Fixing U.S. International Taxation

by Daniel N. Shaviro

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Professor Daniel Shaviro, a distinguished legal scholar, has now added his voice to the large group of economists and attorneys proposing reforms of the international system, which everyone agrees desperately needs reform. His new book, Fixing U.S. International Taxation, is a lively but not entirely convincing contribution to an important and timely subject.

I. PROBLEMS WITH CURRENT ANALYSES

A. Issues and Options

Professor Shaviro has a number of complaints about the current state of knowledge regarding the international tax system. The first is about the pervasive concern with "double taxation" instead of the overall burden of taxation on foreign source income (FSI). His main target is the foreign tax credit, which does not give U.S. companies an incentive to lower their foreign tax burdens. He acknowledges that the current deferral regime does create such an incentive, but his point is directed more to reform proposals that eliminate the repatriation tax and substitute a partial or full current inclusion of FSI. He suggests that maximizing national welfare should be goal of the U.S. tax system rather than maximizing worldwide welfare, in which case foreign taxes should not be counted in the welfare analysis. Consistent with this view, Shaviro supports allowing a deduction rather than a credit for foreign taxes. He also introduces the concept of the Marginal Reimbursement Rate (MRR) for foreign taxes as a useful tool for characterizing international tax proposals. The MRR is the rate at which U.S. tax liabilities are
reduced per dollar of foreign tax when FSI enters the U.S. tax base. It is 1.0 in the case of a full foreign tax credit.

Professor Shaviro criticizes current policy discussions which he claims offer only a choice between full inclusion of FSI in U.S. taxable income with a credit for foreign taxes, and a territorial system with no tax on repatriated dividends. He says that, “Intermediate statutory rates are not so much consciously rejected as ruled out from the start, as if they were (for some reason) logically impossible (p. 10).” This is a somewhat surprising claim because proposals for partial inclusion have been around for a long time and are embodied in various recent versions of a minimum tax on foreign income such as those in Grubert and Altshuler (2013) and the discussion drafts on tax reform presented by Chairman David Camp (R-MI) of the House Ways and Means Committee (2011, 2014) (the latter after the book went to press). Shaviro’s proposal for a “modified territorial” system is to have some positive, but unspecified, low rate on current foreign income with only a deduction for foreign taxes. But as we will see, he recognizes this approach has problems of its own and offers an alternative that is not very different from a minimum tax with full credit for foreign taxes.

The issue of choosing between the goals of maximizing national or world efficiency is, however, a difficult one to resolve. Governments have a wide range of economic and political relations so that gains and losses can be offsetting. Many costs and benefits must be balanced in evaluating a tax reform package. In particular, the United States is a relatively high tax country, so it might be a net loser if maximizing national interest becomes the universal standard. Beyond that, worldwide efficiency is implicitly the standard in many aspects of international tax relations. For example, in the area of transfer pricing, the goal of the arms’ length principle (ALP) is to preserve the neutral choice between related party and unrelated party transactions in the interest of worldwide efficiency. Whether one leg or the other of the transaction is foreign or domestic is not a consideration. Finally, as Grubert and Altshuler (2013) indicate, it is possible to make substantial progress in increasing both national and world welfare, irrespective of what other countries do, without having to choose between the two standards.

Shaviro concedes that the policy of encouraging U.S. companies to lower their foreign taxes may be counterproductive if it leads to the erosion of the U.S. tax base, and notes that more evidence on this issue is needed. In fact, Grubert (2012) shows that a lower foreign effective tax rate is associated with both a significantly higher foreign profit margin and a comparably lower domestic profit margin. A significant part of the foreign tax saving is matched by lower U.S. tax liability. This is confirmed by the finding that the ability to increase foreign profit margins in low tax countries derives principally from the presence of parent industrial intangibles. The foreign income that is shifted from high tax countries to low tax countries is largely income that would have been paid as royalties to the parent in the absence of a foreign-domestic tax differential.

