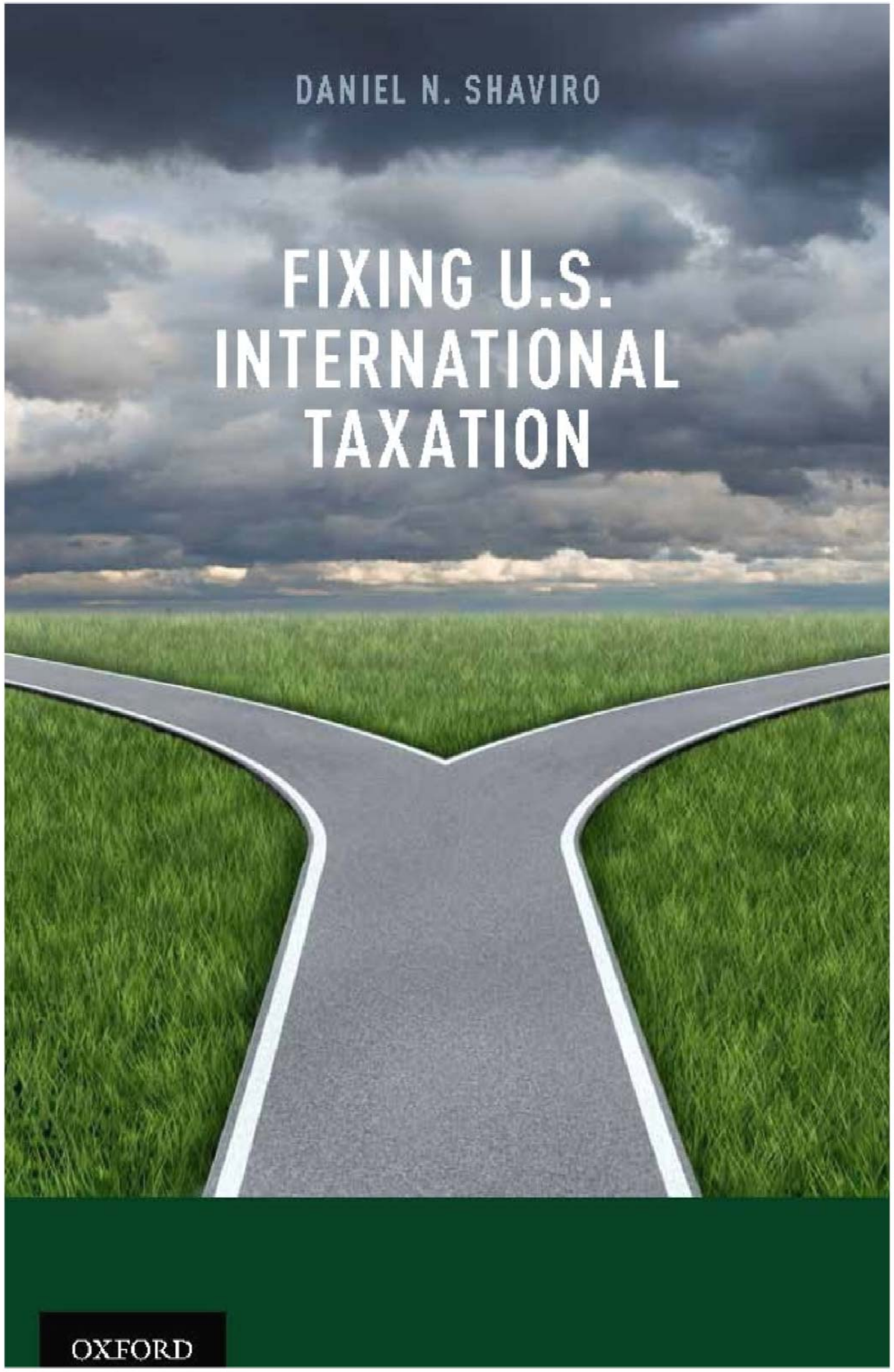

A Quick Overview (based on Chapter 1)

