senators Levin and McCain to the Permanent Subcommittee on Investigations[82] of the U.S. Senate extensively discussed how Apple, Inc. used the CTB regulations in this manner to avoid billions of dollars of U.S. income taxes.[83] Apple established a holding company in Ireland (AOI) as a private company limited by shares that Apple asserted was not subject to Irish or U.S. income tax.[84] Apple claimed that AOI was not subject to Irish tax because it was managed and controlled outside Ireland.[85] At the same time, AOI was also not subject to U.S. tax because it was not incorporated in the U.S. and had no business activity there.[86]

AOI had another lower-tier Irish subsidiary, ASI, which held some of the intellectual property rights to exploit Apple's intellectual property outside the United States.[87] ASI used contract manufacturers in China to produce Apple computers.[88] ASI would then sell those goods to its sister subsidiaries, which were also subsidiaries of AOI (and which were also organized as private companies limited by shares) at a healthy profit.[89] Since ASI was also incorporated in Ireland and did not pay Irish or U.S.

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81. *See, e.g.*, *Moline Props. v. Comm'r*, 319 U.S. 436, 438–39 (1943) (holding a corporation is treated as separate from its shareholders if it has a business purpose or carries on a business activity).

82. *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigation of the S. Comm. on Homeland Sec. & Governmental Affs.*, 113th Cong. Exhibit #1a at 152 (2013) (memorandum of Sen. Carl Levin & Sen. John McCain), https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf [https://perma.cc/J2BL-975R].

83. *See id.* For other examples of how the CTB regulations enabled U.S. MNEs to avoid U.S. tax, see generally Lokken, *supra* note 18, and Martin J. McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES FED. 1017 (2002).

84. *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigation of the S. Comm. on Homeland Sec. & Governmental Affs.*, 113th Cong. 172, 174 (2013) (memorandum of Sen. Carl Levin & Sen. John McCain), https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf [https://perma.cc/J2BL-975R].

85. *Id.* at 174.

86. *Id.*; I.R.C. § 7701(a)(4) (requiring that a corporation be formed in the U.S. for it to be considered a "domestic" corporation and subject to U.S. tax).

87. *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigation of the S. Comm. on Homeland Sec. & Governmental Affs.*, 113th Cong. 170, 175 (2013) (memorandum of Sen. Carl Levin & Sen. John McCain), https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf [https://perma.cc/J2BL-975R].

88. *Id.* at 176.

89. *Id.* at 178, 184.

taxes,[90] ASI's acquisition of computers from the China manufacturer and subsequent sale at a healthy profit to other AOI subsidiaries allowed Apple to in effect "park" most of the profit from the computers in an entity not subject to tax anywhere, unless Subpart F applied. The subsidiaries purchasing computers from ASI would in turn sell the goods to customers outside the Apple family of corporations at an additional markup.[91]

Gain from the sales by ASI to its sister subsidiaries would have been foreign base company sales income under Subpart F subject to U.S. tax, but AOI elected under the CTB regulations to disregard ASI and its sister subsidiaries as separate entities.[92] Disregarding the subsidiaries as separate entities meant that, from a U.S. tax perspective, the sales from ASI to its sister subsidiaries were merely transfers within the AOI corporate shell that were not foreign base company sale income. The ultimate sales by the group to consumers outside Ireland did not produce foreign base company sales income because the ultimate purchasers were not related to Apple. The Levin-McCain Memorandum estimated that Apple avoided $12.5 billion in U.S. taxes in 2011 and 2012 by employing these techniques.[93]

The ability of an owner to disregard a wholly owned foreign entity is undesirable tax policy that arose from a desire for simplification. At the time the CTB regulations were adopted, few envisioned that an effort to simplify the entity classification rules would lead to the wholesale avoidance of Subpart F. The simplicity sought by the regulations has helped to nullify the effectiveness of Subpart F. The irony is that for decades the IRS sought to prevent stockholders from disregarding the separate existence of their corporations because it and the courts recognized that allowing stockholders to disregard its separate existence would create mischief.[94]

C. Impact of the Contract Manufacturing and Check-the-Box Regulations on Manufacturing Employment

It is likely that the contract manufacturing changes and the adoption of the CTB regulations, in combination with other factors discussed below,[95] contributed to the precipitous drop in U.S. manufacturing

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90. *See id.* at 175.
91. *Id.* at 184–86.
92. *Id.* at 186.
93. *Id.* at 185.
94. *See, e.g.*, *Moline Props. v. Comm'r*, 319 U.S. 436, 438–39 (1943).
95. *See infra* text accompanying notes 113–23.

employment from 17 million in 1998 to less than 12 million in 2010, as shown in Figure 1.[96] The timing fits well with the recent findings of Boem, Flaaen, and Pandalai-Nayar that a significant portion of the decline in U.S. manufacturing employment was attributable to MNEs shifting manufacturing outside the U.S.[97] They found that U.S. MNEs accounted for forty-one percent of the aggregate U.S. manufacturing employment decline between 1993 and 2011 and that the MNEs had lower employment growth rates than a group of similar non-multinational firms.[98] They also found significant evidence that the MNEs were manufacturing goods outside the U.S. and then bringing those goods into the U.S.[99] Their data showed that MNEs were responsible for ninety percent of all arms-length and related imports into the U.S.[100] In addition, they found that the fraction of multinationals participating in intermediate input sourcing from related parties in developing countries doubled from 1993 through 2011.[101]

In a 2018 study, similar analysis by Fort, Pierce, and Schott found that "75 percent of the 6.6 million decline in manufacturing employment between 1977 and 2012 took place within continuing firms, largely through plant closures."[102] Since these firms continued after laying off their manufacturing employees, the inference is that they were manufacturing elsewhere.[103]

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96. *See supra* Figure 1.

97. Christoph E. Boehm, Aaron Flaaen & Nitya Pandalai-Nayar, *Multinationals, Offshoring, and the Decline of U.S. Manufacturing*, 127 J. INT'L ECON. 1, 2 (2020).

98. *Id.* at 2, 5.

99. *Id.* at 13, 23.

100. *Id.* at 23. Another study found that firms that outsource their production have imports that are forty percent greater than firms that do not outsource production. Andrew B. Bernard & Teresa C. Fort, *Measuring the Multinational Economy: Factoryless Goods Producing Firms*, 105 AM. ECON. REV 518, 522 (2015).

101. Boehm, Flaaen & Pandalai-Nayar, *supra* note 97, at 2. Other studies have also found empirical evidence that the CTB regulations enabled MNEs to reduce their effective tax rates. Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247, 272–74 (2012); Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 FLA. TAX REV. 153, 178–79 (2005) [hereinafter *Race to the Bottom*]. These studies, however, did not examine the impact of the CTB regulations on the shift of manufacturing outside the United States.

102. Fort, Pierce & Schott, *supra* note 19, at 68.

103. *But see* Fariha Kamal & Mary E. Lovely, *Import Competition from and Offshoring to Low-Income Countries: Implications for Employment and Wages at U.S. Domestic Manufacturers*, J. ASIAN ECON., Feb. 2017, at 100, 100, 117. Kamal and Lovely found that offshoring (which they define as importing intermediate goods) to low-

This inference is also consistent with the results of other studies. One study found that the percentage of companies in the S&P 500 that reported manufacturing goods and used contract manufacturing increased from thirty-one percent in 2002 to forty-six percent in 2012.[104] Moreover, one-fifth of those companies relied *solely* on contract manufacturers for their production.[105] For example, in 2012, Nike reported that "virtually all of our footwear is produced by factories we contract with outside of the United States."[106] That same year, Jupiter Networks, Inc., a major electronics manufacturer, reported that its "manufacturing is primarily conducted through contract manufacturers . . . ."[107]

Prominent practitioners have also observed that MNEs often use the contract manufacturing exception to avoid or minimize U.S. taxes.[108] Similarly, economists Altshuler and Grubert have noted that the CTB regulations played a major role in the ability of MNEs to reduce their effective U.S. tax rates.[109] Other studies have similarly noted the link between tax policy and offshoring. A recent study found some evidence suggesting that the likelihood that U.S. jobs will be offshored to a foreign country with lower tax rates increases by approximately 6.4 percent or each percentage point decrease in the foreign country's corporate income

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income countries was associated with only small employment losses at surviving firms. In contrast, job losses associated with a broader category of imports were large. *Id.*

104. Kimberly Bayard, David Byrne & Dominic Smith, *The Scope of U.S. "Factoryless Manufacturing," in* 2 MEASURING GLOBALIZATION: BETTER TRADE STATISTICS FOR BETTER POLICY 81, 86 (Susan N. Houseman & Michael Mandel eds., 2015).

105. *Id. See also* Diane Coyle & David Nguyen, *No Plant, No Problem? Factoryless Manufacturing, Economic Measurement and National Manufacturing Policies*, 29 REV. INT'L POL. ECON. 23 (2022) (documenting extent of "factoryless manufacturing"—the use of contract manufacturers—in the U.S. and U.K.).

106. Bayard, Byrne & Smith, *supra* note 104, at 85.

107. *Id.* at 85–86.

108. Martin Sullivan, chief economist at Tax Analysts, in discussing the presentation by Paul Oosterhuis, a prominent tax attorney, to Brookings about common international tax avoidance schemes observed:

> Of the three structures discussed [by Oosterhuis], the one given the most attention — because it is the most commonly used — is the contract manufacturing model, in which the principal's sales income (from sales to its related distributor) avoids subpart F because it qualifies for the manufacturing exception to the foreign base company sales rules.

Martin A. Sullivan, *U.S. Contract Manufacturing and Dave Camp's Option C*, 139 TAX NOTES 10, 11 (2013). *See also* Oosterhuis & Spinowitz, *supra* note 18.

109. *Race to the Bottom*, *supra* note 101, at 157–59, 165–66; Grubert, *supra* note 101, at 273–74. *See also* JANES G. GRAVELLE, CONG. RSCH. SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 24 (2022) (discussing studies).

tax rate.[110] The study also found that the number of jobs offshored to that country increases by approximately 6.9 percent for each percentage point decrease.[111] A 2021 article in *Production and Operations Management* observed that Apple has shifted all its production to China in order "to assign a portion of its profits to an affiliate in Ireland, a tax-advantageous locale."[112] These studies are consistent with several others that have observed that investment overseas is strongly affected by lower tax rates overseas.[113]

It is important to note that other factors, in addition to tax, have undoubtedly played a major role. For example, studies examining the impact of NAFTA have found that it had a very harmful impact on less-educated workers in manufacturing sectors that competed directly with Mexico.[114] Similarly, another study that examined the effects of the grant of Permanent Normal Trade Relations to China in October 2000 found that the decline in U.S. manufacturing during the period 2000–10 was

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110. Braden M. Williams, *Multinational Tax Incentives and Offshored U.S. Jobs*, 93 ACCT. REV. 293, 295 (2018). Williams further notes that "[b]ecause of the large number of potential host countries, the unconditional likelihood of hosting offshored U.S. jobs to a particular country is low; hence, these estimates represent increases to small unconditional probabilities." *Id.*

111. *Id.*

112. Guoming Lai, Yixuan Liu & Wenqiang Xiao, *International Taxation and Production Outsourcing*, 30 PROD. & OPERATIONS MGMT. 402, 402–03 (2021) (emphasis omitted).

113. *See, e.g.*, Harry Grubert & John Mutti, *Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making*, 73 REV. ECON. & STATS. 285, 289–90 (1991) (finding that outbound direct investment in plant and equipment increased as foreign tax rate decreased); Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT'L TAX J. 825 (2000) (same); Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Foreign Direct Investment in a World of Multiple Taxes*, 88 J. PUB. ECON. 2727, 2728–29 (2004) (same). *See also* STAFF OF JOINT COMM. ON FIN., 110TH CONG., ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT 17 n.42 (Comm. Print 2008).

114. Shushanik Hakobyan & John McLaren, *Looking for Local Labor Market Effects of NAFTA*, 98 REV. ECON. & STATS. 728, 729, 740–41 (2016). *See also* Mary E. Burfisher, Sherman Robinson & Karen Thierfelder, *The Impact of NAFTA on the United States*, J. ECON. PERSPS., Winter 2001, at 125, 130 (summarizing the earlier studies that found only marginal aggregate effects); Fort, Pierce & Schott, *supra* note 19, at 53–54 (summarizing studies).

larger for industries that directly competed with China.[115] And lower labor costs have certainly been important.[116]

Another very important factor that has contributed to the decline in manufacturing jobs is automation. Studies have attempted to tease out the extent to which automation in the U.S. caused the decline in manufacturing jobs versus the shift of manufacturing overseas. Fort, Pierce and Schott summarized the nature of this inquiry:

> The trade-based explanation contends that import competition has reduced US manufacturing employment by inducing labor-intensive, low-labor-productivity industries to move abroad. The technology view argues that the decline in manufacturing employment stems from innovations in production techniques, such as automation, that have dramatically increased output per worker.[117]

The studies indicate that the flight of manufacturing overseas *and* automation have both decreased employment, but the exact amount of the contribution of each is not clear. In an extensive literature review, Muendler suggested that approximately one-quarter of the decline in U.S. manufacturing may be attributable to globalization and one-third to automation.[118] Another exhaustive literature review by Abraham and Kearney suggests that imports from China accounted for approximately fifty percent, 2.37 million of the 4.6 million jobs lost in the period 1999–2018 while automation accounted for twenty-five percent, 1.1 million of the 4.6 million jobs lost.[119] There are outliers, however. Linda Borrs and

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115. Justin R. Pierce & Peter K. Schott, *The Surprisingly Swift Decline of U.S. Manufacturing*, 106 AM. ECON. REV. 1632, 1633–34 (2016). *See also* Fort, Pierce & Schott, *supra* note 19, at 53–54 (summarizing studies).

116. *See, e.g.*, Martin Sullivan, *U.S. Multinationals Cut U.S. Jobs While Expanding Abroad*, 128 TAX NOTES FED. 1102, 1103 (2010), https://taxprof.typepad.com/files/128tn1102.pdf [https://perma.cc/C3MK-N5QH].

