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WHAT WOULD SURREY SAY? THE LONG REACH OF STANLEY S. SURREY

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I

INTRODUCTION

Stanley S. Surrey died in 1984, two years before the enactment of the Tax Reform Act of 1986, which gave us the Internal Revenue Code of 1986 as amended. Historians have recently discovered Surrey's work through his memoirs, published in 2022, and several articles based on the memoir and on the unpublished Surrey papers at Harvard Law School.[1] There is no doubt that Surrey was a towering historical figure during his "Half-Century with the Internal Revenue Code."[2] As his protégé Donald Lubick, who served as Assistant Secretary for Tax Policy in both the Carter and the Clinton Administrations, stated, Surrey "dominated tax policy both in the United States and internationally in the 1960s and '70s."[3] As of 1970, Surrey was the most cited tax scholar, "with more than twice the citations of his closest contemporary and occasional rival, Boris I. Bittker."[4]

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1. *See generally* STANLEY S. SURREY, A HALF-CENTURY WITH THE INTERNAL REVENUE CODE: THE MEMOIRS OF STANLEY S. SURREY (Lawrence A. Zelenak and Ajay K. Mehrotra eds., 2022) [hereinafter A-HALF CENTURY WITH THE INTERNAL REVENUE CODE]. *See also* Reuven Avi-Yonah & Gianluca Mazzoni, *Stanley Surrey, the 1981 US Model, and the Single Tax Principle*, 49 INTERTAX 729 (2021) (discussing the origins of the single tax principle (STP) and Surrey's contributions towards the implementation of the STP); Reuven Avi-Yonah & Nir Fishbien, *Stanley Surrey, the Code and the Regime*, 25 FLA. TAX REV. 119 (2021) [hereinafter Avi-Yonah & Fishbien, *Stanley Surrey, the Code and the Regime*] (arguing how Surrey's biggest contribution was in shaping the international tax regime in addition to his contribution in shaping domestic tax policy); Nir Fishbien, *From Switzerland with Love: Surrey's Papers and the Original Intent(s) of Subpart-F*, 38 VA. TAX REV. 1 (2018) (discussing how the original intent behind Subpart-F was to eliminate the principle of tax deferral and protection of the U.S. tax base); Reuven Avi-Yonah & Nir Fishbien, *Once More, With Feeling: TRA 17 and Original Intent of Subpart F*, 157 TAX NOTES 959 (2017) [hereinafter Avi-Yonah & Fishbien, *Once More, With Feeling*] (arguing that there should be a return to the original intent of Subpart-F and that foreign income should be subject to the same rate as domestic income).

2. SURREY, *supra* note 1.

3. Lawrence A. Zelenak & Ajay K. Mehrotra, *Editors' Introduction*, *in* A HALF-CENTURY WITH THE INTERNAL REVENUE CODE, *supra* note 1, at xiii (quoting Donald C. Lubick, *A View from Washington*, 98 HARV. L. REV. 338, 338 (1984)).

4. *Id.* at xii (citing Terrance O'Reilly, *Tax Legal Scholarship to 1970*, 34 VA. TAX REV. 269, 273, tbl. 1 (2014)).

But this journal is about law and *contemporary* problems, and someone who is uninterested in tax history but who cares about contemporary tax law and policy may well ask, Why should I care about Surrey? This essay will try to answer this question by discussing some of the ways Surrey influenced current tax law and policy. This is true not just for the myriad of Code provisions Surrey was involved in creating, but also for the provisions that were created long after his death.[5] It is the latter sort that will concern us here, with a focus on (a) the Tax Reform Act of 1986 (TRA86); (b) the current U.S. model tax treaty (2016);(c) The Tax Cuts and Jobs Act of 2017 (TCJA), and (d) the ongoing OECD Base Erosion and Profit Shifting (BEPS) project (2013).

II

SURREY AND THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 is famous for reducing rates (from fifty to twenty-eight percent for individuals and from forty-six to thirty-five percent for corporations), while expanding the base (for example, by creating the passive activity loss limitation for individuals, which eliminated a host of tax shelters, and by limiting the use of losses acquired corporations under section 382, and repealing the *General Utilities* doctrine, to name but a few). It was the last time a tax reform was revenue neutral and is generally regarded positively by tax policy mavens.[6]

Surrey invented the concept of a rate reducing, base broadening tax reform. As he says in his memoirs:

> Perhaps one of the important articles and also Congressional testimony in [the late 1950s] was a discussion of the contrast in our individual income tax between very high tax rates [over 90%] and the undercutting of the tax base through many tax preferences— "loopholes" in popular parlance—that made the actual effective rates of tax far lower than the high rate schedules would indicate, especially in the upper

