The Rising Tax-Electivity of U.S. Corporate Residence (… and Beyond)

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Overview of paper

Recently published Tax Law Review article; my thinking has more recently advanced for a forthcoming book on international taxation.

3 main topics in the article: 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 tax resident companies' foreign source income (FSI)?

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

Plus today I'll briefly discuss: 4) How should we think about the optimal U.S. tax rate on resident companies' foreign source income? (Given everything else in the U.S. tax system.)

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.

NB: the article discusses "tax-electivity" rather than "tax-elasticity," as I wanted a salient label emphasizing the role of deliberate planning, but here we can treat the 2 terms as synonomous.

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.

For this last setting, perhaps "elasticity" is a more semantically apt term than "electivity," but this doesn't really matter.

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.

Allen & Morse, *Firm Incorporation Outside the U.S.: No Exodus Yet* (presented at NTA yesterday afternoon): China / Hong Kong firms driving the rise in tax haven incorporation.

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) <u>Efficiency</u>: Suppose we could tax ALL WW income of ALL companies, no matter where resident.

This would address a fundamental incentive problem: source-based U.S. taxes are a cost to the TP but not to us collectively.

The U.S. tax would now be unavoidable via location choice (for actual investment or reported location of taxable income).

Of course, we can't tax all companies' WW income. Can only do this for the companies that we (colorably) define as U.S. residents.

Hence we get a more complicated efficiency issue – applying even if resident & non-resident companies are otherwise identical.

Why residence-based WW corporate taxation, cont.

By taxing resident companies' FSI, we address the incentive problem for some but not other market actors & incur various efficiency costs.

E.g., we discourage U.S. incorporation & the use of U.S. entities to invest abroad, create clientele effects re. which companies invest where, etc. So, a tradeoff.

Two further rationales for taxing resident companies' FSI:

(a) Distributional aims & domestic SHs if we have a WW income tax on individuals & don't like its avoidance via the use of corporate entities (the "Bill Gates – Mark Zuckerberg problem").

(b) Imposes a fee on foreign SHs of U.S. companies who sufficiently value the indicia of U.S. resident status (although note the odd fee structure of taxing FSI for this reason).

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).

Note recent proposal (from W&M Chair Camp) to have "deemed repatriations" within a several-year period.

4. What should be the tax rate on FSI?

A Ramsey rule / optimal commodity tax / equalize marginal efficiency cost of funds (MECF) from alternative instruments problem. (And Kaplow critique inapplicable.)

It makes sense to equalize MEECF (adding equity or distribution) from different instruments (e.g., source-based & outbound corporate taxation).

35% / 0% (from exemption) appears highly unlikely to be optimal.

Prior literature: Desai-Hines argue for exemption (via national ownership neutrality or NON) by examining whether domestic investment declines when U.S. companies invest outward.

But shouldn't the tax rate for FSI depend on *its* tax-elasticity, rather than on some other elasticity at some other margin?

NON might be a good policy guide if we otherwise had a lump-sum tax.

In as yet unpublished work, I (facetiously) extend NON to suggest that bus drivers' income be exempt (achieving "bus drivers' work neutrality" or BDWN) if no substitution between bus driving & other work.

Setting a tax rate for FSI

FTC & deferral create huge incentive problems. While to a degree offsetting, any system w/ both will have horrible MECF.

In principle: (a) adopt [placeholder]-neutral repeal of FTC & deferral in exchange for lower tax rate on FSI, then (b) suitably adjust that rate.

Again, it may be reasonable to think of source-based domestic business taxation & that for FSI as a “package” – even though in principle should equalize MEECF for *all* instruments.

While this clearly suggests a positive tax rate for FSI, note what I consider the best argument for exemption:

It may be the only politically, etc. feasible system that repeals FTCs & deferral – perhaps offsetting the detriment of its rate being too low.

This of course would add to the urgency of addressing source (e.g., with global unitary business approach to all (not just resident) MNEs?