117. Fort, Pierce & Schott, *supra* note 19, at 49.

118. Marc-Andreas Muendler, *Trade, Technology, and Prosperity: An Account of Evidence from a Labor-Market Perspective* 64, 94 (World Trade Org. Staff Working Paper, No. ERSD-2017-15, 2017), https://www.wto.org/english/res_e/reser_e/ersd201715_e.pdf [https://perma.cc/369B-MLHE]. *See also* David H. Autor, David Dorn & Gordon H. Hanson, *The China Syndrome: Local Labor Market Effects of Import Competition in the United States*, 103 AM. ECON. REV. 2121, 2121 (2013) [hereinafter *The China Syndrome*] (finding import competition explained twenty-five percent of the decline in manufacturing employment in the U.S.).

119. Katharine G. Abraham & Melissa S. Kearney, *Explaining the Decline in the US Employment-to-Population Ratio: A Review of the Evidence*, 58 J. ECON. LIT. 585, 598, 602, 605 (2020). *See also* Daron Acemoglu, David Autor, David Dorn,

Florian Knauth found that automation appears to have played little role in rising inequality in German manufacturing employment.[120] Instead, their data suggest that globalization played a significant role.[121]

Automation will likely increase over time. But this does not mean that U.S. tax incentives that encourage MNEs to shift manufacturing overseas will become harmless error. As discussed in Part II, it is in the best interests of the U.S. that manufacturing, whether automated or labor-intensive, have a significant presence in the U.S. One study suggests that increases in automation may be associated with at least a partial return of manufacturing to the U.S.,[122] perhaps because automation eliminates the advantage of low labor costs offered by other countries. Moreover, while robots reduce production employment, they increase service employment.[123] As a result, our tax system should not continue to provide incentives to manufacture overseas.[124] The expected increases in robotic manufacturing could benefit the U.S. if the robotic manufacturing occurs in the United States.

Gordon H. Hanson & Brendan Price, *Import Competition and the Great US Employment Sag of the 2000s*, 34 J. LAB. ECON. S141, S146–47 (2016) (noting how China accounted for 2 to 2.4 million of the job losses in the U.S. between 1999–2011).

120. Linda Borrs & Florian Knauth, *Trade Technology and the Channels of Wage Inequality*, 131 EUR. ECON. REV. 1, 14, 17–18 (2021).

121. *Id.* at 17–18.

122. Alessandra Bonfiglioli, Rosario Crinò, Gino Gancia & Ioannis Papadakis, *Robots, Offshoring and Welfare* 1, 28 (Ctr. for Econ. Pol'y Discussion Paper No. DP16363, 2021), http://pseweb.eu/ydepot/seance/514073_RobOff-March21_BCGP.pdf [https://perma.cc/U4UQ-92CY].

123. *Id.* at 25. The study stated:

> In particular, robot exposure reduces employment in manufacturing. This is consistent with robot adoption currently being larger in manufacturing than in other sectors. At the same time, robot exposure raises employment outside of manufacturing. Presumably, the increased efficiency induced by automation boosts demand for all factors, including services. Overall, the two effects almost exactly cancel out, so robot exposure has no significant impact on overall employment.

Id.

124. Other factors that may impact the decision by MNEs to invest in automated manufacturing in the U.S. are improvements in delivery time, quality control, and shipping costs. *See* Lindsay Oldenski, *Reshoring by US Firms: What Do the Data Say?* 5–6 (Peterson Inst. for Int'l Econ. No. PB15-14, 2015), https://www.piie.com/sites/default/files/publications/pb/pb15-14.pdf [https://perma.cc/4A4U-HFRU].

II. THE HARMFUL IMPACT OF THE DECLINE IN MANUFACTURING EMPLOYMENT AND PRODUCTION

The U.S. tax incentives for manufacturing to go overseas—along with the other factors discussed in the previous Part that encouraged offshore manufacturing—have significantly harmed the U.S. This Part describes how declines in manufacturing employment have contributed to social and political problems and how shifting manufacturing overseas has created national security issues. It is difficult to justify the existence of our tax incentives that have contributed to these problems.

A. Disparate Impact of the Decline in Manufacturing Employment on Less-Educated Workers and Minorities

The reduction of manufacturing jobs in the U.S. has had a complex impact on aggregate U.S. employment. Kamal and Lovely explain:

> Offshore outsourcing['s] . . . predicted impact on employment is thought to be more complicated than that of import penetration generally. Firms may use offshore outsourcing as a substitute for domestic production of certain inputs, leading to domestic lay-offs. At the same time, imported intermediates may allow domestic firms to compete successfully with imported final goods by lowering production costs. Surviving firms may then be able to expand production domestically while shifting their employment mix away from production workers and toward non-production and headquarter employment.[125]

The jobs most vulnerable to the shift in manufacturing to outside the U.S. have been those at the low-end of the skill spectrum.[126] At the same time, the number of high-end jobs that require more education have often increased.[127] In an excellent 2018 survey of scores of articles that had analyzed this issue, Hummels, Munch, and Xiang state:

> The [literature review] . . . has shown that workers exposed to offshoring experience substantial income losses due to unemployment, so labor market policies targeted toward these workers may be called for . . . . The literature has [also] shown

125. Kamal & Lovely, *supra* note 103, at 101.

126. David Hummels, Jakob R. Much & Chong Xiang, *Offshoring and Labor Markets*, 56 J. ECON. LIT. 981, 1022 (2018).

127. *Id.*

> us that: (i) workers with routine occupations suffer more from offshoring, in terms of wages and employment; [and] (ii) those with communication-intensive or interactive occupations gain more from offshoring, in terms of wages and employment . . . .[128]

They further note that offshoring "increases relative demand for skilled labor within industries over time."[129] As a result of this complexity, the empirical literature analyzing whether the number of jobs lost to offshoring are completely offset by the jobs created is inconclusive.[130]

Despite the uncertainty about the impact of offshoring on aggregate employment, harmful effects have clearly occurred. Classic economic trade theory teaches that the welfare gains from free trade to winners should exceed the losses to those who are harmed by free trade.[131] Theory also notes, however, that free trade can also inflict severe distributional harms:

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128. *Id.* at 1020, 1022.

129. *Id.* at 1022.

130. *See, e.g.*, Boehm, Flaaen & Pandalai-Nayar, *supra* note 97, at 3 ("Whether foreign sourcing increases or decreases domestic employment remains an active debate in the literature.").

For studies finding that offshoring decreases aggregate employment, see, for example, Ryan Monarch, Jooyoun Park & Jagadeesh Sivadasan, *Domestic Gains from Offshoring? Evidence from TAA-linked U.S. Microdata*, 105 J. INT'L ECON. 150, 170–72 (2017) (finding an overall negative effect on employment that was particularly strong for low-wage employees); Boehm, Flaaen & Pandalai-Nayar, *supra* note 97, at 2 ("[I]ncreases in intermediate purchases from abroad reduce U.S. employment at the firm-level when triggered by a reduction in the costs of foreign sourcing.").

Others have found the opposite: that offshoring increases aggregate U.S. employment because the reduced costs of overseas manufacturing allow greater investment at home. *See, e.g.*, Brian K. Kovak, Lindsay Oldenski & Nicholas Sly, *The Labor Market Effects of Offshoring by U.S. Multinational Firms*, 103 REV. ECON. & STATS. 381, 381 (2021) ("Overall, our results indicate that greater offshore activity modestly raises net employment by U.S. firms, albeit with substantial job loss and employment reallocation."); Greg C. Wright, *Revisiting the Employment Impact of Offshoring*, 66 EUR. ECON. REV. 63, 76 (2014) ("[T]he aggregate effect of offshoring is estimated to have led to a cumulative increase in aggregate employment of 2.6% over the period 2001–2007. . . ."); Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Domestic Effects of the Foreign Activities of US Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181, 182–83 (2009) (finding that expansion overseas increases domestic employment).

131. David H. Autor, David Dorn & Gordon H. Hanson, *The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade*, 8 ANN. REV. ECON. 205, 206 (2016) [hereinafter *The China Shock*].

> [C]ompared with the rest of the world the United States is abundantly endowed with highly skilled labor and (. . .) low-skilled labor is correspondingly scarce. This means that international trade tends to make low-skilled workers in the United States worse off—not just temporarily, but on a sustained basis.[132]

In fact, trade theory predicts that domestic factors of production that compete with a lower cost imported item lose not only in relative terms, but also in absolute terms:

> The factor which is used intensively in the importable good *must* experience a decline in its real earnings. Note that the theorem establishes absolute losses, and not relative losses. Note also that the result holds regardless of consumption preferences: there are losses to one group even if they spend most or even all of their budget on the importable good (which gets cheaper in relative terms), although the magnitude of the losses is reduced. Applied with some amount of hand-waving to the US economy, the result predicts that low-skilled workers are *unambiguously* worse off as a result of trade liberalization.[133]

Autor, Dorn, and Hanson argue in *The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade* that even the gains predicted by classic trade theory may not have been fully realized in the case of trade with China.[134] They observe that employment fell in the U.S. industries most exposed to import competition, but that offsetting employment gains lagged,[135] perhaps partly because of labor immobility.[136] Autor, Dorn, and Hanson also note that the evidence is ambiguous as to whether the lower cost of imported goods are fully incorporated into final products in the U.S.[137] and whether the lower costs

132. *Id.* (quoting PAUL R. KRUGMAN & MAURICE OBSTFELD, INTERNATIONAL ECONOMICS: THEORY AND POLICY 64 (8th ed. 2008)).

133. Dani Rodrik, *Populism and the Economics of Globalization*, 1 J. INT'L BUS. POL'Y 12, 14 (2018).

134. *The China Shock*, *supra* note 131.

135. *Id.* at 227–29.

136. *Id.* at 235.

137. *Id.* at 228.

result in greater innovation.[138] They conclude "[t]he aggregate impact of Chinese competition on US innovation remains unknown."[139]

Although service jobs have increased and possibly may have offset the decrease in manufacturing jobs,[140] a significant portion of factory workers, particularly less educated workers,[141] has not shared in that growth.[142] Moreover, the harm inflicted by job loss has often been concentrated in geographic locations,[143] which has made it more difficult for workers to find other gainful employment. For example, Pittsburgh, which was "once the epicenter of the steel industry,"[144] declined from being the tenth largest city in America in 1950 to the fifty-second largest in 2000 as the steel industry lost seventy-five percent of its workforce between 1962 and 2005.[145]

The impact on less educated workers has been devastating for the most vulnerable in the U.S.[146] Studies show that the decline in earnings for male manufacturing workers was largest for workers who were already at the low end of the wage scale[147] and were less educated.[148] In addition, studies suggest that losses of manufacturing jobs correlate with increased social harms. Increases in mortality rates attributable to drug

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138. *Id.* at 228–29.

139. *Id.* at 229.

140. However, the empirical literature analyzing whether newly created jobs completely offset jobs lost to offshoring is contradictory. *See supra* note 130 and accompanying text.

141. Nicholas Bloom, Kyle Handley, André Kurmann & Philip Luck, The Impact of Chinese Trade on U.S. Employment: The Good, the Bad, and the Apocryphal 24 (Feb. 15, 2019), https://economicdynamics.org/meetpapers/2019/paper_1433.pdf [https://perma.cc/F8V7-34BV] (unpublished manuscript).

142. Kovak, Oldenski & Sly, *supra* note 130, at 381–83 (finding several factors affect offshoring's impact on U.S. employment and that different types of jobs are affected differently).

143. *See* ELEANOR KRAUSE & ISABEL SAWHILL, THE BROOKINGS INST., WHAT WE KNOW AND DON'T KNOW ABOUT DECLINING LABOR FORCE PARTICIPATION: A REVIEW 12 (2017), https://www.brookings.edu/wp-content/uploads/2017/05/ccf_20170517_declining_labor_force_participation_sawhill1.pdf [https://perma.cc/2KXZ-WTHJ].

144. *Id.* at 12 n.31.

145. *Id.*

146. *See* David Autor, David Dorn & Gordon Hanson, *When Work Disappears: Manufacturing Decline and the Falling Marriage Market Value of Young Men*, 1 AM. ECON. REV.: INSIGHTS 161, 162–64 (2019) [hereinafter *When Work Disappears*]; Gould, *supra* note 4, at 771–72.

147. *When Work Disappears, supra* note 146, at 162; Denis Chetverikov, Bradley Larsen & Christopher Palmer, *IV Quantile Regression for Group-Level Treatments, with an Application to the Distributional Effects of Trade*, 84 ECONOMETRICA 809, 829 (2016).

148. Gould*, supra* note 4, at 7.

and alcohol poisoning, HIV/AIDS, and homicide all correlate with the decline in manufacturing jobs.[149] Autor, Dorn, and Hanson found that regions in the U.S. exposed to foreign competition not only lost jobs in the manufacturing sector as a result of import growth, but also experienced ancillary problems such as higher disability benefits, and higher unemployment and welfare benefits.[150] Not surprisingly, the decline in manufacturing jobs has also harmed families. Decreases in manufacturing jobs correlate with increases in "the fraction of mothers who are unwed, the fraction of children in single-headed households, and the fraction of children living in poverty."[151]

The decline in manufacturing jobs contributed to increased racial inequality.[152] Within the group of factory workers harmed by the shift in manufacturing to overseas, racial minorities have suffered the most.[153] Similar to the findings of Autor Dorn, and Hanson, Gould found that declines in manufacturing jobs negatively impacted both Black and White persons in terms of their wages, employment, marriage rates, house values, poverty rates, death rates, single parenthood, teen motherhood, child poverty, and child mortality.[154] Black people, however, suffered the greatest degree of harm.[155] The decline in manufacturing employment during the period from 1960 through 2010 is estimated to have lowered wages for Black men by 13.3 percentage points, their employment rate by 5.6 percentage points, and their marriage rate by 4.6 percentage points.[156] Similarly, the estimated impact for Black women is a reduction in the marriage rate by 5.1 percentage points, increased poverty by 8.0 percentage points, and an increase in the rate of single motherhood by 2.9 percentage points.[157] The estimated impact for Black children is an increase in the poverty rate of 9.0 percentage points and an increasing chance of living with only one parent of 4.0 percentage points.[158] That study also found that the decline in manufacturing jobs were associated with a 12 percent increase in the racial wage gap between Black and

149. *When Work Disappears, supra* note 146, at 162–63. *See also* Justin R. Pierce & Peter K. Schott, *Trade Liberalization and Mortality: Evidence from US Counties*, AM. ECON. REV.: INSIGHTS, Mar. 2020, at 47, 47–49.

150. *The China Syndrome*, *supra* note 118, at 2124–25.