5. *See* Avi-Yonah & Fishbien, *Stanley Surrey, the Code, and the Regime*, *supra* note 1, at 125–26. These included the deduction for medical expenses; taxation of alimony to the payee and deduction of the payment by the payor; a deduction for child care expenses; a section allowing a deduction for expenses incurred in investment activities; permission to a corporate group to file a consolidated return; a carryback of business losses; and a rule limiting inclusion in income of recovered items previously deducted—such as bad debts or refunded tax—to situations in which the earlier deduction had produced a tax benefit. Surrey also invented "hobby losses" and got the first limit on the acquisition of loss corporations enacted (Section 269). In 1944, as a result of the extension of the income tax to most of the U.S. population, Surrey was involved in the creation of tax tables and of the standard deduction, both measures designed to simplify tax administration for mass consumption. In 1946 he was responsible for treating stock options as compensation not when they were granted (since "it was really impossible to measure [their] value with any reasonable degree of accuracy") but when they were exercised, an approach that still applies today despite the advances in valuing options since then. He also created the concept of grantor trusts. For an overview of these reforms, see generally SURREY, *supra* note 1.

6. *See, e.g.*, Andrew Chamberlain, *Twenty Years Later: The Tax Reform Act of 1986*, TAX FOUND. (Oct. 23, 2006), https://taxfoundation.org/twenty-years-later-tax-reform-act-1986 [https://perma.cc/M9AJ-5H4V] ("Yesterday marked the 20th anniversary of the nation's most recent federal tax overhaul—the Tax Reform Act of 1986. Although much of what that reform accomplished has been unwound over the years by lawmakers eager to reward constituents with tax preferences, it stands as a rare example of bipartisan support for fundamentally sound tax policy.").

> brackets. I suggested as a broad corrective approach the removal or lessening of the preferences and a reduction in toprates of tax.[7]

In 1960, Surrey (with two economists, E. Cary Brown and Richard Musgrave) wrote a paper on tax policy for the Kennedy presidential campaign:

> The paper then turned to a strongly urged recommendation for reform of the income tax through broadening the taxable base. This goal was to be achieved by eliminating or reducing many existing preferences that presently narrowed that base severely and thus made high statutory rates misleading. Items stressed, in addition to the previously mentioned [ones], included: withholding on dividends and interest payments to end the non-compliance in reporting this income; reduction in percentage depletion for oil and other material resources; a cut-back in various personal deductions such as for state and local taxes and mortgage interest; and restrictions on expense accounts.[8]

After Kennedy's victory in the election, Surrey and Musgrave also wrote that:

> It must be remembered that the case for reform rests on an unassailable base—the concept of tax equity under which persons with equal incomes pay equal taxes. The argument that with each taxpayer paying his share, in relation to other taxpayers with the same income, therates of tax can be reduced and the same revenue still obtained is a highly effective argument.This aspect of associating reform of the tax base with rate reductions in the upper and lowerbrackets significantly differentiates this approach from the usual "loophole closing" campaign. What is needed is strong leadership to bring this argument forcibly to the attentionof the public, backed by a program to accomplish the objective.[9]

The Tax Reform Act of 1986 was based on these concepts. Despite all the subsequent changes, it was still the defining law for the Internal Revenue Code of 1986. It is a real pity that Surrey did not live to see it enacted. He would have been delighted and proud.

III

SURREY AND THE 2016 U.S. MODEL TREATY

Surrey was largely responsible for the original practical application of the Single Tax Principle (STP), which states that cross-border income should be subject to neither double taxation nor double non-taxation.[10] His original statement of the principle came in the context of his 1957 Senate testimony against ratification of a new U.S.-Pakistan tax treaty, which provided for a tax

7. SURREY, *supra* note 1, at 97.

8. *Id.* at 176–77.

9. *Id.* at 184.

10. *See, e.g.,* Reuven Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997); Reuven Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 N.Y.L. SCH. L. REV. 305 (2015) [hereinafter Avi-Yonah, *Who Invented the Single Tax Principle?*] (providing background information on the Single Tax Principle). *See also* Reuven Avi-Yonah, *Full Circle? The Single Tax Principle, BEPS, and the New US Model*, 1 GLOB. TAX'N 12 (2016) [hereinafter Avi-Yonah, *Full Circle?*] (arguing that we have now come full circle from the League of Nations explicitly acknowledging the single tax principle in 1927 to the U.S., OECD, and G20 officially adopting it as their goal in 2015). *See* Gianluca Mazzoni, *Present at the Creation: Archival Research and Evidence on the Origins of the Single Tax Principle,* 47 INTERTAX 813 (2019) (explaining that the historical origins of the STP are much older, dating back to the U.S. adoption of the foreign tax credit (instead of an exemption) in 1918 and to the work of the League of Nations in the 1920s).

sparing credit for taxes that would have been paid to Pakistan, but for a tax holiday:

