Comments for Panel on “International Corporate Taxation: Are We Headed in the Right Direction?”

Daniel Shaviro
NYU Law School

What direction are we headed in?

Hard to tell – compare early 2009 to late 2010 to who knows what in, say, 2013.

So let's ask instead: What direction SHOULD we be headed in? (More WW, or more territorial?)

I will end up concluding: go territorial IF it can be done right AND better alternatives are ruled out.

But I suspect US multinationals would prefer present law to what I suggest.

More important than my bottom line: the standard analysis of U.S. international tax policy issues is flawed & needs to change.

NOT just a reference to pre-2000 work that didn't update Musgrave 1962 – I also mean CON / NON scholarship.

Quick roadmap for my talk

(1) Why might we want to have a WORLDWIDE residence-based entity-level corporate tax?

(2) Why might we instead want to have a purely TERRITORIAL corporate tax?

(3) What would an adequately well-designed worldwide corporate tax look like?

(4) The conditional case for territoriality if we can't get anywhere close to (3).

1. Why have a WW residence-based corporate tax?

NOT to advance capital export neutrality (CEN). Analysis should not depend on battle of the acronyms / alphabet soup.

CEN identifies just one margin, & concerns WW rather than national welfare.

Need to analyze reciprocity / cooperation to connect WW & national welfare.

Assuming source taxation, CEN calls for foreign tax credits (FTCs).

No realistic national welfare framework supports FTCs (with 100% marginal reimbursement rate for foreign taxes paid), even with cooperation & reciprocity.

All tax treaties permit exemption (with 0% MRR for foreign taxes) in lieu of offering FTCs.

A better answer to why WW

A residence-based WW corporate tax penalizes corporate residence. So need (a) market power to impose it, (b) policy goals (distribution &/or efficiency) that it can advance, assuming such power.

Still have some market power – e.g., Americans' start-ups, branding value of U.S. incorporation, U.S. investors' home equity bias – although this market power appears to be declining.

Existing U.S. companies are to a degree trapped – though note the issue of new equity in existing companies.

Distribution: (a) So long as we tax income, WW helps prevent U.S. individuals from avoiding it by overseas investment through U.S. companies. (Including successful start-ups & the "new Bill Gates" problem.)

(b) Extract value from foreigners who value U.S. incorporation – though WW tax on U.S. companies is a very odd fee design.

Why WW & efficiency

U.S. source taxation creates an efficiency problem from a U.S. standpoint if TPs can avoid it by investing abroad.

Suppose we could make ALL TPs (U.S. or foreign) pay tax at the U.S. rate even if they invested abroad.

This would solve the problem by eliminating tax competition as to our source tax – but clearly not feasible. (U.S. can't, e.g., tax Germans who invest in Germany or France.)

WW tax tries the same solution, but just for U.S. residents. 2 reasons why this might not work: (a) clientele effects, (b) corporate residence electivity.

An empirical question whether, given the source tax, residence-based WW tax increases net U.S. investment – some studies say no, but no consensus yet.

2. Why have a territorial tax?

NOT to advance capital import neutrality (CIN) or capital ownership neutrality (CON) – that's just more WW alphabet soup.

If U.S. corporate residence electivity were great enough, WW would be entirely pointless.

And if electivity were great enough for new equity but with old equity trapped, "just" a transition issue (albeit relating to $1 trillion of foreign earnings).

But not currently great enough to justify dropping rate all the way to zero, if its distributional (& efficiency?) effects have some value.

Those concerns might disappear if we (a) replaced the i-tax with a c-tax, (b) developed better fee structure for foreign SHs in U.S. companies, & (c) were sure WW tax doesn't affect net domestic investment.

Pending that, the best case for territoriality depends instead on a critique of WW taxation in practice.

3. What would a defensible WW tax look like?

It would NOT have extremely high behavioral impact / tax planning & compliance costs relative to revenue raised.

Easy (and only) way to get there: (a) no deferral or FTC (foreign taxes merely deductible), (b) improved source rules, (c) lower rate for foreign source than domestic income.

While (c) perpetuates source problems, it's needed due to corp residence electivity, problems (from clientele effects et al) with the efficiency case for NN, reciprocity issues with other countries.

Note that, vs. present law, such a system can either raise, lower, or keep constant (in aggregate) existing burden on / revenue from / quantity of outbound investment.

But such a system might be politically unfeasible & have political economy defects, plus it clearly would violate treaties.

Problems with deferral & the FTC

Everyone understands how inefficient deferral is, & its lack of any good rationale other than as an ad hoc way to lower the U.S. tax burden on outbound investment.

But few have understood how fully the same point applies to FTCs.

Domestic taxes are a cost to the TP but socially a transfer.

But, from a national welfare standpoint, foreign taxes are no different than other foreign expenses (since we don't get the money and exemption countries don't reciprocate).

FTCs' 100% MRR (absent deferral & FTC limits) requires a bevy of anti-avoidance rules that merely address "abuses" – not the fundamentally askew TP incentive to regard foreign taxes as not a cost (or as less of a cost than other equivalent outlays).

Deferral & the FTC: offsetting distortions

Bad as both rules are, each mitigates problems caused by the other.

E.g., can repatriate tax-free if FTCs eliminate the residual U.S. tax.

And the MRR is zero for foreign taxes on earnings that permanently remain abroad (and < 100% if *any* deferral, since delayed reimbursements don’t grow at any interest rate).

But the fact that each rule mitigates the other’s distortions (at the cost of creating its own) doesn’t change the fact that a system with both is inevitably horrendously inefficient.

That is, huge behavioral & planning impact on US MNEs, with high resulting DWL relative to revenue raised.

4. Territoriality after all?

Exemption may be the only politically feasible system that eliminates FTCs and deferral.

So it's arguably preferable to present law even if the rate on foreign source income should be, say, 10% or 20% rather than zero.

But 2 important caveats:

(a) There is no good reason for giving U.S. companies a windfall transition gain. Their CFCs' existing E&P may exceed $1 trillion.

A one-time transition tax on this E&P (perhaps deferred with interest), using a reduced tax rate in lieu of FTC allowance, could easily raise, say, $200 billion.

(b) Need to accompany the change by improving the source rules.

At present, subpart F & the prospect of ultimate repatriation backstop those rules for U.S. (though not foreign) multinationals.