151. *When Work Disappears*, *supra* note 146, at 163.

152. Gould, *supra* note 4, at 7–8, 11.

153. *See id.* at 8, 11.

154. *Id.* at 3, 17.

155. *Id.* at 3.

156. *Id.* at 2–3.

157. *Id.* at 3–4.

158. *Id.* at 4.

White men and a 5.4 percent increase in the racial gap in child poverty.[159] Gould suggests that disparate impact of manufacturing jobs for Black Americans has significantly hampered efforts to achieve racial equality in the U.S.[160]

B. Political Impact of the Decline in Manufacturing Employment

The decline in manufacturing jobs also has an adverse impact on our political system. This adverse impact takes two forms. First, by increasing inequality in the U.S., the decline in manufacturing employment has exacerbated problems arising from inadequate representation of low-income individuals. Second, unemployment or underemployment for a large number of individuals who cannot transition to other jobs has historically been associated with political extremism, such as communism and fascism.

With respect to inadequate representation of low-income individuals, several studies show that the interests of low-income individual are under-represented in the U.S. political system.[161]

> The American creed stresses political equality and political involvement, but political participation and political authority in America are highly stratified by income and education. People with higher income and education are more active participants in American politics. They are more likely to have their interests represented by lobbyists, and they are more likely to have their opinions count for policy outcomes. As a result of the unequal stratification of political participation, authority, and outcomes, those with the most political power can influence the government's tax and expenditure policies to shape economic and social stratification to their taste. This insight is not new. More than 100 years ago, Max Weber recognized that the stratification of political authority could affect the stratification of class and social status.[162]

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159. *Id.*

160. *See id.* at 6, 19.

161. For a recent summary of these studies, see James R. Repetti, *The Appropriate Roles for Equity and Efficiency in a Progressive Individual Income Tax*, 23 FLA. TAX REV. 522, 549–56 (2020).

162. Henry E. Brady, Kay Lehman Schlozman & Sidney Verba, *Political Mobility and Political Reproduction from Generation to Generation*, 657 ANNALS AM. ACAD. POL. & SOC. SCI., Jan. 2015, at 149, 149–50 (citations omitted) (citing SIDNEY VERBA, KAY LEHMAN SCHLOZMAN & HENRY E. BRADY, VOICE AND EQUALITY: CIVIC

The disparate impact of the decline of employment of Black factory workers is particularly disturbing because we do not have a sufficient safety net for minorities. Several studies suggest that countries in which the poor are a different race or ethnicity than the majority engage in less redistributive spending.[163] Unfortunately, this is true in the United States. Three prominent economists observed:

> Opponents of redistribution in the United States have regularly used race-based rhetoric to resist left-wing policies. Across countries, racial fragmentation is a powerful predictor of redistribution. Within the United States, race is the single most important predictor of support for welfare. America's troubled race relations are clearly a major reason for the absence of an American welfare state.[164]

The second adverse impact of the decline in manufacturing jobs in the U.S. is that unemployment or underemployment for a large number of individuals has historically been associated with political extremism, such as communism and fascism, because individuals become frustrated with the inability of their current government to remedy the problem.[165] Arthur Schlesinger wrote that the Great Depression created "contempt for parliamentary dithering," and for "bourgeois civility and cowardice, for pragmatic muddling through."[166] Similarly, an American economist, Lewis L. Lorwin, observed during the height of the Great Depression in 1935 that "democracy is neither very expert nor very quick in action,"

VOLUNTARISM IN AMERICAN POLITICS (1995); KAY LEHMAN SCHLOZMAN, SIDNEY VERBA & HENRY E. BRADY, THE UNHEAVENLY CHORUS: UNEQUAL POLITICAL VOICE AND THE BROKEN PROMISE OF AMERICAN DEMOCRACY (2012) [hereinafter THE UNHEAVENLY CHORUS]; LARRY M. BARTELS, UNEQUAL DEMOCRACY: THE POLITICAL ECONOMY OF THE NEW GILDED AGE (2008); MARTIN GILENS, AFFLUENCE AND INFLUENCE: ECONOMIC INEQUALITY AND POLITICAL POWER IN AMERICA (2012)). *See also* THE UNHEAVENLY CHORUS, *supra*, at 122–39 (2012) (analyzing data showing the relationship between political participation and socio-economic status).

163. *See, e.g.*, Christian Houle, *Inequality, Ethnic Diversity, and Redistribution*, 15 J. ECON. INEQ. 1, 17, 20 (2017).

164. Alberto Alesina, Edward Glaeser & Bruce Sacerdote, *Why Doesn't the United States Have a European-Style Welfare State?*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 187, 189 (2001).

165. *See, e.g.*, Seva Gunitsky, Great Powers and Norm Cascades in Global Politics 22–23 (Sept. 2016) (unpublished paper), http://individual.utoronto.ca/seva/norm_cascades.pdf [https://perma.cc/2Z46-LL8L].

166. ARTHUR M. SCHLESINGER, JR., WAR AND THE AMERICAN PRESIDENCY 107 (2005).

and cannot resolve "group and class conflicts easily."[167] Some have suggested that prior to the COVID-19 pandemic we started to see a similar pattern in the U.S. due to increased inequality and the large number of individuals "mired in permanent unemployment and a massive drug epidemic."[168] One author noted that concerns about job decreases had contributed to the "public's growing pessimism about the viability of the American Dream."[169]

An article by Dani Rodrik of Harvard's John F. Kennedy School summarized the literature that explores how this phenomenon has recently occurred in both the U.S. and Europe:

> Analyzing electoral results across US congressional districts . . . [has] shown that the China trade shock aggravated political polarization: districts affected by the shock moved further to the right or the left, depending which way they were leaning in the first place. Elected Republicans became more conservative, while elected Democrats became more liberal . . . . Also analyzing Brexit [shows that] . . . regions with larger import penetration from China had a higher Leave vote share. . . . [Another paper] undertakes a similar analysis for 15 European countries over the 1988–2007 period. It finds that the China trade shock played a statistically (and quantitatively) significant role across regions and at the individual level. A larger import shock is associated with support for nationalist parties and a shift toward radical right-wing parties.[170]

C. Impact of Decline in Manufacturing Employment and Production Offshoring on National Security

Although manufacturing employment may continue to decline with automation, it is important that the U.S. not cede automated

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167. Lewis L. Lorwin, *The Plan State and the Democratic Ideal*, 180 ANNALS AM. ACAD. POL. & SOC. SCI., July 1935, at 114, 116–17.

168. Seva Gunitsky, *These Are the Three Reasons Fascism Spread in 1930s America — and Might Spread Again Today*, WASH. POST, (Aug. 12, 2017, 6:00 PM), https://www.washingtonpost.com/news/monkey-cage/wp/2017/08/12/these-are-the-three-reasons-that-fascism-spread-in-1930s-america-and-might-spread-again-today/ [https://perma.cc/VG2T-Q4JR].

169. Ron Hira, *Outsourcing: A Case of Shared Mental Models in Conflict*, 73 KYKLOS 410, 410 (2020) (citation omitted).

170. Dani Rodrik, *Populism and the Economics of Globalization*, 1 J. INT'L BUS. POL'Y 12, 23 (2018) (citations omitted).

manufacturing to other countries. Manufacturing located overseas raises important national security concerns apart from declines in employment. First, the increased economic power of China, as a result of the significant increases in manufacturing and capital there, empowers a government inimical to democracies.[171] Second, the use of contract manufacturers exacerbates supply chain disruptions and the likelihood of stolen intellectual property.[172]

The U.S. government has expressed grave concern about the increased economic power and foreign activities of the government of China. In its annual assessment of threats to U.S. national security, the Office of the Director of National Intelligence cautioned that the Chinese government is promoting new international norms for human rights that emphasize "state sovereignty and political stability over individual rights."[173] It also warned that China's government is reducing individual freedoms of its citizens as it erodes the remaining "vestiges of freedom in Hong Kong."[174] Similarly, the FBI's Counter Intelligence website states, "The counterintelligence and economic espionage efforts emanating from the government of China and the Chinese Communist Party are a grave threat to the economic well-being and democratic values of the United States."[175] The FBI very importantly stressed, "To be clear, the adversary is not the Chinese people or people of Chinese descent or heritage. The threat comes from the programs and policies pursued by an authoritarian government."[176]

The impact of offshoring on the U.S. supply chain has similarly caused consternation in Congress and the Executive Branch, as well as in the intelligence community. Over ten years ago, Representative Schakowsky, a member of the House Intelligence Committee remarked that America's "growing reliance on imports and lack of industrial

171. OFF. OF THE DIR. OF NAT'L INTEL., ANNUAL THREAT ASSESSMENT OF THE U.S. INTELLIGENCE COMMUNITY 4–8 (2022) [hereinafter THREAT ASSESSMENT].

172. U.S. DEP'T OF DEF., ASSESSING AND STRENGTHENING THE MANUFACTURING AND DEFENSE INDUSTRIAL BASE AND SUPPLY CHAIN RESILIENCY OF THE UNITED STATES 46–49 (Sept. 2018); GAO, GAO-19-516, DEFENSE SUPPLIER BASE: CHALLENGES AND POLICY CONSIDERATIONS REGARDING OFFSHORING AND FOREIGN INVESTMENT RISKS 27 (2019).

173. THREAT ASSESSMENT, *supra* note 171, at 6–7.

174. *Id.* at 7.

175. *The China Threat*, FBI: WHAT WE INVESTIGATE, https://www.fbi.gov/investigate/counterintelligence/the-china-threat [https://perma.cc/EUW3-Z6PC].

176. *Id.*

infrastructure has become a national security concern."[177] Similarly, in 2011, the Director for National Intelligence (DNI) announced the commencement of a National Intelligence Estimate (NIE) to assess domestic manufacturing.[178] Reportedly, "concern over loss of domestic capability and dependence on foreign nations for key high-tech materials, components and systems has led the DNI office to start such an effort."[179] The results of the study were not publicly disclosed, which is often the case with NIEs.[180]

More recently, other government agencies have issued reports that studied the impact of offshoring on national security. An Interagency Task Force report released by the Department of Defense (DOD) observed that domestic manufacturing capacity is critical to national security in circumstances involving supply chain disruptions and situations that would require significant increases in the production of items critical to strategic deployment.[181] For example, the task force report notes that the U.S. relies on a single foreign source for a type of carbon fibers that is used in missile and satellite programs and for which no substitutes are readily available.[182] This concern has also been expressed by others. A 2014 article in the *SciTech Lawyer* commented that the "risk to national security interests from a resulting constriction in the domestic availability of critical defense materials, like trucks and APCs [Armored Personnel Carriers] and their components and spare parts, even as we continued to prosecute two ground wars, was evident and alarming."[183]

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177. Steven Aftergood, *Intelligence and the Decline of U.S. Manufacturing*, FED'N AM. SCIENTISTS (Mar. 28, 2011), https://fas.org/publication/manufacturing/ [https://perma.cc/M4H8-BE5K] (quoting Rep. Schakwosky).

178. Richard McCormack, *Intelligence Director Will Look at Future for U.S. Manufacturing*, SLDINFO.COM (Mar. 29, 2011), https://sldinfo.com/2011/03/national-security-implications-of-u-s-manufacturing-decline/ [https://perma.cc/F2X5-AZCP]. *See also* Greg Bruno & Sharon Otterman, *National Intelligence Estimates*, COUNCIL ON FOREIGN RELS. (May 14, 2008, 8:00 AM), https://www.cfr.org/backgrounder/national-intelligence-estimates [https://perma.cc/CQ6N-P964] ("A National Intelligence Estimate (NIE) represents the U.S. intelligence community's most authoritative and coordinated written assessment of a specific national-security issue.").

179. McCormack, *supra* note 178.

180. *See* RICHARD A. BEST JR., CONG. RSCH. SERV., RL33733, INTELLIGENCE ESTIMATES: HOW USEFUL TO CONGRESS? 1–12 (2011).

181. INTERAGENCY TASK FORCE IN FULFILLMENT OF EXEC. ORD. 13806, ASSESSING AND STRENGTHENING THE MANUFACTURING AND DEFENSE INDUSTRIAL BASE AND SUPPLY CHAIN RESILIENCY OF THE UNITED STATES 46–49 (Sept. 2018).

182. *Id.* at 49.

183. Michael Aisenberg, *Revitalizing U.S. Manufacturing Will Depend on Policy Tools like Those that Worked in the 1990s*, SCITECH LAW., Fall 2014, at 4, 6.

A Government Accountability Office (GAO) report also voices significant concerns.[184] The GAO report states:

> Panelists noted that offshoring can increase the risk that the defense supplier base may not have sufficient capability and capacity to address current and emerging threats to U.S. national security. For the purposes of the panel discussion, panelists defined capability as the know-how and facilities necessary for production to address a threat, and they defined capacity as the ability to provide sufficient production quantities to address a threat. A sufficient U.S. defense industrial base would have both the capability and capacity to not only address current threats, but also to ramp up production in response to emerging threats.[185]

In addition, the GAO report worries about the loss of skills in U.S. manufacturing as outsourcing increases. The report observes:

> Panelists identified some industries in which they observed that offshoring has contributed to significant risks to the production capability or capacity for textiles, microelectronics, and specialized chemicals used in munitions and missiles, among other things. One panelist cited the erosion of the U.S. textiles industry as an example of a threat to DOD's production capability . . . . The report stated that there is currently no U.S.-based manufacturer with the capability to produce the specialized polyester fibers that meet certain military specifications of manufactured tents.[186]

Government officials have also expressed concerns about the theft of sensitive intellectual property that may result from the use of contract manufacturers. The GAO report states that there are significant national security concerns about the ability of foreign manufacturers to maintain security for software and product design for manufactured goods.[187] In addition, some have worried about tampering with components that are assembled as part of a global supply chain that increase the chance for "the malicious insertion of defects into microelectronic components or

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184. *See* GAO, GAO-19-516, DEFENSE SUPPLIER BASE: CHALLENGES AND POLICY CONSIDERATIONS REGARDING OFFSHORING AND FOREIGN INVESTMENT RISKS 30 (2019).

185. *Id.*

186. *Id.* at 31.