> The foreign tax credit was designed to give a credit for foreign income taxes paid, and thereby to reduce the otherwise double taxation that would arise from application of both the United States and the foreign tax on the same income. But the Pakistan treaty would extend the foreign tax credit to a foreign tax not paid in a situation where no double taxation could exist. A U.S. corporation that could obtain a reduction of its U.S. tax on the foreign source income by showing a receipt for a foreign tax it had paid could now also obtain the credit by showing a receipt for a foreign tax not paid. As a result neither the foreign country, here Pakistan, because of its tax incentive reduction, nor the United States, because of the grant of a credit for a non-tax reducing pro tanto of the U.S. tax, would be taxing the income involved, and the corporation would be home free.[11]

Once he became the first Assistant Secretary for Tax Policy, Surrey was able to implement the STP in actual U.S. tax treaties. Gianluca Mazzoni laid out the details in his excellent article based on the Surrey papers:

> The first US treaty which had some indication that double non-taxation of US source income was inappropriate was the treaty with Luxembourg, concluded in 1962, which precluded the application of reduced US withholding rates to certain Luxembourgian holding corporations that were not subject to tax on a residence basis. . . . Article XV of the 1962 tax convention with Luxembourg was directed primarily at Luxembourg "holding companies" as defined under then existing Luxembourg law. Such companies were exempt from income, property and trade taxes on their dividend income from all sources provided that they did not engage in trade or business. In addition, nonresident shareholders (corporate and individual) were not subject to Luxembourg tax on income from a Luxembourg holding company. Article XV rendered the provisions of the tax convention inapplicable to income of Luxembourg"holding companies" or to income derived therefrom by their shareholders. . . . In summary, the 1962 treaty with Luxembourg was the first one where the US adopted a so-called "preferential tax treatment" approach according to which certain convention benefits are denied to any entity which by virtue of "special measures" issubject to taxation on the benefited income at rates substantially lower than those generally applicable in the State in which the entity is organized, if the entity is ownedto a substantial extent by persons not entitled to the benefits of the convention. . . . According to Surrey, the theoretical justification behind such provisions was that if preferential measures substantially mitigate taxation by the State of residence, e.g., Luxembourg Law of July 31, 1929, and Decree Law of December 27, 1937, then there is little danger of double taxation, and cession by the United States, as a sourcecountry, of its right to tax is not appropriate. . . . Interestingly, the US official explanation proposed by the US Treasury Department stated that although thepreferential tax treatment approach was not found in any income tax convention concluded by the United States . . . certain precedent may be found in some of the relief provisions contained in the conventions with the United Kingdom, Ireland, Australia, and Pakistan requiring that the recipient of treaty income 'be subject to tax'on such income in the country of residence in order to qualify for exemption from, or reduction in the rate of, the tax of the country of source. The US official explanation also stated that Article XV was consistent with the spirit of the provisions of section12 of the Revenue Act of 1962 relating to the taxation of certain "tax-haven" income of controlled foreign corporations ("CFCs") to US shareholders. In our opinion, this last sentence is a clear and undeniable indication that Surrey wanted to close the loopholes of US international tax rules by adopting both a top-down (introducing Subpart F legislation dealing with the issue of base companies from the perspective of residence country) and a bottom-up approach (introducing Limitation on Benefits ("LOBs")

11. SURREY, *supra* note 1, at 164–65.

> provisions dealing with the issue of conduit companies from the perspective of source country).[12]

Similar language to the Luxembourg treaty appears in the 1963 treaty with the Netherlands Antilles.[13]

In renegotiating the treaty with Canada in 1964–1965, Surrey insisted on a provision to close a tax loophole arising out of a combination of Canadian law and the U.S.–Canadian income tax treaty. Under that treaty, a reduced U.S. withholding tax applied to income paid to a corporation created under the laws of Canada. However, under Canadian law, no tax was imposed on a company created in Canada if it was managed and controlled abroad. It appeared to Surrey that such companies were then being organized with management and control in Bermuda, the Bahamas, and other tax haven countries that levied no tax on a company that was managed and controlled there. The result was that third-country nationals were beginning to take advantage of a loophole similar to that of the Netherlands Antilles. On April 13, 1965, the Treasury published the following press release titled, *United States to Act against Tax Avoidance under Canadian Tax Treaty*:

> Action will soon be initiated by the United States to tighten the tax rules that apply to income flowing between the United States and Canada so as to eliminate a tax avoidance device which now permits people living outside both countries to receive investment income from the United States at substantially reduced tax rates, the Treasury Department announced today. This unintended tax preference results from the interaction of existing Canadian law and the provisions of the existing tax treaty between the United States and Canada. The treaty provides that a company organizedin Canada and receiving investment income from the United States is subject to a 15 percent US withholding tax on such income rather than the usual 30 percent. However, Canadian law provides that a company organized under Canadian law but deriving its income from outside Canada shall be exempt from Canadian taxes if the company is managed and controlled outside Canada. The combination of these provisions makes it possible for such a Canadian company to be used by third country residents as a device to avoid US taxes. A holding company, a mutual investment fund, or a similar investment company created under Canadian law but managed and controlled in a "tax haven" country may be used to make investments in the United States by people living in countries that have no tax treaty with the United States. Such people can derive investment income subject only to a 15 percent withholding tax in the United States and to no tax whatsoever in either Canada or their home country. A modification of the income tax treaty between the United States and the Netherlands last year led to elimination of the Netherlands Antilles as a place through which third country residents could similarly avoid taxes on investment income. As a result Canadian corporations may now be in the process of being established for thesame purpose. It is anticipated that discussions will be held soon with the Canadian authorities to consider appropriate measures to eliminate the tax avoidance described.[14]