Professor Shaviro does recognize that his modified territorial system with a low rate of tax on FSI and only a deduction for foreign taxes paid favors tax haven income. He therefore suggests a higher U.S. tax rate on FSI when the foreign tax rate is low. The sliding scale he proposes for a minimum tax results in an MRR, as he calculates it, of
0.8, not very far from the MRR of 1.0 under a full foreign tax credit in a minimum tax. This difference from the conventional analysis may be a modest but useful addition to current proposals.

B. The “Alphabet Soup” of Alternative Principles

Professor Shaviro’s second complaint is about the “alphabet soup” of principles of international taxation and the many margins that must be analyzed. He criticizes the previous international tax literature for restricting the discussion to CEN (capital export neutrality), CIN (capital import neutrality), CON (capital ownership neutrality), and NN (National Neutrality), rather than adopting the methodology found in other areas of public economics of dealing explicitly with the trade-offs between various margins rather than looking at them only one at a time. But it has long been recognized that the international tax problem is a general “second best” issue and the various standards are just special cases of the general problem. For example, CEN assumes that there is a fixed amount of capital in the U.S. corporate sector and that the only issue is whether it will be invested at home or abroad. More generally, there is no “magic-bullet” answer that fits all companies. The general “second best” rule is that the optimal tax depends on which operations (including possibly its own in another location) compete with a company’s foreign investment and what its sources of capital are. Companies vary and the goal of policy is to construct a system responsive to the positions of different types of companies without having to tailor a different tax regime for each company.

There are many relevant behavioral margins, such as the choice of production location, where to exploit a valuable intangible, the choice between related party and third party transactions, etc. Ideally there would be policy instruments to match with each margin so that a “first best” outcome could be approximated. In this context, Shaviro’s MRR can be seen as an instrument targeted to the decision regarding the payment of foreign taxes.

II. REFORM PROPOSALS

Professor Shaviro makes a variety of tentative policy proposals but they do not seem to add up to a coherent package. On the one hand, he proposes a positive but lower tax rate on FSI (with a deduction rather than a credit for foreign taxes), a domestic source rule for royalties, some form of worldwide interest allocation as discussed by Graetz (2008), and a change in the residence rule to include place of management — all sensible provisions, most of which have been proposed by earlier observers. He also wants to retain the “check the box” rules so that U.S. companies can continue to save on foreign taxes by stripping income to tax havens.1

1 The check the box rules, introduced in 1997, allow payments like interest and royalties from one subsidiary to another without triggering current U.S. taxation under the “Subpart F” anti-abuse rules applied to U.S. controlled foreign corporations.
On the other hand, he shows great interest in a version of formula apportionment (FA) with added weight to the sales factor. But FA eliminates intercompany payments like royalties, effectively repeals check the box because the allocation depends on measures of real activity, and implicitly allocates worldwide interest based on the factors in the formula because worldwide third party interest is deducted in calculating the worldwide net income that is to be apportioned. Also, one claimed advantage of FA is that the division of income is independent of corporate residence. Furthermore, FA divides worldwide income among jurisdictions with no further tax on FSI, minimum or otherwise. To impose a tax on FSI, it would be necessary to reconstitute royalties and other intercompany payments, which FA is designed to avoid. Finally, multilateral adoption of FA, which would be necessary, would allocate more U.S. companies’ income to high tax foreign countries because that is where real activity and consumers are located, negating what appears to be the principal goal of Shaviro’s proposals.

Accordingly I will split the discussion of the proposals into two segments: those without FA, and then FA by itself.

A. Reform Proposals without Formula Apportionment

Professor Shaviro’s discussion is deliberately at a general level without the specificity actually required to design a reform plan. One example is that he never precisely defines what he means by the FSI that will be subject to his low tax rate. Presumably this income does not include royalties because that will be declared domestic source and taxed at the full U.S. statutory rate. But what about interest received from an active subsidiary? Will it be taxed at the full U.S. statutory rate or the reduced nonzero rate on foreign equity income?

