

# The New Non-Territorial U.S. International Tax System

Daniel Shaviro, NYU Law School  
International Tax Conference  
Copenhagen Business School  
November 5, 2018

# Overview of my talk

2017 U.S. tax act: important for its own sake, but also more broadly instructive.

(1) Why didn't the U.S. "go territorial" as some expected?  
(And why don't countries seem to want either pure territorial or pure worldwide systems ?)

(2) Ruling out both WW & territorial, what are int'l tax policymakers concerned about?

And how should we think about those issues?

(3) Preliminary evaluation of new U.S. international rules.

# Problems with “WW vs. territorial”

They differ at 2 margins, not one:

(1) Tax rate for FSI: same as domestic rate in pure WW; 0% in pure territorial.

(2) Marginal reimbursement rate (MRR) for foreign taxes: 100% in pure WW; 0% in pure territorial.

Territoriality: implicit deductibility for foreign taxes.  $MRR = MTR$ , so TPs seek to maximize after-foreign-tax income.

# Contra “WW vs. territorial,” cont.

Conflating 2 margins into 1 choice undermines clear thinking.

Why the arbitrary packages; why restrict the policy choices to these polar alternatives?

“WW vs. territorial” also fails to illuminate the main choices that countries actually appear to care about these days.

Let’s consider 4 in particular.

## (1) MNCs vs. domestic companies

Corporate rate reduction responds to international tax competition (corporate tax a proxy for globally mobile income).

But should effective tax rates be lower still for MNCs?

If so, optimal tolerated profit-shifting  $> 0$ .

But MNCs' profit-shifting can also become "excessive."

Rents; purely domestic companies vs. MNCs; resident individuals' labor income).

"Goldilocks problem": too hot, too cold, or just right?

## (2) Taxing resident vs. foreign MNCs

To have CFC rules is to treat the 2 types of MNCs differently, including re. profit-shifting.

May favor this even if they're not systematically different.

For resident MNCs, ability to tax specified ("bad") FSI allows for a more refined tool.

Even assuming good reasons for using this tool when one can, it creates a tradeoff.

U.S., pre-2017, over-focused anti-profit-shifting efforts on resident MNCs (e.g., CFC rules tougher than earnings-stripping rule).

### (3) Identifying “bad” FSI

Considerable consensus on what it is & how to define it.

CFC rules are anti-tax haven rules, whether they focus on where profits actually reported or on what’s easy to shift.

But a lack of consensus (between & within countries) on how rigorously to address it.

On the one hand, why want foreign taxes on FSI to be high rather than low?

But on the other hand, tax haven income may indicate undesired domestic base erosion.

## (4) MRR for foreign taxes

FTCs' MRR of 1 for foreign taxes is clearly too high (though in U.S. practice was mitigated by deferral).

Same problem can arise under a global minimum tax.

Foreign tax deductibility (including implicit from exemption) would be unilaterally optimal but for the “bad FSI” issue.

There's a strong case that tax treaties permit combining partial exemption with partial creditability.

If so, non-zero tax rates for FSI can be combined with partial creditability (subject to design constraints).

## An issue with all these issues

No consensus about any of them! (Although advocates on both sides are often quite self-confident.)

None is well understood, & we lack good empirical inputs.

Answer for each may vary between countries & across time.

Each offers a Goldilocks question; no clean analytic answers.

# Assessing U.S. int'l tax provisions

Harsh perspective would be easy to justify here. Rushed, secretive enactment in a broadly corrupt & aberrant process.

International provisions pervasively show resulting defects.

But prior law was bad; low bar to improve. Also:

- Probably not going back, so how make the best of it?;
- Potential for improvement is surely there;
- MNEs were “liked” rather than “well-liked,” so less crass than other parts of the 2017 U.S. tax act;
- New rules mainly reflect genuine concerns w/o clear answers.

# (1) The BEAT: Rationales

MNC base erosion tools include deductible payments to affiliates.

Can involve transfer pricing &/or concentrating deductions in higher-tax jurisdictions.

Best combated (insofar as one wants to) comprehensively & without undue reliance on labels.

Also a U.S. rationale for shifting anti-base erosion efforts to bear more than previously on foreign MNCs.

Targeting foreign MNCs may also be politically convenient in the face of dire revenue needs.

# The BEAT: Basic mechanics

Minimum tax structure: “broader” base, lower rate, pay to the extent in excess of regular tax.

Add “base erosion tax benefits” (BETB) to convert regular into “modified” taxable income; 10% BEAT rate.

Say \$10X regular taxable income, \$30X BETB. Pay \$2.1X regular tax + an additional \$1.9X of BETB.

MRR for BETBs = 21% until one hits the BEAT, then zero.

Could think of this as a BETB excise tax of 0% then 21% (reversing the deduction).

# Why the min tax/dual rate excise tax?

No clear substantive policy rationale.

With modified taxable income = economic income, might rationalize min tax as target tax rate for MNCs.

But this would require that “correct” transfer prices = zero.

If dual-rate excise tax, reason for the jump is unclear.