On October 25, 1966, a new paragraph 6 was added to article XI of the US–Canada Income Tax Treaty of 1942:

> Paragraph 1 of this Article shall not apply in respect of income derived from sources in one of the Contracting States and paid to a corporation organized under the laws of the

12. Avi-Yonah & Mazzoni, *supra* note 1, at 730–32 (emphasis omitted). On Subpart F, see generally Avi-Yonah & Fishbien, *Stanley Surrey, the Code and the Regime, supra* note 1; Fishbien, *supra* note 1.

13. *See* Avi-Yonah & Mazzoni, *supra* note 1, at 732.

14. *Id.* at 736–37.

> other Contracting State if such corporation is not subject to tax by the last-mentioned Contracting State on that income because it is not a resident of the last-mentioned Contracting State for purposes of its income tax.[15]

In 1981, the first U.S. Model tax treaty was published, which contained the following language:

> 1. A person (other than an individual) which is a resident of a Contracting Stateshall not be entitled under this Convention to relief from taxation in the otherContracting State unless (a) more than 75 percent of the beneficial interest insuch person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States. For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State ispresumed to be owned by individual residents of that Contracting State.
>
> 2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have asa principal purpose obtaining benefits under the Convention.
>
> 3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.[16]

This was the first limitation on benefits (LOB) provision, which thereafter appears in every U.S. tax treaty negotiated from 1984 onward. The LOB provision has been interpreted as preventing a "treaty with the world."[17] However, the last provision (number three above) shows that it was also designed to implement the STP, since source-based taxation would not be reduced unless residence-based taxation was assured, regardless of who owned the foreign corporation. This provision is based directly on the ones negotiated under Surrey's leadership in the 1960s.

Thereafter, such LOB provisions disappear from the U.S. Models of 1996 and 2006 but reappear in the current U.S. Model of 2016, which was drafted in the context of the OECD BEPS project, which in turn was based on the STP.[18] In the 2016 Model, similarly to the 1981 LOB, treaty benefits are denied to a company unless:

> [W]ith respect to benefits under this Convention other than under Article 10 (Dividends), less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property . . .) [either] to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; [*or*] *to persons that*

15. *Id.* at 737.

16. Avi-Yonah, *Who Invented the Single Tax Principle?*, *supra* note 10, at 312 n.49.

17. H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 LAW & POL'Y INT'L BUS. 763 (1983).

18. *See generally* Avi-Yonah, *Full Circle?*, *supra* note 10.

> *meet this requirement but that benefit from a special tax regime in their Contracting State of residence with respect to the deductible payment . . . .*[19]

"Special Tax Regime" is a newly defined term in the 2016 Model:

> The term "special tax regime" with respect to an item of income or profit means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base.[20]

This rule means that the withholding tax reductions of the treaty will not apply to a company when fifty percent or more of its income (or of the income of its consolidated group) is paid in deductible payments either to residents of third countries or to a company in the treaty partner country that is subject to a low effective tax rate because of a special tax regime. As in the 1981 LOB, this provision makes it clear that the purpose of the LOB is to enforce the STP, not just to prevent a treaty with the world. The current provision is derived directly from Surrey's work in the 1960s.

IV

SURREY AND THE TAX CUTS AND JOBS ACT OF 2017 (TCJA)

On its face, it is surprising to assert that Surrey had any impact on the TCJA, given that he was always a Democrat, and the TCJA was entirely created by Republicans. However, several provisions of the TCJA are based on the STP.

The TCJA represents the most far-reaching reform of the U.S. international tax rules since Subpart F was enacted under Surrey in 1962. Most importantly, the TCJA, for the first time since the income tax was enacted in 1913, changes the rule that U.S. resident taxpayers have to pay tax on all income "from whatever source derived."[21] Under the TCJA, dividends paid to U.S. corporate parents from non-Subpart F income of their foreign subsidiaries are exempt from U.S. tax. That remains true even if the dividend was not subject to a withholding tax at source and was paid out of earnings that were not subject to foreign tax in the country where the subsidiary is incorporated.

This participation exemption is similar to the tax rules of our main trading partners in Europe and Asia. On the face of it, the participation exemption represents a glaring deviation from the STP. The participation exemption violates this principle because it exempts dividends from residence taxation even if they were not taxed at source.

But the violation is less blatant than it appears. First, the participation exemption only applies to ten percent of corporate shareholders. Portfolio U.S.