While many of Shaviro’s proposals are relatively uncontroversial, he avoids discussing some of the serious difficulties in designing them. Drafting legislation is not his goal, but it would have been useful to know his views on these important issues. For example, allocating worldwide third party interest to various countries based on assets or cash flow is appropriate in order to prevent disproportionate deductions for interest expense in high tax countries. But this raises the problem of different currencies. Should Japanese and Argentinian interest rates be pooled? In addition, there are severe problems in valuing the assets to which interest expense is to be allocated. Perhaps a general “thin capitalization” rule that relies only on domestic interest expense and operating cash flows is a superior alternative. Further, are intercompany interest payments disallowed? That would seem to be contrary to Shaviro’s goal of letting companies lower their foreign tax burdens. In that connection, there is the meritorious case of companies with a centralized treasury function. If the parent borrows on behalf of a subsidiary, that should count as subsidiary debt as long as it pays the appropriate interest to the parent.

In suggesting a modified territorial system, Shaviro also does not address the serious potential problem of hybrid securities, that is, securities for which the payment is deductible in the host country but qualifies as a dividend in the home country. The deduction abroad reduces the FSI subject to Shaviro’s low rate of tax. Some countries
like Canada confer exemption to the hybrid payment, allowing income that is taxed in no country, while others do not.

In his attempt to offer a new framework, Shaviro overlooks an important feature of some recent proposals — splitting foreign income into the normal return on investment and the excess return, with a different tax treatment of each component. Grubert and Altshuler (2013) suggest expensing for a foreign investment against the U.S. taxable base in a per country minimum tax, thus exempting the normal return from U.S. tax. They also suggest an allowance for the equity invested in foreign acquisitions. The 2011 and 2014 tax reform discussion drafts introduced by Chairman Camp of the House Ways and Means Committee contained provisions in the same spirit. The 2011 draft had an anti-base erosion option that imposed a 15 percent tax on “foreign intangible income.” The revised bill introduced in February 2014 made it the only option and defined intangible income explicitly as income net of a 10 percent allowance for depreciable capital. These proposals are based on the realization that intangible assets and the excess returns they generate are at the center of the international tax problem, as they facilitate income shifting which in turn distorts investment decisions.

All of the companies whose tax schemes have been in the news lately are highly profitable with very valuable intellectual property. If the issue was only a matter of normal returns on standard capital, the U.S. investor could lease the capital from a foreigner not subject to U.S. taxes and achieve the equivalent of exemption. Therefore, the treatment of above-normal returns is crucial. For example, Avi-Yonah’s (2013) recent proposal for a FA system first imputes a return to wages and tangible capital; however, as will be discussed below, problems arise when he allocates the residual above-normal returns based on a sales formula.

The exemption of the normal return preserves U.S. companies’ competitiveness because they will only be taxed by the United States on their excess return. They will be in a position to make an investment or acquisition as long as they can earn their normal cost of capital. At the same time, the taxation of at least part of the excess return will reduce income shifting and the distortion of investment location. Thus, separate treatment of normal and excess returns brings the system closer to the general “second best” condition mentioned above. Companies in a very competitive industry will basically be exempt from U.S. tax. Those earning large excess returns will not find their competitiveness impaired, but the minimum tax will reduce their incentive to shift income from the United States and to locate inefficiently in low tax jurisdictions. Splitting the tax treatment of normal and excess returns adds a policy instrument that increases the ability of the tax system to achieve a desirable result.

B. Reform Proposals with Formula Apportionment

Professor Shaviro argues that the pervasive problems with applying the arm’s length principle (ALP) in transfer pricing makes FA an attractive option. The ALP is intended to provide neutral tax treatment between related party and unrelated party transactions but in practice is exceedingly difficult to apply effectively. Although FA would eliminate
the need for transfer pricing rules, proponents of FA tend to overlook the principal role of transfer pricing within the overall international tax system. Shaviro endorses the usual attack on the conceptual basis of the ALP found in Durst (2007) and many others. Integrated MNCs are intrinsically different from unrelated parties dealing with each other. They don’t have to use prices in intercompany operations. MNCs presumably choose the integrated form because it creates synergies and other “internalization” benefits. Therefore, it is claimed that unrelated party transactions do not provide any information on how income is to be divided between the parties of an integrated MNC.