187. *See id.* at 27.

malware into their embedded software [for weapons systems] that could allow systems to be compromised."[188]

The COVID-19 pandemic has also heightened concerns about non-defense related supply chain vulnerabilities.[189] One of the major areas of focus has been pharmaceuticals, since a significant portion of drugs consumed in the U.S. are manufactured overseas. In 2019, for example, the U.S. imported $128 billion worth of drugs; the annual trade deficit for pharmaceuticals was $74 billion.[190] Similarly, in 2017, the U.S. imported $51.6 billion in medical devices that resulted in a trade deficit for such devices of $4.1 billion.[191] Some have worried that our dependence on foreign manufactured drugs would enable the manufacturing countries to achieve strategic advantages by threatening to withhold the drugs.[192]

The result is a significant amount of hand wringing by government officials. Both recent Democratic and Republican administrations issued executive orders requesting reports on supply chain risks and ways to reduce that risk. A 2021 executive order by President Biden requested recommendations that would include "sustainably reshoring supply chains and developing domestic supplies, cooperating with allies and partners to identify alternative supply chains, [and] building redundancy into domestic supply chains."[193] Similarly, former President Trump

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188. *Id.*

189. *See, e.g.*, *The Coronavirus and America's Small Business Supply Chain: Hearing Before the S. Comm. on Small Bus. & Entrepreneurship*, 116th Cong. (2020) (testimony of Rosemary Gibson, Senior Advisor at the Hastings Center) [hereinafter *Gibson Testimony*].

190. Beth Weinman, Gregory H. Levine, Jenna McCarthy & Grant Sims, *The American Medical Product Supply Chain: Will COVID-19 Drive Manufacturing Back Home?*, 76 FOOD & DRUG L.J. 235, 238 (2021).

191. *Id.* at 239.

192. For example, Rosemary Gibson, Senior Advisory at the Hasting Center, stated:

> China's official news outlet threatened in March 2020, "If China retaliates against the US at this time, in addition to announcing a travel ban on the United States, it will also announce strategic control over medical products and ban exports to the United States. If China announces that its drugs are for domestic use and bans exports, the United States will fall into the hell of a new coronavirus epidemic."
>
> The unleashing of this threat will cause unprecedent deaths and social disorder on a scale never seen before on our country. The civilian and military health care systems will collapse.

Gibson Testimony, *supra* note 189, at 1.

193. Exec. Order. No. 14017, 86 Fed. Reg. 11,849, 11,852 (Feb. 24, 2021).

issued an executive order in 2017 that requested recommendations on ways to strengthen U.S. manufacturing and supply chain resilience.[194]

Despite the decline in manufacturing employment and the concerns of U.S. government officials about the offshoring of manufacturing, there is some disagreement among economists about whether *aggregate* manufacturing output has actually decreased in the United States. Supporting the view that total output in the U.S. has not decreased are statistics that show that manufacturing output in the U.S., measured as a percentage of gross domestic product (GDP), has roughly kept pace with other sectors.[195]

A growing number of analysts have suggested however, that those statistics are misleading and that outsourcing to foreign manufacturers has resulted in decreased aggregate U.S. production. In general, those economists argue that the data examining U.S. manufacturing value-added as a percentage of GDP are misleading because the historic rapid growth in the computer industry masks the declines in most of the other sectors.[196] Susan Houseman states:

> Regardless of whether the view [that domestic manufacturing has remained constant] represents a consensus, it reflects a misreading of the data and research evidence. The apparently robust growth in manufacturing inflation-adjusted (real) output and productivity are driven by a relatively small sector—computers and electronic products, which account for only about 13 percent of value-added in manufacturing. Without the computer and electronic products industry . . ., real value-added or GDP growth in manufacturing was less than half that of the private sector average from 1979 to 2000, and only 12 percent in the 2000s. And without the computer industry, manufacturing labor productivity generally has been no higher or only somewhat higher than that of the private sector.[197]

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194. Exec. Order. No. 13806, 82 Fed. Reg. 34,597 (July 21, 2017).

195. *See, e.g.*, ROBERT D. ATKINSON, LUKE A. STEWART, SCOTT M. ANDES & STEPHEN J. EZELL, WORSE THAN THE GREAT DEPRESSION: WHAT EXPERTS ARE MISSING ABOUT AMERICAN MANUFACTURING DECLINE 27 fig.24 (2012) [hereinafter WORSE THAN THE GREAT DEPRESSION].

196. *See id.* at 33–36.

197. Susan N. Houseman, *Understanding the Decline of U.S. Manufacturing Employment* 2 (Upjohn Inst. for Emp. Rsch., Working Paper No. 18-287, 2018). *See also* Martin Neil Baily & Barry P. Bosworth, *US Manufacturing: Understanding Its Past and Its Potential Future*, J. ECON. PERSPS., Winter 2014, at 3, 3 ("[T]he 90 percent of manufacturing that lies outside the computer and electronics industry has seen its share of real GDP fall substantially, while its productivity growth has been fairly slow.").

A different recent study notes that statistics are sobering when examined without the computer and electronics industry being included:

> When looking at real (inflation-adjusted) U.S. manufacturing value-added as a share of GDP for 18 of 19 U.S. manufacturing industries (leaving out . . . computers and electronics), the picture has been and continues to look bleak. Manufacturing value-added as a share of GDP declined from around 12 percent in 2006 to around 10 percent in the second quarter of 2021.[198]

One might quibble about excluding a major driving force in the U.S. economy, the production of computers, from the data, but recent reports suggest that computer manufacturing is also leaving the United States. For example, it now appears that Apple produces almost all its hardware in China.[199]

Some also argue that another misleading factor in the data is the over-estimation of value added by computers assembled in the United States. Some argue that the Bureau of Economic Affairs (BEA) inflates the value added when computers are assembled in the U.S. because they overestimate increases attributable to processing speed improvements:

> [T]his surge in computer and electronics output doesn't reflect an actual increase in the number of computers the United States is producing. In fact, U.S. companies have been producing fewer computers as manufacturing has shifted offshore. Rather, this massive growth in output and productivity is simply a result of how BEA measures quality adjustments caused by computer speeds increasing according to "Moore's Law."[200]

Empirical studies employing more recent data through 2019 that include the flight of computer manufacturing abroad also suggest real production has dropped domestically. Stephen Ezell reports that real manufacturing value added to our economy declined thirteen percent from 2007 to 2019.[201] He further notes that when one accounts for "the

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198. Robert D. Atkinson, *A Dismal Future: The Projected Decline of U.S. Manufacturing*, INFO. TECH. & INNOVATION FOUND. (Oct. 4, 2021), https://itif.org/publications/2021/10/04/dismal-future-projected-decline-us-manufacturing/ [https://perma.cc/KJ9V-PK69].

199. Lai, Liu & Xiao, *supra* note 112, at 402 ("Specifically, for Apple, according to its 2018 annual report, almost all of its hardware products are manufactured by its outsourcing partners in Asia.").

200. Atkinson, *supra* note 198.

201. STEPHEN EZELL, INFO. TECH. & INNOVATION FOUND., POLICY RECOMMENDATIONS TO STIMULATE U.S. MANUFACTURING INNOVATION 1 (2020).

statistical overstatement of output growth in the computer industry, it fell by 20 percent . . . ." [202] More sobering, Ezell notes that the 11 percent U.S. manufacturing value as a percentage of GDP in 2019 has not kept pace with other developed countries.[203] He states that "while some contend that manufacturing value added as a share of GDP is fated to weaken in advanced economies, the reality is that manufacturing's contribution to German GDP is twice the share as in America, while it remains higher in other economies, such as Austria (17 percent), Japan (21 percent), Korea (27 percent), and Switzerland (18 percent)."[204]

In summary, the U.S. government is concerned that decreased production of key products in the U.S. threatens national security. There is debate, however, about whether *aggregate* manufacturing in the U.S. has also decreased. It is possible that the data suggesting that production in the U.S. has stayed relatively flat are misleading because of issues in measuring the contribution of the computer sector. In addition, some recent data suggest that, as the computer industry shifts most of its production offshore, production in the U.S. is decreasing and lags behind several other industrialized nations.[205] Regardless of whether aggregate production has increased or decreased, our tax system's bias in favor of foreign manufacturing should be eliminated to help ameliorate supply chain and national security issues. Moreover, one has to wonder whether U.S. production would have grown more without the tax biases in our system. Given the problems discussed, we should eliminate the tax incentives.

D. Impact on Research and Development

Another concern about offshore manufacturing is its impact on research and development (R&D). It is important to distinguish between new product development and manufacturing process development. The impact of offshoring on R&D for new products is complex and uncertain:

> Our research is related to a broader set of questions that asks how production, innovation, knowledge, and productivity are related. One perspective is that without production activities located nearby, in the long run a firm cannot continue to

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202. *Id.*

203. *Id.*

204. *Id. See also* MARC LEVINSON, CONG. RSCH. SERV., R42135, U.S. MANUFACTURING IN INTERNATIONAL PERSPECTIVE 3 (2018) (noting decrease in U.S. share of global manufacturing).

205. *See* Atkinson, *supra* note 198; EZELL, *supra* note 201, at 1.

> generate new ideas, improve product quality, innovate its designs, and raise productive efficiency. The counterpoint suggests that the advent of dramatic improvements in telecommunication technology, the rise of the Internet, and the reduction of transportation and trade costs have combined to allow firms to separate their activities geographically and potentially locate them outside the firm. This perspective suggests firms will thrive if they can take advantage of comparative advantage and relative cost differences in the performance of the tasks involved in the creation, production, distribution, and marketing of a product.[206]

Pisano and Shih argue in the *Harvard Business Review* that "[d]ecades of outsourcing manufacturing has left U.S. industry without the means to invent the next generation of high-tech products that are key to rebuilding its economy."[207] On the other hand, others have countered that the costs saved by offshoring, at least in the case of European companies, have allowed those companies to increase their product innovation R&D.[208]

Shifting manufacturing outside the U.S. has resulted in decreased U.S. research on methods of industrial production. Production R&D tends to occur where production occurs.[209] The U.S. invests only 0.5% of its total R&D on industrial production R&D, compared to 7% in Japan, 12% in Germany, and 30% in South Korea.[210] Alarmingly, the OECD average for investment in industrial production R&D is almost forty times greater than the U.S. level.[211]

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206. Bernard & Fort, *supra* note 100, at 519–20.

207. Gary P. Pisano & Willy C. Shih, *Restoring American Competitiveness*, HARV. BUS. REV., July–Aug. 2009, at 114, 114.

208. *See, e.g.*, Bernhard Dachs, Bernd Ebersberger, Steffen Kinkel & Oliver Som, *The Effects of Production Offshoring on R&D and Innovation in the Home Country* 17–19 (Fraunhofer Inst. for Sys. & Innovation, Discussion Paper No. 39, 2014).

209. Graetz and Doud, surveying the empirical literature, suggest that R&D and manufacturing are often located close to each other and that such co-location in some cases increases productivity. Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 385 (2013).

210. EZELL, *supra* note 201, at 1–2; Sridhar Kota & Tom Mahoney, *Reinventing Competitiveness: The Case for a National Manufacturing Foundation*, AM. AFFS. (2019), https://americanaffairsjournal.org/2019/08/reinventing-competitiveness/ [https://perma.cc/3WWB-7HPG].

211. EZELL, *supra* note 201, at 2. The U.S. only invests 0.5% of its R&D budget in industrial production. Kota & Mahoney, *supra* note 210.

This has taken an increasingly greater toll over time. Although, the U.S. manufacturing multifactor productivity (MFP) increased by an average of 2% per year from 1992 to 2004, it decreased by an average of 0.3% per year from 2004 through 2016.[212] Similarly, productivity as measured by the U.S. Bureau of Labor Statistics in the U.S. manufacturing sector increased by only 0.5% over the five years from 2011 to 2016, compared to the growth rate of 3.2% from 1987 to 2016."[213]

Some economists have argued that the U.S. is no longer competitive in manufacturing innovation. Pisano and Shih assert:

> [T]he outsourcing has not stopped with low-value tasks like simple assembly or circuit-board stuffing. Sophisticated engineering and manufacturing capabilities that underpin innovation in a wide range of products have been rapidly leaving too. As a result, the U.S. has lost or is in the process of losing the knowledge, skilled people, and supplier infrastructure needed to manufacture many of the cutting-edge products it invented.[214]

Given the shift toward automation, the U.S. should position itself to be a leader in automated manufacturing. It does not make any sense to have tax subsidies that may hamper our ability to compete in domestic manufacturing.

III. POTENTIAL IMPACT OF PRIOR ATTEMPTS TO LEVEL THE PLAYING FIELD

The prior Parts demonstrate that the contract-manufacturing exception and CTB regulations have created tax incentives to move manufacturing out of the U.S. The previous Parts also discuss the harms that the departure of manufacturing from the U.S. have inflicted.

Recent attempts to level the playing field in the 2017 and 2022 Acts have created more complexity, but have not eliminated the incentives in

212. EZELL, *supra* note 201, at 2; Michael Brill, Brian Chansky & Jennifer Kim, *Multifactor Productivity Slowdown in U.S. Manufacturing*, U.S. BUREAU LAB. STAT.: MONTHLY LAB. REV. (July 2018), https://www.bls.gov/opub/mlr/2018/article/multifactor-productivity-slowdown-in-us-manufacturing.htm.

213. EZELL, *supra* note 201, at 2.

214. Pisano & Shih, *supra* note 207, at 116.

the two acts to shift profits outside the U.S.[215] Ironically, some of the provisions adopted in the 2017 Tax Act and that are included in the OECD Pillar Two initiative may actually encourage MNEs to move more of their tangible assets and manufacturing jobs offshore. In contrast, the corporate AMT, which was adopted in the 2022 Tax Act and became operative in 2023, may reduce the incentive to use contact manufacturers in some instances, but has clearly not eliminated it. This Part explores the impact of the 2017 and 2022 Tax Acts and the potential impact of Pillar Two.

A. The 2017 Tax Act

The 2017 Tax Act[216] contained provisions that were intended to level the playing field, but that instead potentially encourage MNEs to *increase* the assets they invest overseas. These provisions, referred to as GILTI[217] (pronounced "guilty") and FDII,[218] (pronounced "fiddy") may encourage MNEs to open their own factories in a low tax country, rather than to rely on contract manufacturers. The reason for this odd result is that the tax benefits conferred by GILTI increase as a CFC increases the amount of tangible assets in its CFCs. Similarly, FDII, which is also discussed below, encourages U.S. corporations to have fewer tangible assets in the U.S. because the tax benefits from FDII increase as the U.S. corporation's assets in the U.S. decrease.