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19. U.S. Department of Treasury, United States Model Income Tax Convention art. 22 (2016), https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf [https://perma.cc/TZ6D-KAUP] (emphasis added).

20. U.S. Department of Treasury, United States Model Income Tax Convention art. 3 (2016), https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf [https://perma.cc/LY52-6RBH].

21. U.S. CONST. amend. XVI; I.R.C. § 61.

investors still are taxed on foreign source dividends. Moreover, when the U.S. parent distributes a dividend to its taxable U.S. shareholders or buys back their shares, the distribution is fully taxable at the dividend–capital gains rate of 23.8%.

Second, in conjunction with adopting the participation exemption, the TCJA significantly strengthened Subpart F. Specifically, IRC section 951A now currently taxes U.S. parents of controlled foreign corporations (CFCs) on their global intangible low-taxed income, or GILTI, at a 10.5% rate. GILTI is defined broadly as any income that exceeds a ten percent return on the CFCs' basis in their tangible assets (the "hurdle rate") with a credit for foreign taxes.

In the years leading to the enactment of Subpart F in 1962, U.S. multinational enterprises (MNEs) were able to avoid any U.S. tax on the foreign income earned by their foreign subsidiaries due to the rules that imposed U.S. tax only if and when such earnings were distributed back to the U.S. parent. The result was U.S. parents incorporating shell subsidiaries in foreign countries—mainly Switzerland—and booking foreign revenues under those subsidiaries. The U.S. tax on the foreign earnings were in effect deferred indefinitely, as the U.S. parent would cause the earnings to be reinvested outside of the United States or use the equity in subsidiaries, (or their assets) as collateral to finance its activities back home.

The direct effect of deferral was to increase the deficit in the U.S. balance of payments, since U.S. parents were (i) incentivized to invest outside of the United States, thus increasing the outflow of U.S. dollars and (ii) disincentivized to bring foreign earning back home, thus decreasing the potential inflow of U.S. dollars. Indeed, in the years from 1958 through 1960, the United States experienced deficits in its balance of payments, averaging $3.7 billion per year. For comparison, the average U.S. deficit for the years from 1950 through 1957 was only $1.25 billion per year.[22]

An ongoing deficit in the balance of payments meant that foreign hands (and eventually foreign governments) held more U.S. dollars than U.S. hands (or the U.S. government) held foreign currency. To maintain the value of the U.S. dollar and prevent any potential manipulation by foreign governments, the United States had to purchase back U.S. dollars from foreign governments in exchange for gold. Gold reserves were at the utmost value due to the gold standard, and there was a public concern that the United States will not be able to maintain the U.S. dollar's strong position in the world economy, due to its shrinking gold reserves.

Public outrage from the U.S. deficit in the balance of payments provided Surrey, then the first Treasury's Assistant Secretary for Tax Policy, the tailwind he needed to eliminate deferral, at least partially. Surrey strongly opposed deferral for two main reasons.

22. *The United States Balance of Payments 1946-1960*, 43 MONTHLY REV. FED. RSRV. BANK ST. LOUIS, no. 3, 1961, at 2.

First, and most importantly, equity. Surrey did not see a reason to allow a U.S. parent with foreign activities to acquire the tax benefits that the same U.S. parent would not be able to obtain with respect to domestic investment. In his mind, deferral was part of a growing group of tax incentives that resulted in an unfair tax system. The first indication of Surrey's concern for equity and fairness can be found five years earlier, when he wrote in opposition to provisions in the Code granting special tax treatment to certain groups or individuals.[23] Surrey warned in a 1959 statement to the House Ways and Means Committee about the growing trend of differential tax liability with respect to the source of income and its harmful effect on the tax system.[24]

The second reason was that Surrey believed that eliminating tax deferral is efficient, as it maintains the principle of capital export neutrality—that is, the indifference any resident taxpayer should face when considering a domestic versus foreign investment. In an address he delivered following the enactment of Subpart F, Surrey noted:

> [The 1962 Revenue Act] marked the most extensive range of tax legislation affecting the foreign area to be embodied in a single measure. It involved a revision of our statutory international tax rules designed to bring them into harmony with non-tax international developments and to end abuses which had been cumulating in this area. The principal features of the 1962 revision are based on a concept of "tax neutrality" between investment abroad in developed areas and in the United States. Under this concept it is inappropriate for our tax laws to offer artificial tax inducements to investments in developed countries, since given the growing similarity between the investment climate at the United States and the developed world it is no longer in our national interest to offer tax incentives designed affirmatively to encourage investment to leave our shores rather than stay home.[25]

President Kennedy was a full supporter of ending deferral. In his message to Congress about the tax treatment of foreign income on April 20, 1961, he noted:

> Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system of other countries, consistently favor United States private investment abroad compared with investment in our own economy. . . . The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. . . . 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, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States.[26]

23. Stanley S. Surrey, *The Congress and the Tax Lobbyist: How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1146–47 (1957).