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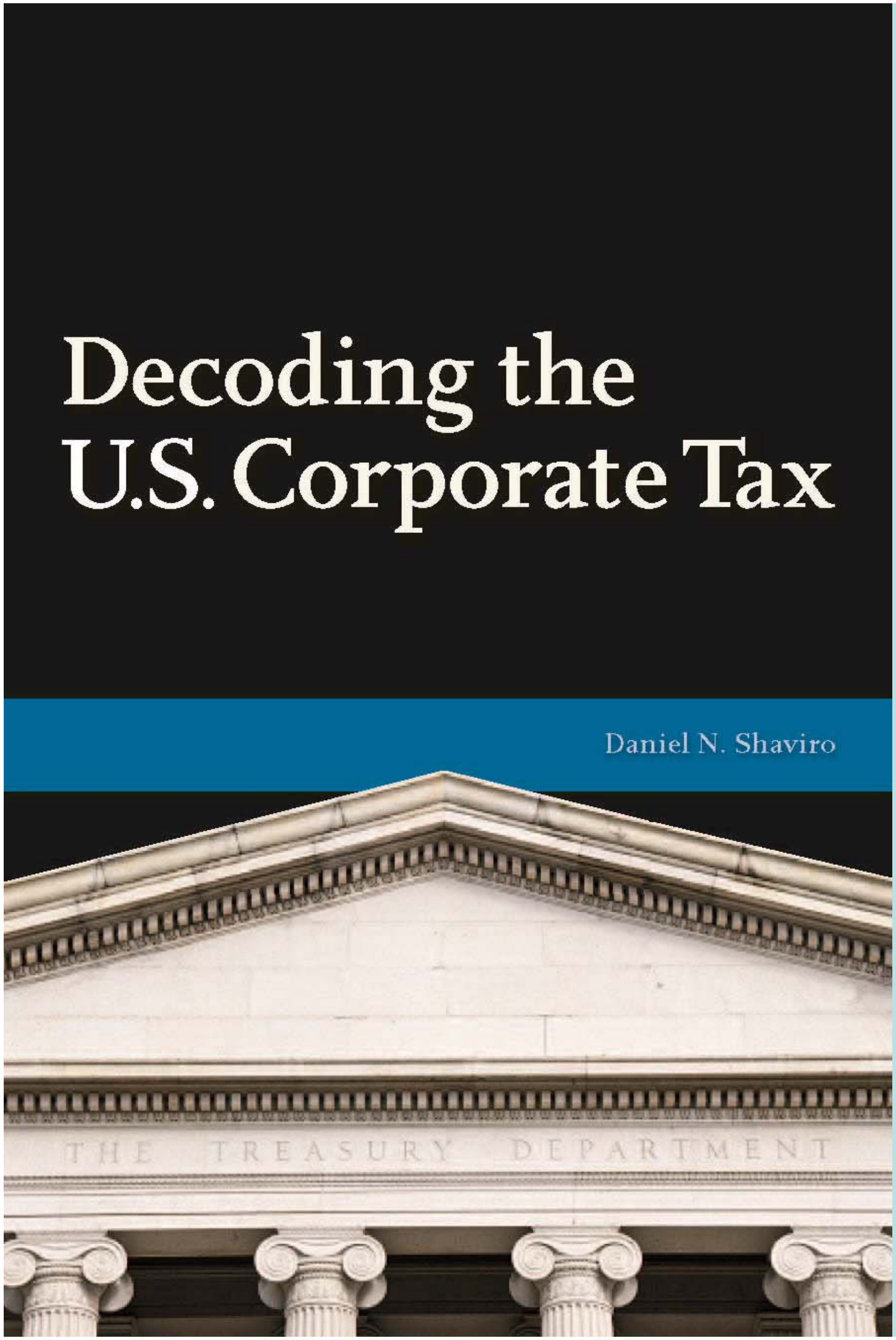
Duke Tax Policy Seminar
February 26, 2014



This 2009 book was the model for *Fixing*, except ...

BIG difference between the corporate tax and international tax literatures.

Corporate tax: "ill-posed problem" inherent to the area; my main aim was just to explain it accessibly.

International tax: cf. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies."

Back to Square 1 for finding suitable analytic tools, but luckily other public economics literatures are up to the task.

The nature of the problem

Say the U.S. corporate tax rate is 35%, Germany's is whatever.

U.S. can tax all income earned in the U.S. or by U.S. companies (e.g., at 35%), but it can't tax income earned in Germany by German companies.

Can't match the U.S. tax rate on U.S. companies' German income to both the domestic rate & the U.S. rate (0%) on German companies' German income.

The usual response: unexplored implicit assumption about global cooperation, followed by "battle of the neutralities."

<u>Analogy</u>: Say 3 drinks: milk, juice, water. We tax milk, can't tax water, must decide about juice, which exceeds milk in its substitutability with water.

Shouldn't analyze this as a choice between milk-juice neutrality and water-juice neutrality (more on this below).

Four fallacies to avoid

(1) "The problem is double (and non) taxation of cross-border investment."

Purely from an economic standpoint (leaving aside treaty issues & political economy for now), the # of times something is taxed doesn't matter.

Rather, what matters is relative & absolute tax burdens on such investment.

Say the German rate is 20%. U.S. company earns $100 in Germany, pays $20 German tax.

Worldwide system with foreign tax credits: U.S. tax is $15.
Exemption system: U.S. tax is 0.

