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Stateless Income and Its Remedies

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Abstract

This outline presentation (I) quickly reviews the current status of business tax reform efforts in the United States, with particular attention to the international treatment of foreign direct investment, (II) summarizes the economic predicates required for territorial tax systems to advance economic efficiency, (III) explains why the phenomenon of stateless income means that those predicates are not met today, and are unlikely to be met in the future, and (IV) analyzes current U.S. legislative international tax proposals. In doing the last of these, the presentation points out how the legislative proposal advanced by Dave Camp, Chairman of the House Ways and Means Committee, might inadvertently operate to treat "good" operating income as subpart F income in a range of plausible cases.

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Stateless Income and Its Remedies

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Part I: U.S. International Tax Reform Status Report

U.S. FDI Tax System Today

- Ersatz territorial tax system
  - As a “cash” tax matter
  - And (probably more important) also as a GAAP matter
- Exception I:
  - Extraordinary dividends are taxed
- Exception II:
  - Royalties and interest from foreign subs are tax-preferred, compared with an ideal territorial system
- Two exceptions point in opposite directions
- Exception III:
  - The lock-out phenomenon

U.S. Ersatz Territoriality In Action

- Hideously complex
  - Firm results vary with vagaries of business or locations
  - Expensive and difficult to maintain the “tax distillery”
- Cash and earnings must follow tax constraints
  - Estimates: $2 trillion in PRE, $800+ billion in cash
- U.S. tax base erosion
  - Borrow here, let PRE accumulate there
  - Few signs of capital markets constraints
  - Trend to lower foreign rates has eased sec. 864(e) issues
- Results turbocharged by:
  - Migration of intangibles out of the U.S. (more base erosion)
  - “Stateless income”

Stateless Income

- Income of an MNE
  - Derived from factors of production in foreign “source” country
  - Taxed in foreign country other than country where factors of production are located or home country of group
- Taxed at very low rates
  - Migration of high tax foreign income to low tax jurisdictions
  - E.G. Software sales in Germany where profits end up in Ireland
- Parallel to avoidance of home country tax
  - Transfer pricing abuses, etc. relevant to both
  - Policy recommendations relevant to both

Practical Consequences of Stateless Income

- U.S. firms are hoist by their own petard!
  - Hugely successful in generating stateless income
  - Wallowing in $2 trillion in permanently reinvested earnings
  - GE worldwide ETR for 2013 (on $13B earnings) = 4.2%
  - Numerous examples of single digit effective foreign tax rates
- No observable current competitiveness costs
  - Except costs of maintaining the tax machinery
  - No current tax or GAAP drag
  - Offshore cash cannot be used to support stock price
    - Must find other uses for all those earnings
    - But money is somewhere in the U.S. economy
  - And domestic tax base is eroded

Where Is U.S. Business Tax Reform Today?

- President:
  - Lower corporate rate perhaps to 28%, somehow
  - Tax existing PRE stockpile to raise $150B for infrastructure
  - Another $250B (mostly international) to pay for rate reduction
- Dave Camp
  - Detailed and comprehensive tax bill with many useful ideas
  - "Revenue neutral" reform with lower personal tax revenues
  - Corporate rate to 25%; individuals to 35% (except manufacturing), but on broader tax base
  - Territorial system, $170B transition tax on PRE stockpile
  - $590B apparently shifted from business to lower personal taxes, but much of that recaptured by unincorporated sector

International Tax Reform Today?

- U.S. taxation of international operations is screwed up
  - “Competitiveness” complaints largely fact-free
  - Stateless income runs rampant
  - Behavioral distortions are pervasive
  - *Domestic* revenue base is at risk
- Other countries engaged in *tax mercantilism*
- Only three obstacles to doing better
  - Definition of corporate “residence” is difficult
  - Identifying the “source” of income is even tougher
  - Politics made still more difficult by tax mercantilism of many countries

Can U.S. Get to a Deal?

