

The Rising Tax-Electivity of U.S. Corporate Residence

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Overview of paper

Forthcoming Tax Law Review article based on 1-hour NYU Tillinghast Lecture, 9/21/10 (hence, my apologies to Rick Krever).

3 main topics: 1) How far has the U.S. gone towards effective tax-electivity of corporate residence?

2) So what? What if any reasons would there be for wanting to continue worldwide residence-based corporate taxation?

3) Transition: If we shifted to a territorial system, what about existing U.S. companies' pre-enactment foreign earnings?

How tax-elective is U.S. corporate residence?

Obviously, what's of interest is substantive (not just formal) electivity.

A matter of degree, Can think in terms of “exercise price” from transaction costs, departing from preferred arrangements, etc.

Rock & Kane: corporate surplus vs. tax surplus from incorporation choice. (Lower stakes for the former -> greater electivity.)

Some key factors: operating costs, corporate law quality (branding), access to US capital markets, investors' home equity bias.

Settings where electivity issues arise

- (a) Determining place of incorporation of a new start-up.
- (b) Does a foreign corporation move to the U.S.? (inpatriation & the “reverse endowment effect,” Murdoch’s News Corporation.)
- (c) Expatriation by an existing U.S. company (inversions, §7874).
- (d) Issuance of new equity to fund investment by a U.S. or foreign corporation.

E.g., suppose G.E. or Siemens will build electric grid in China, with the winner to use equity financing from world capital markets.

Whether or not this looks like “electivity,” it’s really no different.

Anecdotal (pending empirical) inquiry

(a) New start-ups – If you're starting a prospective global business (like Bill Gates), tax advisor should urge you to incorporate abroad.

Standard practice in some niches (e.g., investor funds, reinsurance)
And data show rising tax haven IPOs.

BUT: (a) You may not know you'll be a multinational (depends on hitting a "home run").

(b) Foreign incorporation may raise operating costs, a big concern in the start-up phase.

(c) Still some advantages to U.S. incorporation: branding, appeal to U.S. investors w/ home equity bias (inst'l investors, legal reasons).

(d) For much of the tax benefit, putting the IP abroad before it has demonstrable value is good enough.

(e) U.S. worldwide taxation isn't all that onerous in practice.

Anecdotal inquiry, cont.

(b) Expatriation by existing U.S. firms – §7874 (anti-inversion statute) is very effective – even investment bankers call it “very challenging” (Steinberg: banker-speak for “are you out of your mind?”).

But *genuine* foreign purchases (or mergers with foreign firm left on top) can work.

So we’re tax-encouraging “real” expatriations – & data show that this matters – but still limited in scope.

Hence, existing U.S. equity is indeed, to *some* degree, still trapped.

Perhaps the most important margin ...

New investment by existing companies – a crucial margin, but the one about which we currently know the least.

Significant effects are plausible with firms raising capital on competitive world capital markets.

A la the earlier GE vs. Siemens example, one would expect tax surplus vs. corporate surplus to drive results.

Sufficient electivity would indeed make WW tax on U.S. companies increasingly pointless (& perhaps costly).

Clearly not yet at the point of its being “pointless” (though “costly” is a separate question); more empirical knowledge would be nice.

2. Why residence-based WW corporate taxation?

Though corporate residence is not normatively meaningful, some possible motivations relate to:

(a) **Back-up for source:** though important (a la Kleinbard discussion) I will sidestep this today. (My answer: WW unitary business).

(b) **Distributional aims & domestic SHs** if have a WW income tax on individuals & don't like avoidance via use of US MNEs (the "Gates-Zuckerberg problem").

(c) **"Fee" on foreign SHs** if they value domestic incorporation (though note bizarre fee structure of taxing "outbound" for this reason).

(d) **Efficiency:** trees pointlessly slain for years on alphabet soup / battle of the acronyms, plus failure to consider strategic interactions (including reciprocity) in relating national welfare to WW welfare.

Happily, yesterday's Devereux-Fuest-Lockwood (D-F-L) paper is a step forward.

Why residence-based WW corporate taxation, cont.

D-F-L: With an income (not a cash-flow) tax & non-zero tradeoff between foreign investment & domestic activity, exemption may not be unilaterally nationally optimal.

And of course FTCs are not unilaterally nationally optimal – nor are they reciprocal when treaties permit exemption (an implicit foreign tax deductibility system) instead.

One need hardly add that no imaginable non-1,349th best system would find deferral to be optimal.

My view: leaving aside treaty & political economy issues, a U.S.-style system is dominated by one that's [*placeholder*]-neutral but uses a lower tax rate for FSI in lieu of FTCs and deferral.

A modest argument for exemption: only feasible system that eliminates deferral & the FTC.

3. Transition

Switching to exemption would raise transition issue (pre-enactment foreign earnings).

Note close analogy to transition issues in corporate integration; e.g., David Bradford / William Andrews & implications of the new view.

The prospect of a future shift to exemption without a transition tax has 2 main types of effects:

(a) Reduced tax deterrence of new U.S. equity (good),

(b) Increased incentives for pre-enactment income-shifting, plus increased deterrence of pre-enactment repatriation (bad).

If the second outweighs the first, strong case for transition tax (e.g., 1-time tax on CFCs' E & P, with "rough justice" overall FTC adjustment).

(Suppose my saying this were potentially influential. Various US MNE CFOs would now be asking themselves: how much is Shaviro's life really worth?)