To understand how these strange incentives arose, it is necessary to review the GILTI and FDII rules.

1. GILTI

The GILTI scheme in effect divides the non-Subpart F income of CFCs into two portions.[219] The first portion is the CFC's non-Subpart F income equal to ten percent or less of the CFC's tangible assets.[220] That portion escapes taxation entirely (unless the new corporate alternative minimum tax [AMT], discussed in Section III.B below applies). It is not

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215. *See* Clausing, *supra* note 29, at 1253–54; *Post-TCJA U.S. Multinational Profit*, *supra* note 33, at 1053; *Little Progress on Pharma Profit Shifting*, *supra* note 33, at 1474.

216. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

217. "GILTI" is the acronym for Global Intangible Low-Taxed Income. *See infra* notes 223–24 and accompanying text.

218. "FDII" is the acronym for "Foreign Derived Intangible Income." *See infra* Section III.A.2.

219. I.R.C. § 951A.

220. I.R.C. §§ 245A(a), 951A(a)–(b).

taxed by the U.S. as the CFC earns it and is not taxed when distributed to the CFC's U.S. parent corporation.[221]

GILTI treats very differently the second portion of the CFC's non-Subpart F income, which is the amount of the CFC's non-Subpart F income in excess of 10% of its tangible assets. That second portion is taxed to the U.S. parent at a rate of 10.5% (50% of the regular 21% corporate rate) as it is earned by the CFC regardless of whether it is distributed to the U.S. parent.[222] (That second portion is not taxed again when ultimately distributed to the U.S. parent, since the U.S. parent has already been taxed on it.[223]) Although the GILTI scheme eliminates deferral of U.S. taxation on that second portion of the CFC's income, note that the rate is a very favorable 10.5% compared to the regular 21% tax that would apply to income earned in the U.S. (again, assuming the AMT does not apply).

Why is this hybrid tax regime called GILTI, which is the acronym for Global Intangible Low-Taxed Income? The GILTI tax regime in effect is assuming that non-Subpart F income in excess of 10% of a CFC's tangible assets must be attributable to the CFC's *intangible assets*. In other words, the income in excess of 10% is literally *the* GILTI, the global intangible low-taxed income. Since intangible assets can easily be located anywhere, Congress determined that permitting the income generated by such assets in low-tax countries to escape permanent taxation would encourage locating such assets there even though such location might not be required for nontax competitive reasons.[224] As a result, the GILTI is taxed, but at a favorable rate of 10.5% for corporate U.S. shareholders.

For example, consider a CFC with $100 million of tangible assets that earns $15 million and that is not subject to Subpart F and the new corporate AMT, which is discussed below. The first $10 million of the earnings (i.e., the portion equal to 10% of the $100 million of tangible assets) would not be subject to U.S. tax as earned or when distributed to its U.S. corporate parent. The remaining $5 million, the second portion, would be taxed to the U.S. parent at a rate of 10.5% as it is earned, but would not be taxed when distributed to the parent. In summary, the U.S.

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221. *See* I.R.C. §§ 245A, 951A(b)–(c). Distributions to any of the CFC's shareholders, who are *individuals*, however, are taxable.

222. I.R.C. § 951A(a). I.R.C. § 250(a) allows a 50% deduction for the GILTI income. As a result, the effective U.S. tax rate on the GILTI income is 10.5% (one-half of the 21% corporate tax rate). I.R.C. §§ 11(b), 250(a).

223. I.R.C. § 959(a).

224. *See* H.R. REP. NO. 115-409, pt. 2, at 388–89 (2017).

has three approaches to taxing a CFC's income, if the corporate AMT does not apply:

> (1) Subpart F taxes a U.S. parent annually on the subpart F income of its CFC, such as foreign base company sales income (discussed earlier), regardless of whether such income is distributed to the parent at the regular corporate statutory rate of 21%. As a result, when a CFC, such as an Irish tax haven, sells goods to a related CFC, the gain from that sale will be fully taxed under Subpart F unless the manufacturing exception applies or the related CFC is a disregarded entity similar to the scheme employed by Apple discussed above.
> (2) The foreign source income of a CFCs that is *not* Subpart F income and does *not* exceed 10% of the subsidiary's tangible assets escapes U.S. taxation entirely when earned by the foreign corporation and subsequently distributed to its corporate U.S. shareholders.
> (3) The amount of the CFC's non-Subpart F income that exceeds a 10% return on its assets (the GILTI) is taxed annually to US shareholders at the very reduced rate of 10.5% regardless of whether it is distributed and is not taxed again when distributed to its parent.

The fact that Subpart F applies to tax foreign base company sales income at the regular 21% corporate tax rate and that income earned in the U.S. is taxed at 21% means that there is still a strong incentive for many taxpayers to use the contract manufacturing exception and CTB regulations discussed above to shift income offshore.[225] But GILTI may also have created a new incentive to move tangible assets used in manufacturing out of the United States.[226] This occurs because the GILTI

225. A U.S. MNE, however, may sometimes prefer Subpart F income because the Subpart F income will enable it to use more of its foreign tax credits to reduce its U.S. tax liability. This may be particularly true for financial institutions that are likely to have higher interest expenses, which in turn may result in higher GILTI inclusions. Jessica Silbering-Meyer, *Should Companies Plan into Subpart F Following the TCJA?*, TAX EXEC., Jan.–Feb. 2019, at 76, 76, https://taxexecutive.org/should-companies-plan-into-subpart-f-following-the-tcja/ [https://perma.cc/9VTE-8PGB]. Subpart F income may be preferable to GILTI because the foreign tax credit for GILTI is limited to 80% of the GILTI and cannot be carried over to subsequent years. I.R.C. §§ 904(c), 960(d). Moreover, the GILTI is placed into a separate tax credit basket, I.R.C. § 904(d)(1)(A), which may reduce the tax benefit it generates. I.R.C. § 904(d)(1)(A).

226. *See* James R. Repetti, *The Tax Cuts and Jobs Act Kneecaps American Factory Workers*, THE HILL (Dec. 13, 2018, 10:30 AM),

tax only applies to the extent the CFC's income exceeds 10% of its tangible foreign assets. The larger the size of the CFC's foreign assets, the larger the amount of income that permanently escapes U.S. taxation. In addition, the GILTI portion of the income (that is, the income in excess of 10% of tangible assets) is taxed at a favorable rate of 10.5% instead of the 21% rate that would apply to income from manufacturing in the United States.[227]

For example, if a U.S. MNE doubles the amount of tangible assets held by its CFC in a foreign country, it will double the amount of the CFC's income that will never be subject to U.S. tax. Moreover, the amount of income that exceeds 10% of the CFC's increased assets is still favorably taxed at one-half the rate that would apply to income earned by the MNE in the United States. This creates a strong incentive to move assets, such as factories out of the U.S. *and* to shift profits as much as possible to tax havens outside the United States.

2. FDII

The acronym "FDII" stands for Foreign Derived Intangible Income. The tax scheme for FDII reduces the effective corporate tax rate from 21% to 13.125% on income of a U.S. corporation attributable to sales to foreign buyers that FDII constructively characterizes as arising from its intangible property.[228] FDII accomplishes this by treating income that exceeds 10% of the corporation's domestic tangible assets as though it were attributable to intangible property.[229] FDII then applies the low 13.125% tax rate to a portion of the U.S. corporation's deemed intangible income that bears the same ratio as the ratio of the corporation's income from foreign exports to the corporation's total income.

For example, suppose a U.S. corporation has $10 million in tangible assets in the U.S. and earns $1.5 million ($1 million from U.S. buyers

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https://thehill.com/opinion/finance/421191-the-tax-cuts-and-jobs-act-kneecaps-american-factory-workers/ [https://perma.cc/C4B8-SKGM].

227. The benefit of the low GILTI rate may be offset in some circumstances by foreign tax credit considerations. *See* Silbering-Meyer, *supra* note 225, at 76. A U.S. MNE is limited to claiming a foreign tax credit that equals only 80% of the foreign income taxes paid on the GILTI portion. In addition, the GILTI is placed into a separate tax credit basket, which prevents cross-crediting. I.R.C. § 904(d)(1)(A).

228. I.R.C. § 250(a)(1) allows a U.S. corporation to deduct an amount equal to 37.5% of its foreign derived intangible income in calculating its taxable income. This deduction reduces the effective rate on such income from the regular corporate rate of 21% to 13.125% (21% - (37.5% x 21%) = 13.125%).

229. I.R.C. § 250(a)(1).

and $500,000 from exports). The corporation's income of $1.5 million exceeds $1 million (10% of its tangible assets) by $500,000. As a result, $500,000 of the corporation's income is deemed to be from intangibles. The ratio of export income to total income is 33.3% (the ratio of $500,000 to $1.5 million). Consequently, 33.3% of the $500,000 of deemed intangible income ($166,667) will be treated as FDII and eligible for the 13.125% tax rate.

The reduced tax on a portion of the profits from exports in excess of 10% of domestic tangible assets is intended to encourage U.S. corporations to not transfer intangible property overseas. It is supposed to motivate U.S. corporations to retain intangible property in the U.S. and license such property overseas. But note that the favorable 13.125% tax rate can apply to more of the U.S. corporation's export income if it has fewer U.S. tangible assets. FDII creates yet another incentive for domestic corporations to pull factories out of the United States. Such corporations obtain the benefit of the lower 13.125% tax rate on their export income when they have fewer tangible assets in the country.

For example, a U.S. company that has $100 million of assets in the U.S. needs to earn over $10 million before its tax rate is reduced from 21% to 13.125% on its proportionate export income. In contrast, a company with only $10 million of tangible property in the U.S. needs only to earn $1 million before the low tax rate applies to the export income portion of the deemed intangible income.

B. The 2022 Tax Act: The Corporate AMT

While adding great complexity, GILTI and FDII have not discouraged the use of contract manufacturing. Unfortunately, they have also created incentives for U.S. MNEs to move tangible assets offshore. The 2022 Tax Act[230] added a new corporate AMT beginning in 2023 that attempts to shore up prior tax reforms by subjecting very large corporations to a minimum tax.[231] The new AMT applies only to corporations that report more than $1 billion in profits on their financial statements.[232] As a result, it is estimated that the AMT will impact approximately ninety corporations.[233]

The new AMT imposes a flat 15% tax rate on the income reported by such companies on their annual financial income statements with

230. Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818 (2022).

231. *See* I.R.C. § 55(a)(2).

232. I.R.C. §§ 59(k)(1)(A)–(B).

233. GRAVELLE, *supra* note 109, at 7.

several adjustments.[234] The 15% tax applies to that adjusted financial income if the resulting tax is greater than their regular corporate income taxes described above.[235] The adjusted financial income to which the AMT applies includes the undistributed income of such companies' CFCs.[236]

Because the AMT includes the undistributed income of CFCs, it may burden the income of CFCs in tax havens. There are two reasons, however, why the AMT will not eliminate the incentives for U.S. MNEs to utilize tax havens and contract manufacturers.

First, U.S. MNEs can manipulate the income of their CFCs that they report on their annual financial statements to minimize or avoid the AMT. Generally Accepted Accounting Principles (GAAP), which are promulgated by the Financial Accounting Standards Board, a non-governmental association in the U.S.,[237] allow significant discretion for the manner in which certain income and expenses may be reported by U.S. MNEs on their financial statements.[238] Some examples include when expenses will be accrued for contingent tort and contract liability, when allowances for doubtful accounts should be deducted, when impairment of goodwill should be recognized, when valuation allowances should be accounted for, and the estimation of salvage or residual value.[239]

A tax on annual financial statement income presents a dilemma to management. In a perfect world, management of publicly traded U.S. MNEs would prefer not to reduce the financial statement income of their tax-haven CFCs because of a worry that lower financial earnings could lower the MNEs' stock values.[240] At the same time, failure to exercise discretion in favor of reducing financial statement income will result in a higher tax expense. Empirical studies of the response of U.S. companies to an alternative minimum tax that applied to financial statement income for the period 1987 through 1989 are mixed. Several

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234. I.R.C. §§ 55(a), 55(b)(2)(A), 56A.

235. I.R.C. §§ 55(a), 55(b)(1)(B).

236. I.R.C. §§ 55(b)(2)(A)(i), 56A(c)(3)(A).

237. Michelle Hanlon & Michelle Nessa, *The Use of Financial Accounting Information in the OECD BEPS 2.0 Project: A Discussion of the Rules and Concerns*, 76 NAT'L TAX J. 193, 216 (2023).

238. Jerred G. Blanchard Jr., Jeff Maydew, Daniel Newton & Meaghan A. Wolfe, *The Corporate AMT: Are the Issues Insurmountable?*, 178 TAX NOTES FED. 343, 346 (2023).

239. *See* Christopher H. Hanna, Michelle Hanlon, Norman Richter & Michael Schler, *The Rise of the Minimum Tax*, TAXES, Mar. 2022, at 55, 66–70 (discussing differences between financial accounting and tax accounting).

240. Christopher H. Hanna & Cody A. Wilson, *U.S. International Tax Policy and Corporate America*, 48 J. CORP. L. 261, 273–74 (2023).

suggest that U.S. companies did adjust downward financial statement income in order to decrease their tax liability.[241] The matter is not clear, though, because others suggest that large companies did not respond in that manner.[242]

The empirical studies from the prior AMT may not be predictive of the response of U.S. MNEs today. Since the earlier AMT applied in the late 1980s, many companies now use many methods not regulated by GAAP, in addition to annual financial income statements, to communicate information to investors.[243] Management currently may have to thread the needle because investors may react negatively to increased AMT expenses arising from management's failure to "massage" annual financial statement income where alternative means exist to communicate operating results to investors. Investors may legitimately expect management to reduce or avoid the AMT by manipulating discretionary accounting items and to employ other methods, such as pro-forma income statements, to communicate to stockholders that they reduced financial income in order to minimize the MNE's tax expense. Michelle Hanlon states:

> [I]n a world where [an AMT is imposed on financial statement income] . . . there is a case to be made that the managers will report a lower [financial] income to save taxes, tell the market that is what they are doing, and try to get the information about positive economic performance to the capital markets via other disclosure channels . . . . In other words, managers can in effect say "Look, we reported these low earnings to save taxes. These . . . [other earnings disclosures] are actually the 'truth.'"[244]

The second reason that the AMT will not eliminate the use of contract manufacturers is that it will be extremely difficult for MNEs to forecast the AMT's impact each year because the several economic and tax factors that affect its application change annually.[245] Some have

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241. *See* Hanna, Hanlon, Richter & Schler, *supra* note 239, at 71; Hanlon & Nessa, *supra* note 237, at 217–22 (summarizing the studies).