- There are some points in common
  - Surprising consensus on corporate tax rates in particular
  - And agreement that international system is unstable and must be fixed in ways that eliminate lock-out
  - Weaker consensus that business tax reform cannot be a substantial revenue generator
  - But zero chance of consensus around larger revenue targets
- Can business tax reform move separately?
  - Technical issues of distinguishing labor from capital income
  - Substantial differences in approaches to international income
  - Political goals

Part II: Rethinking the Predicates of Territorial Taxation

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Implicit Taxes

- Implicit taxes = yield reductions when markets bid up prices to reflect a favorable tax attribute
- Tax-exempt bonds are the classic example
  - Assume 10% taxable yield, 35% tax rate on all investors: municipal bonds in an ideal market would yield 6.5%
  - 35% reduction in yield = implicit tax, but implicit taxes are not paid to any revenue authority
- Perfect "tax capitalization" (full implicit taxation) means:
  - The sum of explicit and implicit taxes on all investments is the same (although the proportions will vary)
  - Investments have different pretax or nominal yields, but identical risk-adjusted after-tax yields

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Implicit Tax Is Basis of Territoriality

- Imagine that after-tax rates of return are the same everywhere. This means that *pretax* returns vary: higher in high-tax countries and lower in low-tax ones

- In that world, the U.S. should not tax low-tax Irish foreign income – it already has borne a full tax, in the form of an implicit tax. Tax capitalization means that the prices of Irish firms already reflect their low-tax environment

- Imposing additional tax would be like suddenly taxing US municipal bond income: the tax has already been suffered in yield, through tax capitalization

Ideal Territorial Taxation Requirements

- Geographic source of income (location of strongest economic nexus to income generation) is unambiguous
- After-tax risk-adjusted corporate returns are the same everywhere in the world, so residence tax = double taxation
- Returns therefore are taxed only in source country (i.e. where factors of production are located)
- This is an *implicit tax* (= *tax capitalization*) model
  - Worldwide asset prices adjust to offer investors constant after tax yield
- A principal thesis of my work is that stateless income vitiates tax capitalization, and hence undercuts territorial tax norms

Stateless Income Defeats Tax Capitalization

- In an ideal world, tax capitalization works for “asset” arbitrage
  - Tax-favored assets are bid up in price until after tax yield = yield on ordinary assets (*pace* muni bond experience)
  - And open capital markets mean uniform yields worldwide

- But tax capitalization *cannot* work for “status” arbitrage
  - Example: Taxable government bond held by IRA or charity.
  - Different holders face different tax rates on the same asset, so there is no market clearing price that = single after-tax yield

- Stateless income is an instance of “status” arbitrage
  - A property enjoyed by MNEs, but not wholly domestic firms

Stateless Income in Action

- Stateless income "status" arbitrage gives MNEs reason to favor FDI in *high-tax* countries
- MNEs but not domestic firms can employ stateless income planning to migrate that high-tax income to low-tax locations
- Result: high-tax pre-tax yields at low actual tax rates
  - Low-risk supernormal returns! = *Tax Rents*
- High-tax pretax returns are not bid down, because domestic investors cannot obtain the benefits of stateless income

Example: A Hypothetical Auction

- U.S. and German firms bid for an Irish target
- CEN contemplates that U.S. firm will not prefer the Irish over a U.S. investment
- CON (as per D&H) deprecates that concern (someone somewhere will make the U.S. investment) and emphasizes that U.S. firm should not be outbid by German firm just because latter enjoys a territorial tax system for its FDI
- But if one wants a fair auction, CEN and CON really are complementary. US firm's priorities should not change (CEN) *and* US should not be tax-disadvantaged vis a vis German firm (CON)

The Hypothetical Auction (Again)

- Now imagine that after-tax rates of return are the same everywhere, because domestic buyers are the marginal buyers, but MNEs enjoy stateless income
- In that world, a U.S. MNE will prefer acquiring a target in a high tax foreign country over domestic investment
- The auction is now distorted, in that tax considerations change the US firm's priorities
  - And to say that a foreign firm will make the 'missing' domestic investment now misses the mark
  - First, ownership neutrality has not been achieved, only (perhaps) investment neutrality
  - Second, foreign MNE investment in the US as source country is susceptible of stateless income planning, and hence revenue loss

Policy Implications

- Ideal territorial tax means suppressing stateless income
  - OECD BEPS project is holding back the sea with a broom
  - Can we ever get source (economic nexus) of income right?
    - Section 954(h) is lone success story, but no one wants to replicate that
  - And do we really believe one-world after-tax yield story?
  - Are countries really willing to abandon tax mercantilism?
- And also interest expense allocation
  - Thin cap as a means to move interest expense
- But what is the alternative?
  - Country-by-country minimum tax on FDI?
  - Robust CFC rules, e.g. for rents?
  - Inclusion of FDI but at discounted tax rates?

Part III: Remedying Stateless Income

You *Really* Want to Get Source Right?

