The Prospects for Corporate and International Tax Reform: What to Expect When You're Not Expecting

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Covington Retreat for International Tax Executives, October 18, 2012

Good news about tax reform!

I've devised my own plan for corporate & international tax reform – so clearly meritorious that I expect Congress to adopt it imminently …

… even though they don't know about it yet. But I'm not worried – Tax Notes doesn't require much lead time.

Since I know you'll agree, perhaps we can find some other topics to discuss in the PM sessions.

OK, obviously I'm kidding. Neither the politics nor the merits are quite that easy.

But my "plan" actually would be as good as I say if it were feasible – & more importantly, we learn from its unfeasibility why corporate / international tax reform are so hard & inevitably unsatisfying.

The Shaviro “plan” for corporate & international tax reform

Grant me just one false assumption: that we can attribute all corporate income, from all companies in the world, to the SHs (or others) on a perfect flow-through basis.

Never mind that we can’t actually do this – partnership taxation is a horrendous mess, & subchapter S extremely limited.

But if we could, a whole lot of things would suddenly become easy.

Indeed, we’d now have an ideal system, leaving aside general income tax problems (realization, do we want to tax saving, etc.).

When we *can’t*, corporate & international tax inevitably present awkward dilemmas. Can’t (a) identify everything you’d like to tax the same way or (b) tell apart things you’d like to tax differently.

Details of the Shaviro "plan"

1) Since all tax items were being (perfectly) flowed through to the individual level, corporations would no longer be taxpayers or have residence for tax purposes. (Corporations might or might not *remit* taxes for the TPs.)

2) U.S. individuals: taxable on all WW income (including from any U.S. or foreign company), no deferral, FTCs only on a reciprocal basis with particular countries.

3) Foreign individuals: do we want to tax them on a source basis (& if so, at what rate)? Depends on incidence (economic rents, etc.).

4) Same type of question re. foreign individuals investing through U.S. companies. But any such tax – in effect, cartelizing Delaware vs. Nevada et al – wouldn't necessarily depend on the U.S. company's foreign source income (FSI). And certainly not on the U.S. tax rate for U.S. individuals' FSI.

Merits of the Shaviro "plan"

1) The whole point of an income tax is to tax residents' / citizens' income without regard to where, through what entity, etc., it was earned.

2) No U.S. tax disadvantage for U.S. companies except insofar as we can make foreigners pay a tax for investing in U.S.-incorporated (&/or headquartered?) companies.

3) No need for source rules, except for inbound taxation by foreign individuals if we decide we can truly make them pay.

4) No debt vs. equity issues, no dividend tax or other double tax, no deferral & repatriation issues, no FTC planning issues, etc.

Absent the Shaviro "plan"

Back in the real world, we end up taxing likes differently, unlikes the same (defined in terms of *people*).

<u>Example 1</u>: U.S. individuals who earn income through corporations (including as owner-employees).

While there is no relevant difference between them & U.S. individuals who earn income directly, we can't tax them all the same.

FSI automatically escapes if earned through a foreign corporation (e.g., mega-millions earned by IP startups' founders).

We can't even tax U.S. individuals' domestic source income unless we impose a source-based tax.

But now we get <u>Example 2</u>: U.S. vs. foreign individuals who earn $$ (including just as investors) in the U.S. Shouldn't want to tax them the same (easy for foreigners to leave), but now we must.

More headaches absent the Shaviro "plan"

Example 3: U.S. individuals who earn FSI (a) directly, (b) through a U.S. company, (c) through a foreign company.

We should want to tax all 3 the same. But since we can't tax (c), (b) must be unduly tax-favored vs. (a) or tax-penalized vs. (c).

Example 4: Foreign individuals who want to use a U.S. company.

Even if we want to charge them something beyond the source-based tax on U.S. source income, the tax rate for FSI that we choose with U.S. individuals in mind is unlikely to offer a good fee structure.

Corporate tax reform in the real world

By keeping the entity-level corporate tax, we guarantee ourselves a messy starting point.

There nonetheless – surprisingly – is a near-consensus plan: lower the rate, but make it revenue-neutral by broadening the base.

But the consensus disappears when you start to dig down a bit.

Problems include:

--Should the corporate sector pay? The broader business sector?

--How can we even think about the relationship between corporate & non-corporate business (or about taxes inside the corporate sector) if the burden of the SH-level tax is variable?

--If it's revenue-neutral overall, can the taxpayers that would be happy to have their taxes increased please stand up?

Why favor a corporate rate cut?

There actually is a good reason: it's a proxy for reducing source-based taxation of mobile capital. (Also, the tax bias favoring debt over equity.)

Foreigners can invest elsewhere: U.S. individuals can invest abroad w/o paying U.S. tax, either through foreign companies or (given our international tax rules) U.S. companies. Plus, reduced profit-shifting would give us some "free money" even if the rate cut costs $$ overall.

But doing this means offering a tax cut to owner-employees of U.S. companies who earn labor income (economically speaking) in the U.S.

No good reason to make use of the corporate form a tax shelter for U.S. individuals (a la the "John Edwards sub S tax shelter").

There are some possible responses (e.g., the Scandinavian "dual income tax"), but don't hold your breath.

Paying for a corporate rate cut

If we're concerned about the deficit & fiscal gap, is paying for the rate cut good enough? (Who's to say it's better than other "wish list" items?)