242. Hanlon & Nessa, *supra* note 237, at 218.

243. *Id.* at 219 n.47 (citing several studies that note the "explosive" use of non-GAAP disclosures since the 1990s).

244. Michelle Hanlon, *The Possible Weakening of Financial Accounting from Tax Reforms*, ACCT. REV., Sept. 2021, at 389, 395. *See also* Hanna, Hanlon, Richter & Schler, *supra* note 239, at 71–72; Hanlon & Nessa, *supra* note 237, at 219.

245. For the difficulties in calculating and anticipating application of the AMT, see Hanna, Hanlon, Richter & Schler, *supra* note 239, at 71–74.

suggested that "the existence of the AMT may cause future marginal tax rates to be quite uncertain, causing tax planning . . . to be difficult, if not impossible, and prone to error in retrospect."[246]

With a regular corporate tax rate of 21%, the 15% AMT will apply when the MNE's financial statement income is more than 140% of its regular taxable income.[247] The magnitude of the actual difference between the adjusted financial income subject to the AMT and the regular taxable income of many MNEs will change annually depending on financial accounting rules and the MNE's activities.[248] Consequently, there is likely to be major variability in the application of the AMT each year. For example, the CRS examined the period 2004 through 2017 and found that aggregate book income for large corporations ranged from more than $500 billion *below* taxable income in 2008 to well over $500 billion *above* taxable income in 2017.[249]

This uncertainty about when the AMT will apply means that MNEs will continue to use tax-haven CFCs and contract manufacturers. Using contract manufacturers and maintaining a shell CFC in a tax haven does not require a significant commitment of capital compared to building a factory in the U.S.[250] The shell CFC is easy and inexpensive to maintain and the contract manufacturer is a variable expense that can be terminated quickly.[251] The possibility of a favorable tax outcome using contract manufacturers, combined with the low costs of maintaining a shell tax haven CFC and hiring a contract manufacturer, provide an inexpensive "hedge" against the unknown. In years when the AMT does not apply, the MNEs will have effectively lowered their tax liability by using contract manufacturers. Even in years when the AMT does apply, the effective tax rate of the 15% AMT on the tax haven CFC's financial income may still be lower than the effective marginal tax that would have applied had the MNE manufactured in the U.S. where its taxable income would certainly be subject to a 21% statutory tax rate.

246. *Id.* at 72.

247. The ratio of the regular corporate tax rate to the AMT rate provides the extent to which AMT income needs to exceed taxable income in order for the AMT to apply: 21% regular corporate tax / 15% AMT = 1.4. *See id.*

248. *Id.*

249. MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RSCH. SERV., IN11646, A LOOK AT BOOK-TAX DIFFERENCES FOR LARGE CORPORATIONS USING AGGREGATE INTERNAL REVENUE SERVICE (IRS) DATA 2 fig.1 (2021).

250. *See* Coyle & Nguyen, *supra* note 105, at 25 (describing the business benefits of outsourcing factory building overseas).

251. *See* Benito Arruñada & Xosé H. Vazquez, *When Your Contract Manufacturer Becomes Your Competitor*, HARV. BUS. REV., Sept. 2006, at 135, 138–39.

C. Pillar Two

The OECD is currently developing a new tax regime, called Pillar Two, to reduce the incentive to shift income to low tax countries.[252] In its current form, Pillar Two will subject a portion of the income of all MNEs that have revenues in excess of 750 million Euros to a minimum tax.[253] It imposes a 15% tax on the "excess" financial statement income of a CFC in a low tax country.[254] The "excess" financial income subject to this 15% tax is the amount of income reported on its financial statements that exceed 8% of the CFC's tangible assets and 10% of the CFC's payroll for employees.[255] The 8% and 10% exclusion percentages will gradually decrease to 5% over a period of years.[256]

Pillar Two contains two alternative methods to impose the 15% tax. The first envisions that the resident country of the CFC's parent will impose a "top up" tax on the parent to make up any shortfall arising from the low tax country's failure to impose a 15% tax on the CFC.[257] But, if the parent's country fails to impose such a tax, the second alternative permits other countries that have agreed to Pillar Two to collect the shortfall from the parent's subsidiaries that operate in their respective countries.[258]

Pillar Two shares some of the same deficiencies discussed above with respect to both GILTI and the U.S. corporate AMT. As is the case

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252. *See* GLOBAL ANTI-BASE EROSION MODELS, *supra* note 20, at 6.

253. *Id.* at 10; OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR TWO BLUEPRINT 15 (2020) [hereinafter REPORT ON PILLAR TWO BLUEPRINT].

254. *See* GLOBAL ANTI-BASE EROSION MODELS, *supra* note 20, at 6. The financial statement income is calculated using international financial reporting standards, accounting principles similar to GAAP that are used in Europe. REPORT ON PILLAR TWO BLUEPRINT, *supra* note 253, at 54.

255. OECD, TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO): INCLUSIVE FRAMEWORK ON BEPS 30–31, 49–50 (2021) [hereinafter INCLUSIVE FRAMEWORK ON BEPS]; OECD, STATEMENT ON A TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY 4 (2021), https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf [https://perma.cc/4BSS-FLQ9] [hereinafter STATEMENT ON A TWO-PILLAR SOLUTION].

256. INCLUSIVE FRAMEWORK ON BEPS, supra note 255, at 49–50. The OECD's finalized framework also allows a country adopting Pillar Two to set an exclusion percentage that is below the initial 8% and 10% amounts. GLOBAL ANTI-BASE EROSION MODELS, *supra* note 20, at 107.

257. GLOBAL ANTI-BASE EROSION MODELS, *supra* note 20, at 98.

258. REPORT ON PILLAR TWO BLUEPRINT, *supra* note 253, at 123–24; STATEMENT ON A TWO-PILLAR SOLUTION, *supra* note 255, at 4.

with GILTI,[259] Pillar Two may actually encourage U.S. MNEs to relocate tangible manufacturing assets and jobs to low-tax jurisdictions because of its exemption of income equal to 8% (later 5%) of the tangible assets and 10% (later 5%) of the payroll paid to employees in the foreign jurisdiction.[260] The amounts of income shielded by these exemptions could be significant. An article examined a sample of European and U.S. companies that have revenues in excess of 750 million Euros and, therefore, would be subject to Pillar Two.[261] It found that the 10% payroll and 8% tangible asset exclusion would shield 37% of pretax profit and that the final 5% exclusion would shield 23%.[262]

Moreover, as discussed with respect to the corporate AMT,[263] U.S. MNEs may be able to minimize the impact of Pillar Two's 15% minimum tax through creative accounting. Pillar Two's use of annual financial statement income as the tax base creates opportunities for CFCs to reduce their financial income and thereby avoid or minimize the 15% tax. As mentioned earlier, there is a strong argument that management will wish to exercise the discretion available in financial accounting to reduce the book profits of CFCs and use other avenues to communicate the "real" operating results to investors. But management may have the best of both worlds with Pillar Two. Michelle Hanlon and Michelle Nessa note that management may not have to reduce the consolidated income of the entire MNE group to avoid the Pillar Two tax.[264] This occurs because Pillar Two in its current form allows the MNE to treat financial accounting items differently in each country. Hanlon and Nessa suggest that management can exercise the discretion financial accounting permits to reduce book income in low income tax countries to avoid Pillar Two's minimum book tax, while offsetting such reductions by increasing financial income in the high tax countries where the Pillar Two tax is not a threat.[265]

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259. *See supra* text accompanying notes 226–27.

260. *See* Reuven Avi-Yonah & Young Ran (Christine) Kim, *Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax*, 43 MICH. J. INT'L L. 505, 550–51 (2022); Lilian V. Faulhaber, *Pillar Two's Built-in Escape Hatch*, 76 NAT'L TAX J. 167, 181 (2023).

261. Michael P. Devereux, Johanna Paraknewitz & Martin Simmler, *Empirical Evidence on the Global Minimum Tax: What Is a Critical Mass and How Large Is the Substance-Based Income Exclusion?*, 44 FISCAL STUD. 9, 16 (2023).

262. *Id.*

263. *See supra* text accompanying notes 236–51.

264. Hanlon & Nessa, *supra* note 237, at 219.

265. *Id.*

In addition, there will still be significant uncertainty, similar to the AMT discussed above,[266] as to whether the 15% burden Pillar Two imposes on a CFC's financial income will be greater than the 21% U.S. tax on taxable income that would be imposed if the income were earned in the U.S. Given the great variability between financial income and taxable income, the use of financial statement income as the tax base makes it very difficult to forecast the relative size of the two tax burdens. In years when Pillar Two does not apply, the MNEs will have effectively lowered their tax liability by using contract manufacturers. Even in years when Pillar Two does apply, its effective tax rate may still be lower than the effective marginal tax that would have applied had the MNE manufactured in the U.S. where its income would be subject to a 21% statutory tax rate. The result is that U.S. MNEs will still be motivated to locate CFCs in low-tax jurisdictions and to have them engage contract manufacturing as opposed to manufacturing in the U.S.[267]

D. Summary of the Potential Impact of the 2017 and 2022 Tax Acts and Pillar Two

While GILTI, FDII, and Pillar Two are intended to level the playing field, they instead potentially encourage MNEs to *increase* tangible assets they invest overseas. At the same time, the great variability between financial statement income, the measure used by the AMT and Pillar Two, and taxable income, the measure used by the regular corporate tax, creates significant uncertainty about when liability from the AMT or Pillar Two will exceed the regular twenty-one percent corporate tax. Thus, U.S. MNEs will still use contract manufacturing to avoid Subpart F and the twenty-one percent regular corporate tax.

IV. RECOMMENDED REGULATORY AND LEGISLATIVE ACTION

A. Introduction

Economists teach that the most efficient tax system is one that does not influence economic behavior.[268] From that perspective alone, our tax policy should not subsidize foreign manufacturing. But the harms that the

266. *See supra* text accompanying notes 237–51.

267. Of course, if the effective U.S. tax rate on income earned in the U.S. ever becomes equal to or drops below the Pillar Two's 15% rate on financial income, then this incentive to offshore will disappear.

268. *See, e.g.*, HARVEY S. ROSEN, PUBLIC FINANCE 292 (2d ed. 1988); JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 29–30 (1994).

tax incentives have helped create, which this Article has discussed, further emphasize the importance of eliminating the subsidies.

This Article recommends that the contract manufacturing exception be repealed. As a result, only goods manufactured by the CFC itself, either in the country in which it is located or elsewhere, and goods manufactured by a third party in the country in which the CFC is located would qualify for an exemption. This will eliminate the opportunity for U.S. MNEs to establish "shell" subsidiaries in tax havens and then have the tax haven CFC manufacture goods elsewhere using contract manufacturers. CFCs could continue to establish their own factories inside or outside the country in which they are incorporated, but the branch rule, discussed above,[269] would trigger Subpart F income recognition in abusive situations where the CFC manufactured goods outside its country.

This Article also suggests that we amend the CTB regulation so that the sole owner of an entity cannot elect to disregard an entity that has been formed outside the U.S.. As discussed earlier, this provision has contributed to significant harm that far outweighs any benefit from simplicity.

B. Validity of the Proposed Regulation to Limit the Manufacturing Exception

To determine the validity of amendments to narrow the scope of the contract manufacturing exception and CTB regulations, it is necessary to enter the increasingly murky world of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*[270] and the major questions doctrine. Both of these doctrines have rapidly evolved over the past several years.[271] Under *Chevron*, a regulation is entitled to judicial deference if

269. *See supra* text accompanying notes 45–52.

270. 467 U.S. 837 (1984).

271. Linda Jellum predicted *Chevron*'s muddled destiny over fifteen years ago. Linda Jellum, Chevron*'s Demise: A Survey of* Chevron *from Infancy to Senescence*, 59 ADMIN. L. REV. 725, 726 (2007) ("*Chevron* has proved to be less clear, predictable, and simple than originally envisioned. Its guidance is unclear; its application has been, at best, uncertain."). For other excellent discussions of the recent uncertainty surrounding the application of *Chevron*, see, for example, Kristen E. Hickman & Aaron L. Nielson, *Narrowing* Chevron*'s Domain*, 70 DUKE L.J. 931, 933 (2021) ("Administrative law today finds itself in a state of commotion."), and GARY LAWSON, FEDERAL ADMINISTRATIVE LAW 633 (9th ed. 2022) ("Opposition on the bench to a broad application, or in some cases *any* application, of *Chevron* has become more open in recent years.").

Similarly, for uncertainties about the MQD, see, for example, Natasha Brunstein & Richard L. Revesz, *Mangling the Major Questions Doctrine*, 74 ADMIN. L. REV. 217,

the statute does not directly address the subject matter of the regulation and the regulation is a reasonable interpretation of the statute.[272] The Supreme Court has ruled in a series of recent cases, however, that *Chevron* deference is not available if the regulation involves a "major question."[273] The Court has stated that a major question exists where an agency is issuing a regulation that entails "vast economic and political significance."[274] This Section first explores the likely outcome if the proposed regulations are deemed to not involve a major question and, therefore, *Chevron* deference applies.[275] It then analyzes application of

218–19 (2022), and Mila Sohoni, *The Major Questions Quartet*, 136 HARV. L. REV. 262, 263–67 (2022).

272. *Chevron*, 467 U.S. at 842–43. The Court in *Chevron* described its two-part test as follows:

> [A] court . . . is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Id. (footnotes omitted).

There has been significant debate about the number of steps *Chevron* actually requires. *See, e.g.*, Daniel J. Hemel & Aaron L. Nielsen, Chevron *Step One-and-a-Half*, 84 U. CHI. L. REV. 757, 759 (2017) (summarizing articles that have posited a number of different steps).

273. *See, e.g.*, *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159–60 (2000); *King v. Burwell*, 576 U.S. 473, 485–86 (2015); *Util. Air Regul. Grp. v. EPA*, 573 U.S. 302, 321 (2014).

