The Rising Tax-Electivity of U.S. Corporate Residence

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Overview

1) Defining tax-electivity of U.S. corporate residence.

2) Rationales for a worldwide, residence-based, entity-level corporate tax (hence, what are the stakes).

3) How far have we gone towards electivity – and with what implications for the WW system?

4) Transition: What about existing U.S. companies if we shift to a territorial system?

1. Defining Tax-Electivity

Electivity: Formal (or explicit) vs. substantive

Formal electivity: e.g., check-the-box for unincorporated entities.

Widely used to create "hybrid entities" (corps abroad, "transparent" here) that ease foreign tax planning by U.S. companies without adverse U.S. tax consequences.

But suppose that exercising a formal election had adverse non-tax consequences.

E.g., suppose U.S. corporate residence were formally elective but led to bad publicity (Cong'l hearings, consumer anger, etc.).

What really matters is substantive electivity (ability to make the preferred tax choice without adverse non-tax consequences).

1. Defining Tax-Electivity, cont.

Substantive electivity: X leads to Tax Result A, Y leads to Tax Result B, but you're indifferent between X and Y.

Example: gain on appreciated stock isn't taxed unless you sell it.

Why does selling stock matter? (Get cash, change risk position, voting rights, transaction costs, etc.)

The more you can get (or avoid) these consequences whether or not you sell a given share, the greater the tax-electivity of a sale.

At the limit, selling shares of stock could be substantively as elective as check-the-box.

Note tax rules (e.g., §1257, constructive sale) that reduce the tax-electivity of sales.

1. Defining Tax-Electivity, cont.

Substantive electivity: a matter of degree (something can be more elective or less so), not either-or.

Can think of it in terms of "exercise price" (how much one must "pay" to get the preferred result, whether from transaction costs, etc., or departing from the economic arrangements one preferred).

U.S. corporate residence: formally non-elective, as it depends on where one is incorporated.

But substantive electivity depends on the costs & benefits of U.S. vs. foreign incorporation.

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.

1. Defining Tax-Electivity, cont.

Settings where issues of corporate residence electivity may arise:

(a) Determining place of incorporation of a new start-up.

(b) Does a foreign corporation move to the U.S.? ("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.

Though the Chinese gov't picks the winning bid (with capital market conditions in background), this is a lot like (a) through (c), w/ corporate surplus vs. tax surplus driving likely outcomes.

2. Why residence-based WW corporate taxation?

To assess rising electivity, need to think about the value of what it's potentially undermining (residence-based WW taxation).

So: why might U.S. want to tax residents' WW, rather than just domestic income?

But keep in mind that, for active business income, we are talking mainly about a *corporate* tax on *resident corporations*. (Could be very different than directly taxing resident individuals.)

The WW vs. territorial aspect has been debated for 50+ years …

… at length and perhaps ad nauseum, but without sufficiently focusing on why it matters that tax is mainly levied at the entity level based on *corporate* residence.

2. Why residence-based WW corporate taxation, cont.

Debate is typically about WW welfare: CEN vs. CIN vs. CON.

Unsatisfying for many reasons, including: why WW welfare for national policymaking?

I'll instead ask (a) what unilaterally promotes national welfare, followed by (b) could multilateral cooperation improve the outcome?

Also unlike the usual debate, I'll examine distribution issues as well as efficiency.

And I'll keep in mind that we are talking about an entity-level tax, but should care only about INDIVIDUALS as such – legal entities don't actually "live" anywhere, nor can they feel pleasure or pain.

2. Why residence-based WW corporate taxation, cont.

Two-stage analysis. ***(1)*** Suppose we taxed individuals directly on corporate income (partnership tax model). If we did this, what motive for WW rather than merely territorial taxation?

Under this model, suppose U.S. & German individuals own stock in both G.E. (a U.S. company) & Siemens (a Germany company).