24. *See* STAFF OF H.R. COMM. ON WAYS AND MEANS, 86TH CONG., INCOME TAX REVISION: PANEL DISCUSSION 6–8 (Comm. Print 1959). Surrey opposed tax breaks, arguing that "[t]his method of reducing tax burdens has resulted in very considerable tax inequalities. . . . The important point is that the Treasury and the Congress face the issue and recognize the serious problems and discriminations brought about by the present income tax differentials." *Id.* at 6, 8.

25. Stanley S. Surrey, *The United States Tax System and International Tax Relationships*, 43 TAX MAG. 1, 24 (1965).

26. *See* President John F. Kennedy, Special Message to the Congress on Taxation (Apr. 20, 1961).

But things didn't go exactly as planned. The plan to eliminate deferral and subject foreign earnings of U.S. MNEs to full current taxation encountered fierce opposition both from the business community and Congress. Congress was mainly concerned with the principle of capital import neutrality, noting that U.S. MNEs operating in foreign countries should be subject to the same level of tax as their domestic competitors to maintain a competitive position. The result was legislation that eliminated deferral only with respect to foreign passive income. This measure was later easily bypassed by U.S. MNEs with the introduction of the check-the-box regulations. That piece of regulation adopted by the Clinton administration in 1996 completely undermined Subpart F and allowed U.S. MNEs to amass three trillion dollars in low-tax jurisdictions without being subject to current U.S. tax (a situation that would have appalled Surrey). Ironically, it is the TCJA and, in a sense, the GILTI regime that better reflects what Surrey originally envisioned—both in terms of subjecting all foreign earnings of a CFC to U.S. tax and in terms of focusing on tax haven corporations.

On June 22, 1961, Surrey drafted a memo, addressed to Secretary Dillon, titled "Foreign Income — Stages of retreat on the proposal to tax the U.S. shareholders of controlled foreign corporations on undistributed profits and the technical changes to be considered as a result of the hearings."[27] The purpose of the memo was to provide the Secretary of the Treasury, Douglass Dillon, with alternative measures when facing Congress's opposition to the original draft of the legislation, which would have eliminated deferral all together—not just with respect to passive income—and subject foreign earnings of U.S. MNEs to full U.S. tax on a current basis.

Surrey included in his memo a couple of interesting alternatives. The first was to limit the scope of the proposal by raising the percentage of ownership required to qualify as a CFC from fifty to eighty percent. The second was to limit the application of the proposal to tax haven corporations that were subject to lower or zero rates of tax.[28]

Under GILTI, U.S. parents of CFCs are effectively subject to a minimum tax of 10.5% on all of their offshore earnings, whether passive or active, that exceed the hurdle rate. The tax on GILTI is consistent with the STP and Surrey's view. Albeit it provides a lower rate, contrary to pre-TCJA law, it ensures that offshore earnings that exceed the hurdle rate are taxed at 10.5%, and that a residence-based tax applies to those earnings to the extent they are not taxed at source. Notably, the rate is set to increase to 13.125% in 2026 (in effect reducing the deduction under section 250), and the recent green book by the Biden administration has proposed raising the effective rate under GILTI to twenty

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27. Memorandum from Stanley S. Surrey to Douglass Dillon, Secretary of the Treasury (June 22, 1961), *as reprinted in* Reuven Avi-Yonah, *Territoriality and the Original Intent of Subpart F*, 155 TAX NOTES 1581 (2017).

28. Fishbien, *supra* note 1, at 36.

percent, in tandem with increasing the general corporate tax rate to twenty-eight percent, applied on a country-by-country basis.[29]

Further, the GILTI regime allows for an eighty percent foreign tax credit under section 960(d)(1), effectively applying only to foreign earnings that are subject to a foreign tax of less than 13.125%, which Surrey would have referred to as 'tax haven corporations.' Further, the TCJA included a transition tax under section 965 which was imposed on accumulated and unrepatriated earnings of CFCs. The transition tax was aimed to capture all those foreign earnings parked offshore that were able to escape any tax under Subpart F. It subjected those earnings to preferred lower tax rates—foreign earnings held in cash and cash equivalents were taxed at 15.5%, while those not held in cash or cash equivalents were taxed at only eight percent.

While the tax rates under GILTI and the transition tax are definitely low, compared to the regular corporate tax, they represent the idea of the STP, which Surrey has advocated for. As a well-known supporter of base broadening, he would probably prefer GILTI over the currently pierced Subpart F regime, especially if the rate under GILTI increases.

In addition to GILTI, the new anti-base erosion anti-abuse tax (BEAT) imposes a ten percent tax on deductible payments made by U.S. corporations to their foreign affiliates (which can be foreign parents or CFCs). The BEAT upholds the STP because it imposes tax at source under circumstances where there may not be a tax at residence. Because of these and other provisions of the TCJA, it can actually be seen as more consistent with the STP than previous law. On the outbound front, prior law permitted U.S. based multinationals to accumulate over $3 trillion in low tax jurisdictions offshore without current U.S. or foreign tax, which was a blatant violation of the single tax principle. On the inbound front, prior law only had a weak limit of interest deduction to foreign related parties, so massive earnings stripping out of the United States could occur.

