THREE FALSE STATEMENTS CONCERNING INTERNATIONAL TAX POLICY

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The 3 false statements

(1) “International tax policy issue analysis should depend on one’s choice of worldwide welfare norm.”

(2) “For outbound investment, the basic policy choice is between (a) exemption and (b) a worldwide system with foreign tax credits.”

(3) “It makes no real difference that corporations, rather than individuals, are the main resident taxpayers subject to the rules for foreign source active business income.”

At least in the U.S., all 3 statements describe prevailing beliefs & assumptions – yet all are erroneous.

The first false statement

“International tax policy issue analysis should depend on one’s choice of worldwide welfare norm.”

Often assumed in U.S. (whether or not elsewhere).

E.g., Treasury and JCT reports, debate about CEN vs. CIN vs. CON (assumed to be actual policy guides).

The obvious objection: Why focus on a single margin of choice when multiple margins are likely to be implicated? (More on this shortly.)

But also: How constructive is it to analyze a given country’s policy choices in terms of WW rather than national welfare?

Why worldwide welfare?

A WW view is morally compelling, but not really expected of individuals or countries.

Plus, agency issue if policymakers (not voters) implement WW.

The implicit claim: countries are actually following it, so it’s practical & realistic after all.

Underlying assumption: Unilateral self-interest would dictate full double taxation, which would have disastrous effects on cross-border activity – but we don’t observe this.

Thus: “Yes, Virginia, there is a Santa Claus” ?

Why don't countries double-tax more?

No need for Santa Claus unless full residence & source-based tax are indeed unilaterally optimal.

Just as w/ tariffs, national benefit from imposing taxes on cross-border transactions depends on market power.

Some issues:

--Source-based taxation of mobile capital;

--Corporate residence as a basis for WW taxation;

--Evidence that one can't increase domestic investment by taxing outbound investment (Desai-Hines et al)

Little evident temptation in most countries to double-tax (though this reflects internal politics as well as national interest).

The puzzling case of foreign tax credits

But before we reject the claim that countries are maximizing WW welfare, consider FTCs.

FTCs treat it as irrelevant to whom one pays taxes.

Few creditors are so generous!

Hence no surprise that Peggy Musgrave thought FTCs must reflect a WW welfare norm (CEN).

Graetz & O'Hear (1997) – first FTC enactment (by the U.S.) was motivated by supposed unfairness to domestic TPs of "double taxation" – not the aim of promoting WW welfare.

Anti-double tax a common (but incoherent) tax policy trope.

Beyond “double taxation”

Even if not expressly WW-minded, are FTCs implicitly so? (Granting source country priority might reflect anticipating & expecting reciprocity.)

Maybe so – but this changes the terms of welfare debate from **WW vs. national** to **unilateral vs. cooperative**.

As we’ll see, this reformulation fails to save the case for the FTC.

The second false statement

(2) “For outbound investment, the basic policy choice is between (a) exemption and (b) a worldwide system with foreign tax credits.”

Consider ideal income & consumption taxes, which differ at just 1 margin (treatment of normal return to saving).

Hence, tax base debate involves 1 choice at 1 margin.

But (a) and (b) above differ at 2 margins: (i) tax on outbound; (ii) foreign taxes’ marginal reimbursement rate (MRR).

Exemption has 0% actual & effective rate at (i), 0% MRR (equal to the MTR; implicit deductibility) at (ii).

WW w/ FTCs has positive rate at (i), 100% MRR at (ii).

Separability of the 2 margins

The tax burden on outbound investment & the MRR for foreign taxes are indeed separable.

Under WW, can shift from creditability to deductibility w/o increasing taxation of outbound investment – e.g., by lowering the tax rate for foreign source income.

OR, could have an exemption-equivalent FTC system by weakening FTC limits & adjusting the tax rate as needed to raise zero net revenue.

To mix my metaphors: one more nail in the coffin of “alphabet soup” (unitary welfare acronyms such as CEN, CIN, CON, NN, NON, GPN). Need to consider distinct margins separately!