Residence-based WW taxation would mean taxing Americans on non-U.S. income from both G.E. & Siemens (& Germans only on U.S. income from both).

Under this scenario (effectively *assumed* when analysts ignore corp residence issues), what motives for WW taxation of U.S. individuals?

Then ***(2)*** what difference does it make that we DON'T do this? (And that *corporate* not SH residence determines who faces WW tax.)

2. Why residence-based WW corporate taxation, cont.

U.S. individuals & distribution: Why do we need to tax ANY corporate income (including that earned domestically)?

If we had a consumption tax instead of an income tax, this might be unnecessary (depending on the c-tax model).

But with an income tax, if corporate income isn't taxed to SOMEONE, corporations would in effect be giant IRAs.

In purely domestic setting, entity-level tax can be a decent proxy for owner-level despite such details as (a) applicable tax rate & (b) use of losses against income.

Same rationale for ind'ls' taxing *foreign source* income as *corporate* income: don't let U.S. individuals use it to avoid the income tax

2. Why residence-based WW corporate taxation, cont.

Hence, there is a distributional motive for WW residence-based taxation of individuals.

But what about *foreign* taxes on income earned abroad? E.g., say U.S. ind'ls can earn foreign income either in Germany (w/ U.S.-style rates) or the Caymans (w/o significant income tax).

From a unilateral U.S. national standpoint, this makes *no difference* – paying taxes to Germany doesn't do *us* any good.

But say we make a deal w/ Germany, mutually exempting foreign source income (or offering FTCs).

If rates & base are similar, this can approximate mutually exempting *inbound* investment from the other country's nationals.

SO: Deal w/ Germany – but not with the Caymans – can make WW tax *selectively* unnecessary to achieve income tax distrib'l goals.

2. Why residence-based WW corporate taxation, cont.

Any efficiency reasons for WW taxation of resident individuals?

Seemingly yes, for a reason known in the literature for 50 years (Peggy Richman Musgrave, “national neutrality” or NN).

Suppose we take it as given that income earned in the U.S. is taxed.

This tax is a cost from the TP’s standpoint – but socially a transfer (U.S. Treasury gets the money & can give it to someone).

Hence, TP incentives are fundamentally distorted, from a U.S. national standpoint, if they can avoid this tax by investing abroad.

And this seems to suggest a compelling efficiency case for WW taxation (make the tax unavoidable / lump sum so far as locational choice is concerned).

2. Why residence-based WW corporate taxation, cont.

Despite its seemingly compelling logic, the efficiency-based case for WW taxation ISN'T as clearly right as it initially appears.

Suppose we could impose WW taxation on everyone in the world (!!).

This would entirely eliminate the distortion (from our standpoint) of discouraging U.S. investment by taxing U.S. source income.

But we can't do this. The only foreign-source income we can tax is that of U.S. residents (under the current hypothetical, individuals).

This *potentially* has only clientele effects (i.e., affecting who owns which assets – not where assets are located).

(Note effect on U.S. vs. foreign individuals' *relative* valuations of U.S. assets vs. tax haven assets.)

If so, no U.S. efficiency gain from WW tax. But is it so? We don't know. (It's an empirical question based on a counterfactual.)

2. Why residence-based WW corporate taxation, cont.

In sum: if individuals were taxed directly on corporate income, there would be a distributional reason, & *possibly* an efficiency reason, for residence-based WW taxation.

But now let's return to the real world – entity-level corporate tax, with residence determined at the entity level.

How does this affect the analysis?

<u>Distribution</u>: We are now effectively taxing both U.S. & German SHs on non-U.S. income earned through GE, but neither on such income earned through Siemens.

So need to think through (a) losing the income tax when U.S. ind'ls invest through Siemens & (b) gaining it when Germans use GE.

2. Why residence-based WW corporate taxation, cont.

U.S. individuals investing through Siemens: inability to tax this means we can no longer defend the income tax via WW taxation IF they are sufficiently willing & able to invest abroad through foreign entities.