274. *West Virginia v. EPA*, 142 S. Ct. 2587, 2605 (2022). *See also Nat'l Fed'n of Indep. Bus. v. Dep't of Lab., Occupational Safety & Health Admin.*, 142 S. Ct. 661, 665 (2022) (stating that Congress must "speak clearly when authorizing an agency to exercise powers of vast economic and political significance") (quoting *Ala. Ass'n of Realtors v. Dep't of Health & Hum. Servs.*, 141 S. Ct. 2485, 2489 (2021) (per curium)); *Util. Air Regul. Grp.*, 573 U.S. at 324 (quoting *Brown & Williamson*, 529 U.S. at 160) (same). See *infra* text accompanying notes 298–302 for a discussion of other factors relating to the existence of a major question.

275. Although the proposed regulations would change existing policy in current regulations, *Chevron* deference should still apply so long as the proposals do not raise the MQD. In *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 514 (2009), the Court determined that a heightened level of scrutiny is not required in reviewing an agency's change in policy: " . . . [O]ur opinion in *State Farm* [*Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983)] neither held nor implied that every agency action representing a policy change must be justified by reasons more substantial than those required to adopt a policy in the first instance." *Id.* An agency changing its policy is required, however, to explain the reason for the change. *See*

the evolving MQD to the proposed regulations if a major question is present and *Chevron* deference is inapplicable.

1. ANALYSIS OF THE PROPOSED REGULATION TO ELIMINATE CONTRACT MANUFACTURING IF *CHEVRON* APPLIES

A regulation is entitled to *Chevron* deference if (1) the statute does not directly speak to the precise question at issue and (2) the regulation is a permissible interpretation of the statute.[276] The Court has not designated the appropriate method of statutory interpretation to determine whether the statute speaks to the precise question.[277] Both statutory methods of interpretation, textualist and purposivist, however, show that Section 954 does not address the level of activity needed to have manufactured an item. Moreover, both interpretive methods suggest that the elimination of contract manufacturing is a permissible interpretation (and likely the best interpretation) of the statute. As a result, the proposed change would be valid under a *Chevron* analysis.

The relevant portion of Section 954(d)(1) defines foreign base company sales income, which will be taxed to a U.S. shareholder under Subpart F, as follows:

> (1) IN GENERAL.—For purposes of subsection (a)(2), the term "foreign base company sales income" means income . . . derived in connection with the purchase of personal property from a related person and its sale to any person, . . . the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—
> (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and
> (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property

KRISTIN E. HICKMAN & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 11.6 (6th ed. 2023). This requirement appears to be "equivalent, or at least overlap considerably" with *Chevron*'s step two. *Id.* § 11.7. *See infra* text accompanying notes 281–84.

276. *See supra* note 272.

277. HICKMAN & PIERCE, JR., *supra* note 275, § 3.5.2 ("The Supreme Court has not been consistent—or at least not explicitly so—in using traditional tools of statutory interpretation to evaluate statutory meaning at *Chevron* step one.").

> purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.[278]

Focusing on the statutory language using the textualist method of interpretation shows that Subpart F applies where a CFC "purchases" property and sells it to a related person.[279] As required by *Chevron*'s step one, the statute clearly does not speak directly to what constitutes a "purchase" and does not elaborate what types of manufacturing activity by a CFC would be necessary to avoid having "purchased" property.

Turning to step two, the *Chevron* Court indicated that an interpretation of the statute is "permissible" if it is a "reasonable" interpretation of the statute.[280] It has long been recognized that a statute should be interpreted to conform to its legislative purpose.[281] The language of Section 954(d)(1) suggests that its purpose is to prevent U.S. MNEs from serving as a conduit or "base" of operation for sheltering income in a low tax country. The statute taxes transactions where the CFC had no business purpose for being in the country other than to "park" taxable income there. It applies where the CFC purchased goods from a related party and sold them to an unrelated party or purchased goods from an unrelated party and sold them to a related party and those purchased goods did not have a business connection to the CFC's country (for example, the goods were not manufactured there or the goods were not consumed there).

Consequently, the word "purchase" should not be defined so that a CFC can easily avoid foreign base company by contracting with an unrelated foreign manufacturer to produce the good for it. The language of the statute, standing alone, supports a definition of "purchase" that will prevent a CFC from using a low tax jurisdiction as its base of operations where the CFC does not engage in meaningful production activities with respect to the item it asserts was not "purchased." The current regulation's determination that a CFC has not "purchased" goods when it has manufactured the goods, itself, makes sense.[282] What lacks sense, however, is the notion that a CFC engages in meaningful activity in its country of incorporation by contracting the manufacturing to an

278. I.R.C. § 954(d)(1).

279. *Id.*

280. HICKMAN & PIERCE, JR., *supra* note 275, § 3.5.1 (discussing the uncertainty surrounding what is "permissible" and noting that the Court regularly employs the words "permissible" and "reasonable" "more or less synonymously").

281. *See, e.g.*, *United States v. Am. Trucking Ass'ns*, 310 U.S. 534, 543 (1940) ("When . . .meaning has led to absurd or futile results, . . . this Court has looked beyond the words to the purpose of the act.").

282. Treas. Reg. § 1.954-3(a)(4) (1999).

unrelated third party outside its country. A requirement that the CFC manufacture goods itself is the best way to avoid having the CFC simply serve as an intermediary purchasing and reselling the goods.

In an analogous case, *Gray v. Powell*,[283] the Court addressed whether it should approve a decision by a commission of the Department of the Interior that the taxpayer was not a "producer" of coal.[284] Had the taxpayer "produced" coal that it had consumed, it would have avoided a 19.5 percent penalty tax.[285] The taxpayer, which had consumed coal, argued that it was the "producer" of the coal because it had leased a coal mine and hired independent contractors to extract the coal that it then consumed.[286] The commission determined that the taxpayer was not a "producer"[287] because the taxpayer had not used its own employees and did not own the land from which the coal was extracted.[288] The Court noted that the term "producer" was ambiguous in that it was not defined in the statute and that a range of activities existed that might distinguish a producer from a consumer.[289] The Court stated:

> The separation of production and consumption is complete when a buyer obtains supplies from a seller totally free from buyer connection. Their identity [as a producer] is undoubted when the consumer extracts coal from its own land with its own employees. Between the two extremes are the innumerable variations that bring the arrangements closer to one pole or the other of the range between exemption and inclusion.[290]

Although *Gray* predates *Chevron* by several decades, it illustrates that the term "purchase" is sufficiently ambiguous to satisfy the first step of *Chevron*.[291] The issue of whether a CFC has purchased an item by transacting with a contract manufacturer is directly analogous to whether the taxpayer in *Gray* should qualify for the exemption from the penalty tax as a "producer" by contracting with a third party. Just as finding the

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283. 314 U.S. 402 (1941).

284. *Id.* at 403.

285. *Id.* at 403 & n.1. The 19.5 percent penalty tax did not apply to producers of coal that consumed coal they had produced themselves. *Id.* at 403 n.1.

286. *Id.* at 414–15.

287. *Id.* at 406.

288. *Id.* at 413.

289. *Id.*

290. *Id.*

291. *Cf.* Hickman & Nielson, *supra* note 271, app. at 1000–13 (listing cases that have applied the *Chevron* two-step analysis).

meaning of the word "producer" required examination of the range of potential definitions, so does finding the meaning of "purchased."

Presaging *Chevron*'s second step (asking whether the agency's interpretation is a reasonable interpretation), the Court in *Gray* went on to approve the commission's determination that the taxpayer's activities did not rise to the level of being a "producer."[292] The Court stated:

> To determine upon which side of the median line the particular instance falls calls for the expert, experienced judgment of those familiar with the industry. Unless we can say that a set of circumstances deemed by the Commission to bring them within the concept "producer" is so unrelated to the tasks entrusted by Congress to the Commission as in effect to deny a sensible exercise of judgment, it is the Court's duty to leave the Commission's judgment undisturbed.
> Consumers of bituminous coal are naturally desirous of obtaining supplies free of the tax and free of the risk and investment typical of production. If independent contractors are employed for extraction, there is an obvious breach in the full consumer-producer identity. This may create consequences which would not follow if the enterprise itself, through its own employees, accomplished the same ultimate result.[293]

Similar to *Gray*, the determination that using a contract manufacturer is in substance a "purchase" satisfies the second step in *Chevron* that the regulation be a reasonable interpretation. Just as using independent contractors in a leased coal mine did not qualify as the production of coal in *Gray*, using contract manufactures that produce in their own facilities is not manufacturing by the CFC-purchaser. Contract manufacturing permits CFCs easily to circumvent the legislative purpose underlying the foreign base company sales rule, *i.e.*, setting up a base of operation in a tax haven country and funneling profits through the tax haven. Thus, it is likely that a textualist would conclude that the proposed regulation satisfies the *Chevron* test.

A purposivist would similarly determine that the proposed regulation comports with the meaning of Section 954, since the legislative history makes clear that the "evil" Subpart F was addressing was using a tax haven as a base to collect tax-free income. Contract manufacturing greatly facilitates the use of the tax haven to accomplish this, and therefore, should be curbed.

292. *Gray*, 341 U.S. at 416.
293. *Id.* at 413.

When President Kennedy introduced legislation that ultimately led to the adoption of Subpart F, he stated:

> To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, . . . and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries.[294]

President Kennedy proposed eliminating the deferral of U.S. taxation on the earnings of CFCs in most situations. Congress, however, rejected this approach and instead sought to end deferral in certain situations that it identified as abusive. One such abuse was the separation of manufacturing activity from the tax haven subsidiary that would then be selling the goods outside the tax haven country. The Senate report, which accompanied the enactment of Subpart F, stated:

> The House bill did not go as far as the President recommended. It did not eliminate tax deferral generally, but instead was concerned primarily with what had been referred to as "tax haven" devices. To accomplish this result the House bill in general sought to end tax deferral for income . . . from foreign sales subsidiaries *which are separately incorporated from their manufacturing operations* . . . .[295]

The Senate report also noted:

> The definition [of foreign base company sales income] does not apply to income of a controlled foreign corporation from the sale of a product which *it manufactures*. In a case in which a controlled foreign corporation purchases parts or materials which *it then transforms or incorporates into a final product*, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, *so that, in effect, the final*

294. John F. Kennedy, Message from the President of the United States Relative to Our Federal Tax System (Apr. 20, 1961), *in* H.R. DOC. NO. 87-140, at 6–7 (1961). See also Lokken, *supra* note 18, at 189–9, for an excellent review of legislative history.

295. S. REP. NO. 87-1881, at 79 (1962) (emphasis added).

> *product is not the property purchased*. Manufacturing and construction activities (and production, processing, or assembling activities which are substantial in nature) would generally involve substantial transformation of purchased parts or materials.[296]

This legislative history shows that Congress wanted the manufacturing process to be conducted by the CFC itself, not by a third party. Consequently, the proposed regulation should be valid under the *Chevron* test.

2. Analysis of the Proposal to Eliminate the Contract Manufacturing Exception If the MQD Applies

The validity of the proposed regulations if the MQD applies is far less certain. The Supreme Court has ruled that *Chevron* deference does not apply where a regulation addresses a "major question."[297] The Court has stated that a major question exists where an agency is issuing a regulation that entails "vast economic and political significance."[298] Other factors considered by the Court are whether the subject matter of the regulation was outside the agency's core expertise[299] and whether the subject matter has intruded onto the domain of the states.[300] In a recent application of the MQD,[301] the Court stated that when a major question exists "[t]he agency . . . must point to 'clear congressional authorization' for the power it claims."[302]

Critics of the MQD have rightly pointed out that this inquiry can be abstract and open ended.[303] Given the MQD's ambiguity, it is not entirely

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296. *Id.* at 245 (emphasis added).

297. *See West Virginia v. EPA*, 142 S. Ct. 2587, 2610 (2022).

298. *Util. Air Regul. Grp. v. EPA*, 573 U.S. 302, 324 (2014) (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160 (2000)). *See also Nat'l Fed'n of Indep. Bus. v. Dep't of Lab., Occupational Safety & Health Admin.*, 142 S. Ct. 661, 665 (2022) (quoting *Ala. Ass'n of Realtors v. Dep't of Health & Hum. Servs.*, 141 S. Ct. 2485, 2489 (2022)).

299. *King v. Burwell*, 576 U.S. 473, 486 (2015).

300. *West Virginia*, 142 S. Ct. at 2620–21 (Gorsuch, J., concurring) (outlining circumstances that might "trigger" the MQD).

301. *Id.* at 2610.

302. *Id.* at 2609 (quoting *Util. Air*, 573 U.S. at 324). *See also Nat'l Fed'n of Indep. Bus.*, 142 S. Ct. at 665 (quoting *Ala. Ass'n of Realtors*, 141 S. Ct. at 2489) (stating that Congress must "speak clearly when authorizing an agency to exercise powers of vast economic and political significance"); *Util. Air*, 573 U.S. at 324 (same).

303. *See, e.g.*, Brunstein & Revesz, *supra* note 271, at 218–19 ("The Court has never defined what constitutes a major question, nor has it ever enumerated factors or set

clear whether the proposed amendment to the contract manufacturing exception involves a question of vast economic and political significance. Viewed in isolation, it is hard to believe that a highly technical, complex international tax provisions could be viewed as involving a major question.[304] International tax policy is clearly within the scope of IRS expertise and is not a matter commonly viewed to be within the domain of the States. However, the international tax provisions have significantly affected corporate tax revenues and have inflicted serious social and economic harms.[305]

The sense of the Senate vote discussed earlier,[306] also significantly complicates the analysis. Recall that Treasury proposed regulations in 1998 that would have repealed the contract manufacturing exception along with several other loopholes in the U.S. international tax scheme.[307] Treasury withdrew the proposed regulations after the Senate adopted a sense of the Senate vote that recommended that Treasury not adopt the proposed regulations.[308] Although the Senate report did not refer specifically to the repeal of contract manufacturing as a reason for its recommendation,[309] the report expressed the view that Subpart F was complex and should be addressed by the Senate as a whole:

> The subpart F provisions of the Code reflect a balancing of various policy objectives. Any modification or refinement to that balance should be the subject of serious and thoughtful debate. It is the Committee's view that any significant policy developments with respect to the subpart F provisions, such as those addressed by Notice 98–11 and the regulations issued

thresholds to answer this inquiry."); Sohoni, *supra* note 271, at 266 (observing that the Court's rulings have created "deep conceptual uncertainty"); Jonas J. Monast, *Major Questions About the Major Questions Doctrine*, 68 ADMIN. L. REV. 445, 448 (2016) ("More is unclear than clear about the bounds of the major questions doctrine at this stage."); Cass R. Sunstein, Chevron *Step Zero*, 92 VA. L. REV. 187, 243 (2006) ("[T]he difference between interstitial and major questions is extremely difficult to administer.").