- § 954(h) (the "active finance exception) is a rare example of successful source policing
- But look what it requires
  - CFC must be *predominantly engaged* in finance business and must directly conduct *substantial activity* with respect thereto
    - "Predominantly engaged" means > 70% of income from financing business
    - "Substantial activity" means conducting *substantially all* the activities needed to operate a "customer" business, from beginning to end
  - And then only "qualified income" is covered
    - Income from non-U.S. *local* customers where *substantially all* activities are conducted by home office in home country, or QBU in QBU country
    - Income treated as earned in home country (or QBU country) for purposes of that country's tax laws
    - 30%+ of income must be from 3rd party business in home (or QBU) country
    - And still more stringent rules for cross-border lending

Antiabuse Rules = Residence Taxation

- Many antiabuse proposals are really ersatz residence based corporate tax systems
  - CFC rules, CbC minimum tax, inclusion at discount rates
- Easier to police corporate residence than income nexus
  - But is it economically rational, or just a pragmatic answer?
- Requires thinking about theory of corporate tax
  - Corporate tax justifiable as a withholding tax on shareholders
  - WW taxation of individual residents is an accepted norm
  - U.S. still can treat a US corporation as a good proxy for US people – roughly 85% overlap
  - Foreign control in Canadian economy overall ~ 29% of revenue, ~47% in manufacturing

Camp Bill International Provisions - I

- Lower domestic corporate tax rate to 25%
  - Also for passthroughs' manufacturing income
  - No *domestic* thin cap
  - Reduce many business tax expenditures
- Adopt territorial tax for FDI
  - Technically, 95% exclusion on dividends
- Impose complex new subpart F rules
  - Income from exploiting U.S. market fully taxed at 25%
  - New FBCSI; new "Foreign Base Company Intangible Income"
- Budget Consequence: *Loses* $100 billion/10 years
  - Technically raises $70B, thanks to $170B one-time transition tax

Camp Bill International Provisions - II

- FBCSI
  - Effectively a minimum tax of 12.5% for non-treaty CFCs
  - And does not apply at all to treaty CFCs
- FBCII
  - A minimum tax on returns >10% on tangible assets
  - Includible in US at 15% rate; same rate for direct sales from US
  - Really a tax on excess returns, not on specific intangibles
  - Estimate (Sullivan): FBCII = 77% of CFC income
- Extremely Complex
  - Interactions between categories; Treaty countries will cut deals?
- How better than a CbC minimum tax?

Camp Bill Example With Interactions - I

- FACTS
- CFC has $1,000 of operating (nonsubpart F) income and tangible assets of $10,000.
- By itself, no FBCII issue (return does not exceed 10% of tangible assets).
- CFC also has a portfolio securities investment of $10,000, which hits a home run and yields $4,000 this year.
- CFC has zero foreign tax.

- FPHCI
- CFC's Adjusted Gross Income = $5,000 [Ignore operating expenses]
- CFC's E&P = $5,000
- FPHCI = $4,000, fully includible in US Parent's income

Camp Bill Example With Interactions - II

- **FBCII**: No rule turns off FBCII even though $4000 = FPHCI
- Excess Return = AGI - [10% x $10,000 tangible assets] = $4,000
- FBCII = Excess Return - [(Excess Return/AGI) x Other Subpart F Income]
- FBCII = {$4,000 - [4000/5000 x $4,000]} = [$4,000 - $3,200] = **$800**
- (FBCII + FPHCI) < CFC's e&p, so 952(c)(1)'s limitation of subpart F income to current E&P does affect analysis
- US shareholder gets a 40% deduction, so **$480 of FBCII** includible in US shareholder's income, in addition to $4,000 of FPHCI.
- **So net effect is that $480 of operating income has been converted into subpart F income.**

The U.S. – Embrace Residence Taxation

- Full inclusion but low rate = Baucus Option Z++
  - WW tax consolidation
    - So foreign losses are utilizable in US
  - One tax rate (25%?) for net global income
  - Full FTC utilization, no 864(e) expense allocation
  - Much simpler than Camp FBCII etc.
- More robust than territorial
  - *Domestic industries will work to protect rate too*
  - No risk of 'silent' rate increase through expense allocation
  - Won't lose $100 billion/10 years, like Camp Bill
- Requires low tax rate
  - Implies some loss of control over corporate rate setting

But What About the Rest of the World?

- Corporate tax on WW income + many nonresident owners leads to double tax on nonresidents
- Imputation solutions + refundability leads to gaming
- WW corporate tax + individual level exemption requires global coordination and tough domestic political story
- Chip away at stateless income
- And move capital income taxation to individual level
- And that is what the Business Enterprise Income Tax does . . . .