So residence electivity matters! (If complete, the tax would now be pointless.)

Foreign individuals investing through GE: If they value investing through U.S. entities, why not charge them for it? (More $$ for us.)

U.S. states may charge them “too little” for incorporating here, due to interstate competition.

So again electivity matters – though, why would the optimal levy be a residual income tax on the companies’ foreign source income?

2. Why residence-based WW corporate taxation, cont.

Last piece of the "why WW" analysis – effect on *efficiency* of imposing WW tax on corporate residents rather than individuals.

Same empirical question as before: does the WW tax on residents increase domestic investment relative to a source-based tax only?

But additional reason to doubt it will work: rather than just U.S. & foreign individuals swapping claims effects, can also have both using foreign rather than U.S. entities.

Empirical literature to date suggests that imposing WW tax on U.S. entities (so they can't escape the domestic tax by investing abroad) probably fails to increase U.S. investment. (Is mainly firm-level, but …)

SO: the main surviving rationale for WW pertains to distribution & U.S. ind'ls who invest abroad but prefer to use U.S. entities.

3. Is electivity rising enough to change the analysis?

Hard to gauge empirically. What should fall, if electivity is rising, is not so much U.S. incorporations as *use of U.S. entities (new or old) in business activity outside the U.S., relative to what it would have been otherwise.*

3 possible arenas for electivity are especially important:

(a) New start-ups of prospective multinationals by U.S. individuals,

(b) Expatriation by existing U.S. companies,

(c) Who makes new investments abroad as between U.S. & foreign companies (new equity in existing companies).

3. Is electivity rising enough, cont.

(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's demonstrably valuable is good enough.

(e) U.S. worldwide taxation isn't all that onerous in practice.

So: electivity remains non-trivially limited.

3. Is electivity rising enough, 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 a significant degree, "trapped."

3. Is electivity rising enough, cont.

New investment by existing companies – a crucial margin, but the one about which we currently know the least.

Significant effects are plausible if firms are ultimately raising capital on competitive world capital markets based, inter alia, on the after-tax returns they can offer (tax surplus vs. corporate surplus).

2008 Tillinghast lecture (J. Samuels): a key reason for shifting to exemption: U.S. SHs of U.S. companies are losing rents due to the tax disparity here.

I am skeptical of this claim (& can discuss in the Q & A).

But electivity re. which company invests would indeed make WW tax on U.S. companies increasingly pointless (& perhaps costly).

3. Is electivity rising enough, cont.

Bottom line– rising electivity matters (but perhaps is less far along, & less unstoppable, than I thought at the start of this project).

It weighs against retaining WW system, but significance depends on how strong you'd otherwise find the case for WW.

My view: Suppose we could repeal FTC & deferral, using instead a lower rate for foreign source income (FSI) to achieve the optimal tax burden on outbound.

Exemption is one example of such a system, in which the outbound rate happens to be zero.

With no FTCs or deferral, remaining U.S. market power re. corporate residence suggests the optimal outbound rate may be > zero.

But – any WW system we might actually have will use FTCs & deferral, rather than a rate between 0% & 35%, to fine-tune the burden on FSI.

3. Is electivity rising enough, cont.

FTCs & deferral guarantee a horrible ratio of tax planning, et al costs to revenue raised.

And, since their distortions tend to offset, cutting back on either just makes the other worse (in addition to raising the tax burden on FSI).

Hence, with deferral & FTCs being inevitable in a system where the outbound rate > 0, exemption is an appealing alternative.

Rising electivity, by moving the optimal tax rate for FSI closer to zero, strengthens this indirect case for exemption.

Your mileage admittedly may vary.

BUT – if we shift to exemption, what about "trapped" U.S. companies with unrepatriated foreign earnings? Issue of TRANSITION.

4. Transition to a territorial system

Nominally prospective law changes (applying only post-effective date) can retroactively affect pre-enactment decisions.

