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

Daniel Shaviro

NYU Law School

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Overview of paper

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

2) Possible rationales for a WW, 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?

(But for today, only have time for topics 1 & 3.)

1. Defining Tax-Electivity

<u>Electivity</u>: 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.

Depends on market completeness, operative "constructive sale" rules, etc.

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.? (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.

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?

VERY quick summary: Though corporate residence is not normatively meaningful, some possible motivations relate to:

(a) Distributional aims & domestic SHs if have a WW income tax on individuals & don't like avoidance via use of US MNEs (the "Gates-Zuckerberg problem").

(b) "Fee" on foreign SHs if they value domestic incorporation (though note bizarre fee structure of taxing "outbound" for this reason).

Efficiency: substitution vs. complementarity; suppose one could use revenues to lower the source-based domestic rate.

Are intermediate MTRs for FSI (between 0 & 35%) permissible?

To promote peace & harmony here, note why I favor exemption if intermediate MTRs are unavailable: it's the only way to wipe out deferral & FTCs; 0% may be closer to optimal than 35%.

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.*

This raises the 4 settings from earlier slide, which (other than inpatriation by foreign companies) were:

(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. Rising electivity, 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 has demonstrable value is good enough.

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

So: electivity remains non-trivially limited.

3. Rising electivity, 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, trapped.

3. Rising electivity, cont.

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.

3. Rising electivity, 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.

Note briefly Topic 4: switching to exemption would raise transition issue (pre-enactment foreign earnings).

A sensitive & complex topic, but note:

(a) Bradford / Andrews view of transition & corporate integration.

(b) Incentive issues: prospect of a future shift to exemption without transition tax has 2 main effects: reduced tax deterrence of new equity (good), increased deterrence of pre-enactment repatriation (bad).