The TCJA should be seen as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project. From 2013 to 2015, the U.S. participated in the OECD/G20 effort to limit BEPS. However, until the TCJA, the general view was that following the conclusion of the BEPS negotiations and the change of Administration, the United States was stepping back from the BEPS process. While the EU was charging ahead with implementing BEPS through the Anti-Tax Avoidance Directive (ATAD), the United States stated that it was already in compliance with all BEPS minimum standards and therefore, other than Country-by-Country (CBC) reporting, it had no further BEPS obligations. The United States refused to join the Multilateral Instrument (MLI) to implement BEPS into tax treaties and did not join the common reporting standards (CRS) to further automate exchange of information, leading the EU to call it a tax haven. As shown above, the United States did adopt BEPS provisions in its 2016

29. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 3 (2022), https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf [https://perma.cc/8C52-49WX].

model tax treaty, but those have not been implemented in any actual U.S. treaty. Thus, before TCJA, most observers believed that the United States had abandoned the BEPS effort.

But this view was and is wrong. TCJA clearly relies on BEPS principles and, in particular, on the STP. This represents a triumph for the G20/OECD and is incongruent with the generally held view that the U.S. will never adopt BEPS. This can be seen in both the outbound and inbound provisions of the TCJA.

For outbound transactions, GILTI means that Amazon, Apple, Facebook, Google, Netflix, and the like will have to pay tax at 10.5% on future GILTI because they have CFCs that produce tested income and no loss in excess of ten percent over their basis in offshore tangible assets. This amount is zero or close to it, since they derive almost all of their income from intangibles. This provision imposes residence taxation in cases where there is no or low taxation at source. For inbound transactions, the BEAT means that a minimum tax of ten percent will apply to many payments to foreign related parties. This imposes source taxation where there may not be taxation at residence.

TCJA also contains two anti-hybrid provisions that directly implement the single tax principle, similarly to the ATAD. The first, IRC 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, IRC section 267A, limits the deductibility of payments on hybrid instruments or to hybrid entities. These provisions clearly implement OECD BEPS Action 2 in accordance with the STP.

Overall, the TCJA contains multiple provisions that incorporate the principles of the OECD/G20 Base Erosion and Profit Shifting (BEPS) into domestic U.S. tax law. Together with the changes in the 2016 U.S. Model tax treaty, these provisions mean that the United States is following the EU in implementing BEPS and, in particular, its underlying principle, the STP. This represents a triumph for the G20/OECD and is incongruent with the generally held view that the United States will never adopt BEPS.

To the extent that the STP can be traced to Surrey's efforts in the 1960s, Surrey'sinfluence can thus be discerned in the TCJA.

V

SURREY AND THE OECD BEPS 2.0 PROJECT

Pillar Two of the new OCED/G20 Inclusive Framework on BEPS 2.0 project that was introduced in 2018 represents a global acceptance of the STP. It includes two interlocking domestic rules (together the Global anti-Base Erosion Rules (GloBE) rules): (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR; and a treaty-based rule—the Subject to Tax Rule (STTR)—that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.[30] Pillar Two should be brought into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024.

The GloBE rules will apply to MNEs that meet the 750 million euros threshold as determined under BEPS Action 13 (country by country reporting). Countries are free to apply the IIR to MNEs headquartered in their country, even if they do not meet the threshold. Government entities, international organizations, non-profit organizations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group, or any holding vehicles used by such entities, organizations, or funds are not subject to the GloBE rules.

The GloBE rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).[31] The minimum tax rate used for purposes of the IIR and UTPR will be fifteen percent.

Pillar Two is clearly based on the STP. Specifically, Pillar Two envisages residual taxation by the residence or source jurisdiction when the tax imposed by the source or residence jurisdiction falls below a specified level. To the extent that the STP can be traced directly to Surrey's work, therefore, Pillar Two is based on his work as well.

VI

SURREY AND THE INFLATION REDUCTION ACT

If there is one single tax concept Surrey is associated with, it is the tax expenditure analysis. Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[32] The term was coined by Surrey in the late 1960s and was codified by the Congressional Budget Act of 1974, which requires that a list of tax expenditures be included in the U.S. budget. It most prominently

30. ORG. FOR ECON. CO-OPERATION & DEV., STATEMENT ON A TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY 3 (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/9KCC-6PBB].

31. *Id.* at 4. The GloBE rules will provide for a formulaic substance carve-out that will exclude an amount of income that is five percent of the carrying value of tangible assets and payroll. In a transition period of ten years, the amount of income excluded will be eight percent of the carrying value of tangible assets and ten percent of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years. The GloBE rules will also provide for a de minimis exclusion for those jurisdictions where the MNE has revenues of less than EUR ten million and profits of less than EUR one million.