E.g., you buy tax-exempt municipal bonds & then the exemption is repealed – is next year's interest taxable?

Shifting to exemption for foreign source income: U.S. companies incorporated here & invested abroad in the expectation that foreign earnings would be taxed upon repatriation.

U.S. companies have > $10 trillion invested abroad, including as much as $1 trillion in unrepatriated foreign earnings.

Why excuse the expected tax on these earnings just because we've decided that we like exemption prospectively?

4. Transition, cont.

Three leading perspectives that suggest denying the transition gain:

(a) Reliance (“old view”): if imposing transition losses (a la muni bond repeal) is unfair, so is allowing transition gains.

Cf., William Andrews, David Bradford: prevent unfair “windfall gain” to SHs from corporate integration (e.g., via dividend exemption).

(b) Lump sum taxation: a one-time taking is efficient if unanticipated & not expected to recur. (So less need for distortive taxes.)

Weighs against a one-time giveaway, increasing the need for distortive taxes.

But overshooting the mark may prompt concerns about recurrence.

(c) Incentive effects of anticipation (“new view”): a bit more complicated.

4. Transition, cont.

Prior to enacting exemption, the prospect of a transition tax would *increase* discouragement of new U.S. equity (presumably a bad thing).

But it would *reduce* discouragement of pre-enactment repatriations of foreign earnings (since waiting for exemption doesn't help).

I'd argue that the latter is more tax-responsive, & hence that the new view suggests NOT allowing windfall gain.

The problem: how preserve expected tax revenues without having to keep a complex system in place indefinitely?

But not to worry: I have a modest proposal (& fallbacks).

4. Transition, cont.

The best solution is a one-time tax on unrepatriated foreign earnings & profits of U.S. companies' foreign subsidiaries.

For simplicity, no foreign tax credits or deferral – can simply lower the tax rate instead (applying "burden-neutral" rate in PV terms).

U.S. companies are supposed to keep of foreign subs' E&P anyway (so as to test repatriations for dividend treatment).

Revenue raised would = the tax base (about $1 trillion) X the rate.

In determining the burden-neutral rate, consider not just expected future taxes under present law, but expected tax planning & compliance costs that TPs anticipated under the old system.

4. Transition, cont.

Grubert-Altshuler 2008 + Clausing-Shaviro 2010: may suggest that a plausibly burden-neutral rate (in lieu of deferral & FTCs) is, say, 20%. (But – this is *very* preliminary & back-of-the envelope.)

Thus, a plausible transition tax, accompanying a prospective shift to exemption, conceivably might raise in the neighborhood of $200B.

Nominally similar to original Obama Admin. international tax proposals' 10-year estimate (though here it's up-front, no revenue outside the 10-year window, no adverse prospective incentive effects).

Payment of the transition tax could be deferred with interest (and could await end of the current recession).

A fair one-time price to pay for shifting to exemption? (Since it's just pre-payment, not an *extra* cost.)

4. Transition, cont.

If the one-time transition tax is politically unfeasible, one might want to consider messier alternatives.

E.g., follow the Andrews ALI proposal for corporate integration w/o windfall gain (limiting the new tax benefit to “normal” returns on post-enactment new equity).

Problems include the need for rules to prevent “freshening up” old equity (such as via round-trip stock repurchase / new issuance).

More imperfect still: enact reduced repatriation tax rate, which goes to zero for a given company once it has repatriated amounts equal to all pre-enactment E & P.

And in conclusion …

1) Electivity is important prospectively. Surely rising, though note reasons for expecting continued U.S. incorporation of future "home run" global companies (Microsofts of the future).

Concern about rising electivity strengthens the case for shifting to a territorial system – though the issue of income taxation & future Bill Gateses can't be entirely dismissed.

The arguments for shifting to a territorial system do not support handing a "windfall" gain to existing U.S. companies.

An administratively (if not politically) feasible transition tax might conceivably raise on the order of $200 billion.