Worse still, the BEAT combines harshness with avoidability, due to various escape routes.

# Avoiding/revising the BEAT

--Doesn't apply to cost of goods sold (COGS). (Has rationale, but what about everything else; tax planning responses.)

Doesn't apply if <3% of deductions are BETBs. (Rationale??; cliff problem; tax planning responses.)

Doesn't apply if 3-year average gross receipts <\$500M. (Too high? Cliff problem.)

A modest proposal: (1) extend to COGS, (2) eliminate 3% rule, (3) lower the gross receipts floor, (4) offset extra burden by commensurately lowering rate (or via excise tax?).

(Which is not to judge treaty-compliance, whether good policy on balance, etc.)

## (2) GILTI: Rationales

The standard rationale for CFC rules is that one may want to tax resident MNCs' high rate-of-return, low-taxed FSI.

Intangible income may often (though not uniquely) fit these criteria.

Subject to usual objections: e.g., can't reach such income when earned by non-resident MNCs; paying low foreign taxes not itself objectionable.

GILTI aims to do this in a broad-based fashion, while arguably no more than gesturing at "true" intangibility.

# GILTI: Basic mechanics

Reduce “net CFC tested income” ( $\approx$  FSI – subpart F income) by 10% deemed return on QBAI (adj. basis, tangible assets used in CFC businesses).

This is taxable (– 50% deduction), subject to FTC for 80% of relevant foreign taxes.

Say Acme-US has \$100X of relevant FSI, \$200X of QBAI, paid \$10X foreign taxes.

$GILTI = \$100X - .1(\$200X) = \$80X$ , reduced by 50% deduction to \$40X.

$GILTI \text{ liability @ } 21\% = \$8.4X - \$8X \text{ FTCs} = \$.4X$ .

## GILTI tricks and traps

Lots of little tricks & traps can harshen GILTI's effects. E.g.:

--May get perverse results if loss as well as gain CFCs.

--The 50% deduction can't create or increase NOLs.

--GILTI FTC basket has internal cross-crediting, but not vs. other baskets, & no FTC carryovers if excess-credit.

Global minimum tax of 13.125? (From 10.5% rate, foreign tax rate needed to eliminate all U.S. liability.)

Not if one gets trapped by other features! (E.g., pay foreign taxes in the wrong year.)

# Assessing GILTI

Its tricks & traps (but also perhaps its allowing internal cross-crediting) seem foolish.

Can make offsetting changes (e.g., to deduction %) to keep net revenue or net burden constant.

Can defend 80% FTC both substantively & on treaty grounds.

The 10% QBAI rule may have perverse effects. *Expected return* (given market rates) needed to avoid odd incentives.

Opinions may reasonably differ on GILTI's core purpose & effects.

## (3) FDII: Rationales

U.S. policymakers wanted a “carrot,” alongside GILTI’s “stick,” to encourage keeping intangible-type income in the U.S.

Patent / innovation box would have been the obvious thing.

But instead Congress enacted FDII, differing in 2 key ways:

- 1) Intangible income inferred via QBAI structure, rather than being directly observed.
- 2) Special tax rate only for exports – so an (almost surely WTO-violating) export subsidy.

## FDII: Basic Mechanics

Deduct 37.5% of “foreign-derived intangible income,” lowering its effective tax rate to 13.125%.

FDII is basically U.S.-source income from exports. But such income is reduced by the ratable portion of a 10% deemed return on U.S. QBAI.

Say Acme-US has \$100X of relevant US source income, \$40X of it from exports. Say also \$200X of US QBAI.

40% of the 10% deemed return (\$8X) reduces FDII to \$32X.

Acme deducts 37.5% of this amount (\$12X), reducing its U.S. tax liability by \$2.52X.

# Policing the border

FDII's being an export subsidy is not only WTO-violating & bad policy, but yields tax planning/compliance headaches.

Destination-based taxes (such as VATs) treat exports & imports symmetrically, so "round-tripping" is not generally a problem.

But FDII makes it both fundamental & imperfectly definable.

Just a question of how closely & detectably the export & re-import are linked.

Legislative history suggests that one need only avoid making the foreign re-importer too much of a pure conduit.

## Summing up from a U.S. perspective

Good riddance to “WW vs. territorial”! – focus instead on margins countries care about. Answers often unclear.

U.S. isn't going back to pre-2017 act international tax law, & why should it.

The BEAT & GILTI are in the ballpark of addressing reasonable concerns, although serious flaws as implemented.

FDII is fatally flawed by its being an export subsidy. Could replace w/ a more conventional patent box, or w/ nothing.

Obviously, the future of U.S. tax legislative (& other) politics is currently quite unclear.

# Summing up from a EC perspective

BEAT may adversely affect European companies that invest in the U.S.

Tax treaty / WTO violations? Retaliate? Emulate?

GILTI has treaty issues but may reduce U.S. companies' gain from profit-shifting out of higher-tax EC countries.

Tolerate? Cooperate? Undercut? Emulate?

FDII is an unwise but apparently ineffective export subsidy.

U.S. as an ally / rival / peer / counterparty ...