The revenue-raisers can't *also* be used to improve our fiscal situation – which needs to be addressed at least eventually.

If base-broadening keeps *average* U.S. corporate tax rates the same, will we really get more investment here?

Investment choice (such as where to put a factory) often depends on average rates, even if profit-shifting depends on marginal rates.

Many base-broadeners might involve repealing incentives for new investment, whereas lowering the corporate rate is partly a windfall for old investment.

International tax reform

Initial problem: two rival definitions are (a) territoriality, (b) more robust WW tax on U.S. companies.

Both have intuitive & political appeal that help explain the horrendous current “ceasefire-in-place” (with full U.S. statutory rate for FSI, but deferral. FTCs, high ratio of tax planning costs to revenue raised).

The 2012 campaign has helped show the continuing political pull of both poles – e.g., “competitiveness” vs. attacks on “outsourcing.”

Multiple layers of confusion / conflation between distinct issues here. E.g., tax rate on FSI, vs. marginal reimbursement rate (MRR) for foreign taxes. And we can’t solve it through the “Shaviro plan.”

We should want full WW taxation of *U.S.* individuals – the issue at the heart of controversies about tax planning by Apple, Google, etc. – but can’t if they use a non-U.S. company. (Plus, basing the tax on U.S. companies drags in foreign investors.)

A 2nd international tax reform thought experiment

How I think about international tax reform: 3 conceptual steps.

(1) Revenue-neutral combination of (a) repeal deferral and the FTC with (b) lowering the tax rate on FSI.

Everyone knows deferral makes no sense (just a way of lowering the effective tax rate relative to pure WW tax).

FTCs create zero cost-consciousness if not counter-acted by deferral – we should want U.S. companies to seek foreign tax savings.

Given the spread of exemption in other countries, FTCs are increasingly non-reciprocal (since exemption is an implicit deductibility system for foreign taxes).

But this is only Step 1 (base-broadening;no analysis yet of what the effective rate should be). Revenue neutrality is just a placeholder.

More of the thought experiment

(2) Having swapped FTCs for mere deductibility plus a lower rate, are we done with the issue of foreign taxes?

Exemption countries often address tax havens – e.g., through a list or a minimum-rate requirement (like Japan's).

The dilemma: We should be glad if a U.S. company shifts high-tax German income to Bermuda (at least if U.S. investment is constant) – but maybe not if they do this with U.S. source income.

"Tagging" rationale for treating very low foreign taxes as a possible indicator of the "wrong" kind of income-shifting.

Very important to design this with an eye to the resulting MRRs for foreign taxes (note, e.g., the pitfalls of a minimum rate "cliff").

The rest of the thought experiment

(3) Appropriately change the effective tax rate on FSI by raising or lowering the rate (again, holding it constant was just a place-holder).

If the tax rate on FSI is zero, this is simply exemption! Territoriality is thus an example of my preferred approach, so far as tax base design is concerned.

However, I'd argue that the tax burden on U.S. companies' FSI should be somewhere *between* 0% & the full domestic rate.

A key issue is the "tax elasticity of U.S. corporate residence." And this is *not* just about new incorporations plus expatriation.

More formally stated, a key issue is the marginal efficiency cost of funds (from the ratio of deadweight loss borne by U.S. individuals to revenue raised).

Summing up the 2nd thought experiment

In sum, we should: (a) significantly lower the (currently 35%) statutory tax rate for FSI, (b) repeal deferral, (c) make foreign taxes merely deductible, but perhaps with some sort of anti-tax haven rule that is effectively worse-than-deductibility at least in some settings.

U.S. tax revenue from FSI might go up or down, but a more efficient system, with lots of room for U.S. companies' real tax burdens (including from tax planning & compliance costs) to decline.

Unfortunately, this is probably no less a fantasy than my first thought experiment.

For example, companies might reasonably worry that, once they've traded base-broadening for a lower rate, the rate will rise again.

Where does this leave international tax reform?

Deferral + FTCs guarantee a horrendously bad ratio of tax planning, compliance costs, & other deadweight loss to revenue raised.

Exemption gets rid of these problems due to the base, not the rate. But if zero is the only permissible rate that uses the correct base, we have an awkward tradeoff that – in Washington today, as opposed to 2-3 years ago, I believe only the Republicans, not the Democrats, might accept.

The zero rate is a hard sell when profit-shifting is so rife, & when the "runaway factories" scenario retains so much political resonance.

So I'd predict continuation of the current "ceasefire-in-place," horribly unsatisfying to everyone though it is.

More on the politics

Both corporate and international tax reform present complicated issues & have no consensus “right answer” a la 1980s fundamental tax reform.

And even if something gets pushed through, how stable will it be?

Rule 1 of revenue-neutral tax reform: unless it makes no difference, there are bound to be both losers and winners.

Rule 2 of tax reform: losers’ anger > winners’ gratitude.

Rule 3: it helps if the parties can work together (not just on substance but “mutual disarmament”). Not realistic for **at least** the next 4 years.

Rule 4: revenue –neutral tax reform seems like an awful lot of work for zero change in the long-term U.S. fiscal situation.

I also see *NO* good reason for 1986-style tax reform of the individual tax. Why lower the top rate?