304. *See* Nathan Richardson, *Keeping Big Cases from Making Bad Law: The Resurgent "Major Questions" Doctrine*, 49 CONN. L. REV. 355, 383 (2016) (observing that tax cases are unlikely to involve major questions even though "[m]any tax regulations are of crucial importance to an industry").

305. *See supra* Part II; *see also supra* text accompanying note 28.

306. *See supra* text accompanying notes 56–58.

307. *See supra* text accompanying notes 56–58.

308. *See supra* text accompanying notes 55–58.

309. S. REP. NO. 105-174, at 110–14 (1998).

> thereunder, should be considered by the Congress as part of the normal legislative process.[310]

In light of the sense of the Senate vote, it seems more likely than not that a court would conclude that eliminating the contract manufacturing exception is a major question.[311] The question then becomes how should the MQD be applied? Some have suggested that its application may takes two forms, which Sunstein describes as the "weak" form and "strong" form.[312] Sunstein theorizes that the "weak" form is, in effect, a "carve-out from *Chevron* deference."[313] Applying the weak form, a court eliminates judicial deference to an agency's interpretation and, instead, applies a de novo interpretation of the regulation.[314] In the strong form, a court simply invalidates the regulation.

Sunstein suggests that the strong form applies when a major question exists and the agency "is seeking to assert very broad power."[315] He cites as an example, *Utility Air Regulatory Group v. EPA*,[316] which Leske describes as a "divided and complex decision,"[317] which he interprets as the Court rejecting an EPA rule as unreasonable because the EPA's interpretation would have expanded its regulatory authority in a "transformative" way without "clear authorization from Congress."[318] A more recent example of the strong form of the MQD is *West Virginia v. EPA*[319] where the Court declined to "uphold EPA's claim of '*unheralded*' regulatory power over 'a significant portion of the American economy.'"[320]

Would the strong form or weak form of the MQD apply to a regulation that eliminates contract manufacturing? If the strong view applies, the Court would determine that the proposed regulation is invalid without any further analysis and legislative action would be required.

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310. *Id.* at 113–14.

311. *See generally Nat'l Fed'n of Indep. Bus. v. Dep't of Lab., Occupational Safety & Health Admin.*, 142 S. Ct. 661, 666 (2022) (observing that the Senate had disapproved the regulation under review in ruling that the regulation raised the MQD).

312. Cass R. Sunstein, *There Are Two "Major Questions" Doctrines*, 73 ADMIN. L. REV. 475, 477 (2021).

313. *Id.*

314. *Id.*; Kevin O. Leske, *Major Questions About the "Major Questions" Doctrine*, 5 MICH. J. ENV'T & ADMIN. L. 479, 496–97 (2016).

315. Sunstein, *supra* note 312, at 477.

316. 573 U.S. 302 (2014).

317. Leske, *supra* note 314, at 490.

318. Sunstein, *supra* note 312, at 477 n.17, 479 n.28.

319. 142 S. Ct. 2587 (2022).

320. *Id.* at 2608 (quoting *Util. Air Regul. Grp. v. EPA*, 573 U.S. 302, 324 (2014)).

There are strong arguments, however, that the strong view should not apply. First, the proposed amendment does not represent an "unheralded" expansion of Treasury's authority. Section 7805 authorizes Treasury to "prescribe all needful rules and regulations for the enforcement of this title . . . ."[321] Issuing regulations to close a loophole, which the IRS, itself, created in a prior regulation and which the NYSBA said renders the foreign base company sale rules ineffective represents "needful" regulations. Second, the proposed regulations are not outside the IRS expertise. The IRS is preeminently qualified to analyze international tax provisions. Third, the committee report accompanying the "Sense of the Senate" vote did not refer to the contract manufacturing rules and, therefore, arguably did not negate the directive in Section 7805. On the other hand, the "Sense of the Senate" vote could be viewed as a statement that the Senate preferred to reserve *any* change to Subpart F, including a change to the manufacturing exception, to itself, not to Treasury. While the answer is not entirely clear, the arguments do favor application of the weak form.

The only Supreme Court decision to apply the MQD to a tax regulation is *King v. Burwell*[322] and the Court did apply the "weak form" in that decision. The question in *King* was whether a tax credit for the purchase of health insurance should apply to insurance that has been purchased on a federal-established exchange.[323] The statute allowed the tax credit for insurance purchased "on an Exchange established *by the State* . . . ."[324] The IRS adopted a regulation allowing the credit for insurance purchased on a *federal* exchange as well as for insurance purchased on a state exchange.[325]

The Court determined that a major question was involved, stating that the tax credit involved "billions of dollars in spending each year" and affected "the price of health insurance for millions of people."[326] The Court also noted that the IRS lacked expertise in formulating health insurance policy.[327] Although the Court refused to apply *Chevron* deference, it upheld the regulation based on its determination that the regulation was a "correct" interpretation of the statute.[328]

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321. I.R.C. § 7805(a).

322. 576 U.S. 473 (2015).

323. *Id.* at 479.

324. *Id.* at 483; 26 U.S.C. § 36B(b) (emphasis added).

325. *King*, 576 U.S. at 483; Treas. Reg. § 1.36B-2 (2013).

326. *King*, 576 U.S. at 485.

327. *Id.* at 486.

328. *Id.* Rejecting the applicability of the *Chevron* standard, the Court stated, "It is instead our task to determine the correct reading of Section 36B." *Id.*

The arguments for applying the weak form of the MQD to the proposed regulation to eliminate contract manufacturing are stronger than in *King*. The IRS possesses significant expertise in international tax (as compared to health insurance) and the regulation addresses a subject matter (international tax) that is not within the domain of states (as compared to health insurance, which is often subject to significant state oversight).

If the weak form of the MQD applies, a de novo review, similar to the review in *King*, of the proposed regulation should determine that the proposed regulation is the correct interpretation of the statute under either a textual or purposivist method of interpretation. As discussed earlier, the purpose of Section 954 is to prevent U.S. MNEs from funneling their income through a CFC located in a tax haven.[329] The statutory language and legislative history strongly suggest that to avoid having "purchased" an item, the CFC must have manufactured the item itself.[330]

C. Validity of the Proposed Regulation to Narrow the Scope of the CTB Regulation

1. ANALYSIS UNDER *CHEVRON* IF THE MQD DOES NOT APPLY

Similar analysis applies to this Article's proposal to not allow the sole owner of a foreign entity to disregard it. If the proposed regulation is not a major question, it is likely that the proposed regulation would be valid under the *Chevron* doctrine.

In compliance with step one of *Chevron*, Section 7701 is quite ambiguous. Section 7701 does not address the treatment of wholly owned entities and, in fact, provides little guidance on the classification of entities in general, including (amazingly) the classification of corporations.[331] Section 7701(a)(3) merely states, "The term 'corporation' includes associations, joint-stock companies, and insurance companies."[332] In an early case, *Morrissey v. Commissioner*,[333] the Supreme Court, approving a previous version of regulations under Section 7701, stated:

> As the statute merely provided that the term "corporation" should include "associations," without further definition, the

329. *See supra* text accompanying notes 281–82.
330. *See supra* text accompanying notes 281–82.
331. *See* I.R.C. § 7701.
332. I.R.C. § 7701(a)(3).
333. 296 U.S. 344 (1935).

> Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction.[334]

The Court went on to note that Treasury would be free to make future changes to the regulations as well:

> Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision.[335]

Several courts have subsequently applied the *Chevron* doctrine to determine the validity of the CTB regulations.[336] All the cases have concluded that Section 7701 is ambiguous and that the regulation was a reasonable interpretation.[337]

As a result, if the change proposed in this Article does not present a major question, it is likely that a court would similarly conclude that *Chevron* deference should apply to eliminate the election to disregard foreign entities. The Court in *Chevron*, as had the Court in the earlier *Morrissey* decision, observed that an agency's interpretation of a statute, as reflected in the regulations it promulgates, can be revised to meet changing circumstances. This should be particularly true given that the election has created such a large opportunity to avoid Subpart F and has had such an adverse effect on our nation.

2. Analysis If the MQD Does Apply

As is the case with the manufacturing exception, the application of the MQD to this proposal is not entirely clear. In 1998, Treasury proposed regulations under Subpart F that would have curtailed transactions under Subpart F that involved the use of hybrid entities.[338] Hybrid entities are entities that are treated as a corporation in one jurisdiction, but as a different type of entity, such as a partnership, in

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334. *Id.* at 354–55.

335. *Id.* at 355. *See supra* note 275 (discussing the current standard of review for changes to regulations).

336. *See, e.g.*, *McNamee v. Dep't of the Treasury*, 488 F.3d 100, 105 (2d Cir. 2007); *Littriello v. United States*, 484 F.3d 372, 374 (6th Cir. 2007); *Med. Prac. Sols., LLC v. Comm'r*, 132 T.C. 125, 129 (2009), *aff'd without published opinion* (1st Cir. 2010); *Kandi v. United States*, 295 F. App'x. 873 (9th Cir. 2008).

337. *See* cases cited *supra* note 336.

338. T.D. 8767, 1998-1 C.B. 875, *withdrawn by* T.D. 8827, 1999-2 C.B. 120.

another jurisdiction. The regulations proposed by Treasury in 1998 did not target the abuses discussed in this Article. Rather they focused on payments by a CFC to a related hybrid entity that would reduce the paying CFC's tax liability in its country while not increasing the recipient hybrid entity's tax liability.[339] The Senate passed a bill that would have placed a moratorium on the regulations.[340] The accompanying committee report noted that "[t]he impact of such administrative guidance on U.S. businesses operating abroad may be substantial."[341]

Although the moratorium was not ultimately enacted, Treasury withdrew the regulations, only to propose them again one year later.[342] The proposed regulations have never become effective.[343]

This Article's proposal to prohibit the disregard of a wholly owned entity that is formed in a foreign country could be viewed as involving a "hybrid" entity. The foreign "eligible entities" that may be disregarded in the CTB regulations are often entities that have characteristics that resemble both partnerships and corporations. When a sole shareholder elects to disregard its wholly owned entity that is incorporated in another country, it is in effect creating a hybrid entity that may be taxed as a corporation in the foreign country and disregarded in the U.S. Consequently, the Senate's caution about the treatment of hybrids could be viewed as applicable to the proposal in this Article.

The result is that it is not clear whether this Article's proposal rises to the level of a major question. On the one hand, the Senate has expressed concern about using regulations to correct the abuse of Subpart F by hybrids.[344] On the other, the specific abuse targeted in the proposed regulations that concerned the Senate is not the same as the considered here. Moreover, the regulation is within the scope of IRS expertise, is

339. S*ee* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 69.13.1 (3d ed. 2023).

340. H.R. RES. 2676, 105th Cong. § 3713(a) (as amended and passed by Senate, May 7, 1998).

341. S. REP. NO. 105-174, at 110 (1998). To expand, the Senate Finance Committee explained:

> Notice 98 -11 and the regulations issued thereunder address complex international tax issues relating to the treatment of hybrid transactions under the subpart F provisions of the Code. The impact of such administrative guidance on U.S. businesses operating abroad may be substantial. The Committee believes that it is appropriate to place a moratorium on the implementation of the regulations with respect to Notice 98 -11 so that these important issues can be considered by the Congress.

Id.

342. BITTKER & LOKKEN, *supra* note 339, at ¶ 69.13.1.

343. *Id.*

344. *See supra* text accompanying notes 306–11.

not within the domain of the states and Section 7805 grants rule making authority to issue "needful" regulations.[345] Lastly, if the proposed regulation implicates the MQD, presumably the initial adoption of the CTB regulations did as well.

If the MQD does apply, the fact that the proposal is within IRS expertise is not within the domain of the states, and is a "needful" regulation under Section 7805, strongly supports application of the weak form of the MQD. Applying the weak form of the MQD, it is more likely than not that the proposed restriction on disregarding foreign entities would be valid. The ambiguity of Section 7701 allows for many potential interpretations.

This Article's proposed regulation is the best interpretation. Given the historic insistence of the courts to treat entities as separate from their owners,[346] the proposal is merely returning the state of law back to its original form with respect to foreign entities by requiring that an entity be treated as separate from its owner. As the Court noted in *Morrissey*, Treasury can modify the regulations "to meet administrative exigencies."[347] The attempt of the CTB regulations to achieve simplification with respect to foreign entities has created such an exigency given its harmful impact on the Subpart F rules and our nation. Simplicity should not be allowed to undermine the important objectives of Subpart F.

CONCLUSION

Two tax regulations that permit U.S. MNEs to use foreign contract manufacturers and to disregard their wholly owned foreign subsidiaries have created significant tax incentives for MNEs to move manufacturing outside the United States. These tax incentives have contributed to the loss of five million manufacturing jobs and the closure of more than 91,000 plants since 1997. The job losses have increased racial and economic inequality and stressed our political system. But the losses arising from offshore manufacturing extend to other areas, as well. Offshore manufacturing increases U.S. exposure to supply chain disruptions, threatens U.S. national security, and decreases research and development efforts to improve production techniques. Also, as automated manufacturing increases, the use of offshore manufacturing hinders the ability of the U.S. to compete in that sector. Although the

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345. *See supra* text accompanying notes 320–22.

346. *See supra* text accompanying notes 81, 94.

347. *See supra* text at note 335. *See also supra* note 275 (discussing the current standard of review for regulations, which involve an agency policy change).

recently enacted U.S. corporate AMT and the OECD's Pillar Two initiative may in some instances reduce the incentive to use offshore contract manufacturers, they have not eliminated it.

This Article proposes two amendments to eliminate the regulations' incentives. First, CFCs should not be allowed to use contract manufacturers to qualify for the manufacturing exception in Subpart F. Second, U.S. MNEs should not be permitted to disregard foreign entities. Under the *Chevron* doctrine, both proposals would clearly be valid. The evolving MQD, however, has created significant uncertainty about whether the deference provided by the *Chevron* doctrine would apply. This Article concludes that the "weak form" of the MQD should apply to validate the proposed regulations.

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