What is the nationally optimal MRR for foreign taxes?

In a unilateral national welfare framework, foreign taxes no different from any other outlay (as we don't get the money).

Hence, we want TPs to be indifferent between a $1 foreign tax liability, and any other $1 reduction to net foreign income.

Thus, the MRR should equal the MTR for such income.

This results automatically from foreign tax deductibility.

Making things worse …

100% MRR eliminates all TP cost-consciousness re. foreign taxes.

Suppose MRR > 100%. Easy to see the problem.

Now consider Case 1: foreigner pays me $1 to pay its $1B foreign tax bill (if permitted by the rules).

Or Case 2: I pay $100K to be treated as the payer of a $1B foreign tax bill (a la *Compaq* et al).

These are not much better.

Likewise, Case 3: I earn $100K before-tax in a country charging 35%, rather than $90K in a country w/ no income tax.

Reciprocity and foreign tax credits

With cooperation, anything that increases WW welfare can create Pareto improvement.

Where sufficiently reciprocal, FTCs can be a wash (defeating my argument that the MTR provides the optimal MRR).

But note that allowing exemption in lieu of WW w/ FTCs (as in typical treaties) is enough to violate reciprocity.

Thus, FTCs are best thought of as unilateral, not reciprocal.

The third false statement

(3) "It makes no real difference that corporations, rather than individuals, are the main resident taxpayers subject to the rules for foreign source active business income."

While not asserted, for decades effectively assumed in the literature & in public political debate.

Close enough if individual (SH) & corporate residence had 100% overlap.

But not with cross-border shareholding & distinctive corporate residence determinations.

Distribution & resident SHs

Distributionally, the only reason to tax corporations is as a proxy for taxing individuals (such as SHs),

But need to distinguish between resident & non-resident SHs.

For resident SHs, realization-based income tax must apply to corp income, or corps become tax-free savings accounts.

And if we want to tax resident individuals on their income, hard to see why we'd exempt foreign source.

But if they can (& sufficiently do) avoid the tax via foreign corps' foreign income, then what's the point?

Distribution & foreign SHs

Domestic distributional aims presumably don't apply to foreign SHs (in general or just when they invest in resident corps).

To be sure, we may want to charge foreign SHs for investing in our resident corps (if they bear the incidence of the tax).

This depends on market power: will they pay for benefits of domestic corp residence (e.g., from U.S. incorporation)?

In the U.S., states might under-charge for the benefits of using their corporate law because they're competing w/ each other.

But why would the optimal fee involve taxing domestic companies' foreign source income?

Efficiency & outbound taxation

At least prospectively, corporate residence is far more tax-elastic than that of individuals,

For new companies, if corporate residence is purely elective, WW taxation makes no sense – election to pay more tax??

But also an issue for existing corps even w/o expatriation (new equity, own vs. arm's length for foreign operations).

Potentially a game-changer in international tax policy debate (though it weakens the argument that attempting WW taxation is affirmatively harmful to national welfare).

Insofar as NOT purely elective, need to ask: what factors limit electivity? Do we want to tax them? How & how much?

How much electivity going forward?

U.S. practitioners: U.S. corporate residence is indeed increasingly elective for new global businesses w/ IP.

Already malpractice per se for U.S. tax lawyers not to urge foreign incorporation! (Though they don't always prevail.)

Of course, the U.S.'s place-of-incorporation rule all but invites electivity.

A meaningful HQ rule might be less elective – though not necessarily, in the future, non-elective enough.

But suppose local HQ has positive externalities – then one might want to subsidize, not tax-penalize, it.

Summing up

International tax policy discourse is badly in need of revision.

Replacing CEN with a focus on ownership was a good start, but not nearly enough.

--Not WW vs. national, but unilateral vs. reciprocal (& strategic interactions more generally).

--Dump the acronyms / alphabet soup & look at distinct margins (importantly, including the foreign tax MRR).

--Evaluate corporate residence electivity / factors limiting it.

--Existing vs. new corporate equity; importance of transition when countries shift to / towards exemption.