32. *Tax Expenditures*, U.S. DEP'T OF TREASURY, https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures [https://perma.cc/5PAM-GHH5] (last visited Mar. 3, 2023).

reflects Surrey's disdain from the unfairness of the U.S. tax system due to the special preferences that mainly benefited certain groups of taxpayers and that were deviations from the normal structure of the system.[33]

On August 16, 2022, President Biden signed the Inflation Reduction Act of 2022. The act included, for the first time, a new fifteen percent corporate minimum tax (CMT) on large U.S. corporations, U.S. subsidiaries, and branches of certain large foreign-parented corporate groups. The CMT only applies to very large corporations: (i) U.S. corporations with average annual adjusted financial statement income (AFSI) in excess of $1 billion measured on a consolidated basis using a three-year average; (ii) U.S. corporations with average annual AFSI of $100 million or more, measured on a consolidated basis using a three-year average, that are members of foreign parented groups with average annual AFSI in excess of $1 billion, again measured using a three-year average; and (iii) foreign corporations that meet the above-income thresholds taking into account any U.S. branches as if each were a U.S. corporation.

Most interestingly, the tax is imposed on a corporation's annual AFSI. Annual AFSI is generally net income for financial statement or book purposes, but taking into account certain modifications. The book net income is generally based on the corporation's applicable financial statement, which in most cases will be a Form 10-K or a similar foreign financial statement.

Since the CMT applies on book income, in-scope corporations will need to calculate their corporate tax liability under two different systems: First, under the traditional twenty-one percent corporate income tax regime that includes all the exclusions, deductions, and other loopholes that Surrey was concerned about. Second, corporations will need to apply a fifteen percent tax rate on their book income, with only a limited set of adjustments. After figuring out tax liabilities under both calculations, corporations will have to pay the higher of the two. In a sense, imposing the tax on a base that is book income while providing only a limited set of adjustments eliminates the effects of the countless tax expenditures in the code for those in-scope corporations.

Though in another sense, allowing certain adjustments to be made with respect to book income opens the door for Congress to introduce a new set of tax expenditures, as indeed was done in this piece of legislation—for example, by specifically allowing the tax amortization deductions under section 197 only for qualified wireless spectrums used in the trade or business of a wireless telecommunications carrier. This goes back to Surrey's 1957 paper (that later caused him trouble in his later confirmation hearings)[34] in which he articulated the process of tax legislation in the United States:

> At another level, what should the Treasury reply to a congressman who says, "I have fought hard in this committee for your position on all of the major issues. Yet when I introduce a minor amendment to take care of a problem of one of my constituents, you

33. *See generally* Surrey, *supra* note 23.

34. *See generally* George K. Yin, *"Who Speaks for Tax Equity and Tax Fairness?": Stanley Surrey and the Tax Legislative Process*, 39 VA. TAX REV. 39 (2019).

> take a self-righteous stand and tell me and the committee that the amendment is inequitable and discriminatory. Is that any way to treat your real friends on the committee?". . . . [T]he congressman does not see a dispute over a special provision as one between a particular group in the community and the rest of the taxpaying public. He sees it only as a contest between a private group and a government department. He begins to think of the government department as representing only itself and as having no identification with the public and with taxpayers in general. Far too often this picture passes swiftly into that of a hard-pressed, struggling group of citizens engaged in worthy endeavors only to be opposed by an unsympathetic bureaucracy. When this image appears, victory for the special tax provision is inevitable.[35]

In terms of foreign earnings, the AFSI generally does not take into account Subpart F and GILTI inclusions and dividends and other distributions from CFCs. Rather, in-scope corporations are required to take into account their pro-rata share of book income of their CFCs (while a book loss of a CFC is not taken into account and is instead carried forward), the effect of which is to impose the minimum rate on foreign income the same way as on domestic income—a component that Surrey would surely support.

VII

CONCLUSION

This article has tried to trace the enduring influence of some of Surrey's ideas such as the ideal of a base broadening, tax rate reducing tax reform, and the STP. Surrey set the stage for discussions related to tax policy and tax legislations years after his passing.

Base broadening clearly influenced the Tax Reform Act of 1986, but its impact can still be felt in the TCJA, which offset its large corporate tax rate cut with significant base broadening in the international provisions and with the Inflation Reduction Act. This provides a base broadening with respect to corporations that are subject to the minimum fifteen percent tax rate. The STP influenced the 2016 U.S. Model, as well as the international provisions of the TCJA, Pillar Two of BEPS 2.0, and the Inflation Reduction Act, and has become a recognized norm in international taxation. Thus, even truly contemporary tax developments can be traced back to Surrey and his notion of the system and a tax reform, almost forty years after his death.

35. Surrey, *supra* note 23, at 1165–66.