Nothing intermediate is allowed??
Horrible violation of global norms if, say, foreign taxes were merely deductible & the U.S. tax rate for FSI were 15%, leading to a U.S. tax liability of $12??

In substance, this is a victimless "crime."

Fallacy # 2

(2) "The U.S. has two choices: worldwide and exemption."

That is, either the U.S. tax for FSI = the domestic rate & foreign taxes are creditable, or else it's zero & foreign taxes are ignored.

Such a choice is not only surprisingly discontinuous, but unduly compound.

It's important to think separately about (a) the tax burden imposed on "outbound" investment, and (b) the domestic treatment of foreign taxes.

MRR (marginal reimbursement rate): 100% in a WW system absent deferral or foreign tax credit limits.

In an exemption system, the MRR is zero. But since this = the marginal tax rate (MTR) for FSI, exemption has implicit foreign tax deductibility.

In such a system, domestic TPs should be indifferent between $1 in foreign taxes & any other $1 net cost.

Do FTCs actually create a 100% MRR?

Not where FTC limits apply (although these yield an oddly discontinuous decline in current year MRRs).

Plus, note the effects of deferral for unrepatriated FSI with associated taxes.

Deferral is condemned for creating at least formal "lockout." It wouldn't under "new view" conditions (fixed repatriation tax rate that will eventually be paid), but these conditions don't generally hold, so (at least formal) lockout is widespread.

Under new view conditions, FTCs might yield 100% MRRs despite deferral.

But under actual conditions, U.S. companies are foreign tax cost-conscious after all. (E.g., suppose they will never repatriate, pending exemption or a "tax holiday").

So deferral mitigates the incentive effects of FTCs – and the opposite is also true. But a system with both is certain to have high DWL relative to revenue.

The deferral/FTC interaction (with each other & the effective tax rate on FSI) yields what I call the "iron box" for U.S. international tax policy.

Fallacy # 3

"Paying foreign taxes is just as good as paying U.S. taxes."

Not from a U.S. standpoint – we don't get the $$ from foreign tax payments!

From this perspective, foreign tax payments are no different than any other overseas outlays by firms that U.S. individuals own (supporting mere foreign tax deductibility).

While we might benefit from reciprocal creditability, this is no longer very relevant in a world where most countries have exemption systems.

Mere foreign tax deductibility + taxing FSI at the full U.S. rate would probably over-play our hand re. the tax burden imposed on "outbound." But that's not to say that FTCs, rather than a lower tax rate for FSI, are the right answer.

A complicating factor: when FSI is reported as arising in a tax haven, this may be a "tag" suggesting that it is income we especially want to tax (e.g., because we suspect it may have been shifted out of the U.S. via accounting games).

Fallacy # 4

"Achieve neutrality at one margin, while ignoring all the other margins."

Hence alphabet soup or battle of the acronyms: CEN vs. CIN vs. CON &/or NN vs. NON.

Note the "global welfare fallacy" (from its internal intellectual inconsistency) and the "global convention fallacy."

The single-bullet domestic welfare norms are no better than the global ones.

Note decreasing marginal welfare gain from approaching the optimum at any margin. Need to optimize (under severe choice constraints) in light of multiple relevant margins.

From a unilateral U.S. standpoint, could think of foreign companies' FSI as "water," U.S.-source income as "milk," & U.S. companies' FSI as "juice" …

… at least, assuming continued entity-level corporate income taxation as an underlying constraint.

What to do, part 1

I'm much less committed to particular proposed solutions than to the proposed mode of analysis.

Key features of the proposed mode of analysis include :

(1) separating the 2 margins (tax burden on outbound, MRR),
(2) US national welfare with attention to reciprocity,
(3) optimal commodity tax-style analysis in lieu of alphabet soup,
(4) "iron box" interactions between deferral, the MRR from foreign tax credits, & the tax rate on FSI, and
(5) Intermediate solutions should be explicitly on the table for both the tax rate on FSI (not just zero or the full domestic rate) & the MRR (not even nominally just 100% or the statutory tax rate on FSI).

That said, however, it would be unsporting not to at least briefly address the way forward.

To make it hard rather than easy, let's suppose that entity-level corporate income taxation remains in place as a key U.S. tax system feature.

What to do, part 2

I tend to favor:

(1) tax rate for FSI between zero and the full domestic rate, but probably closer to zero,
(2) repeal of deferral,
(3) treatment of foreign taxes that is more like deductibility than creditability, albeit with anti-tax haven rules that may create intermediate MRRs.

Such an approach admittedly poses both treaty issues & political economy issues that I do not more than cursorily address (in the hope that others will address them elsewhere; the book is already long enough).

The recent Senate Finance Committee discussion draft on international tax reform suggests that there may be treaty-compliant ways of adopting this type of approach.