This conceptual issue can be addressed by extending ALP to include arm’s length “affiliations” such as acquisitions, mergers, and joint ventures. If there are advantages to an integrated company, these transactions would occur, and the terms of the affiliation would indicate how the profits including synergy benefits should be split. For example, if a U.S. pharmaceutical company develops a breakthrough active ingredient and considers acquiring a routine packager or marketer in a host country, the developer of the intellectual property would presumably receive most of the profits. It would have been in a position to negotiate with a large pool of potential targets. On the other hand, potential targets may have developed their own intellectual property. Independent companies in the host country typically may have been willing to take risks because of their knowledge of the local market. They would have to be compensated for their greater return when being acquired. In general, the particular type of arms’ length transaction relevant in any given case is the one that would yield the greatest consolidated profits.

To be sure, it is the implementation of ALP that has proved very difficult. Therefore, Shaviro states that FA deserves serious evaluation, particularly his preferred version that overweights sales. He does refer to the potential for the manipulation of a formula, as outlined by Altshuler and Grubert (2010). The problems arise because of the asymmetry between the factors that contribute to income, particularly intangible assets, and the items in the formula. Payrolls are particularly easy to manipulate because wage costs are deducted from worldwide profits. The company can, for example, consider hiring a worker in a low tax country whose marginal product is just equal to the wage rate. Net worldwide profits to be divided among countries do not change but a greater share of both the normal return and in particular the excess return is shifted to the low tax location. The gain from such manipulations can be large.

Professor Shaviro favors overweighting sales in the formula presumably because they are less susceptible to manipulation. The proponents of sales-based allocations seem to assume that all goods are final consumer goods and that the location of the ultimate consumer can be identified. But Bureau of Economic Analysis data indicate that more than 65 percent of U.S. exports in 2012 were either “capital goods” or “industrial supplies and materials” where the ultimate consumer would be very difficult to identify. Knowing the final destination of products like oil and copper sold through organized exchanges would be virtually impossible. “Consumer” goods account for only 12 percent of exports. The destination of the sales of these intermediate goods can easily be manipulated. For example, an aircraft manufacturer could choose to sell airplanes to a
leasing company in a low tax country. The manufacturer of high end microprocessors would prefer to contract with a computer company in a low tax location. These kinds of relatively routine late stage operations by buyers may be much more mobile than the high tech component stage that commands the excess return.

Even for “market” goods and services like fast food or household goods, a company can shift excess returns to low tax locations by engaging in franchising and outsourcing marketing in high tax locations. Companies producing highly profitable consumer goods can also route their goods through unrelated distributors in low tax locations. This is specifically allowed under UDIP TA, the Uniform Division of Income for Tax Purposes Act, the model for U.S. states using formula apportionment. The unrelated distributors selling to high tax countries may just earn a normal return.

As suggested above, any FA system of necessity has to be multilateral. One reason is that foreign governments would have to provide information on resident companies exporting to the United States. Also, mixing destination-based and source-based taxation could lead to no taxation on some transactions and double taxation on others.

One of the reasons for the problems of applying the ALP is the way it has been interpreted. In particular, there is the very important question of “respecting the contract” that Professor Shaviro does not discuss. Current procedures tend first to recognize the contract before deciding how income is to be attributed to the parties. The transaction is apparently only recharacterized under very special circumstances. It may, however, be that the contract itself should be subject to ALP concepts. Would an unrelated party enter into a risk sharing agreement and provide all the capital to the risk sharer? In this case, an arms’ length price for that arrangement does not exist, and a transaction in which one does exist should guide the result. But that is not to say that the risk premium should always be assigned to the parent. As noted, if a U.S. company acquired a foreign company, the acquisition terms would reflect any risk premiums the target was earning, which should be assigned to the host country. Any other result would bias the company’s choice between acquiring a local firm and starting its own enterprise. This analysis also applies to the “restructuring” strategy in which all but a riskless routine return is stripped out of the host country.

C. Reforms Related to Corporate Residence

Professor Shaviro also considers the important subject of corporate residence and the possibilities of expatriation. He suggests expanding the current U.S. rule that residence is based on place of incorporation to include place of management, although he recognizes the possibility that this could drive some headquarters offshore. The other possibility he mentions, the inclusion of companies whose stock trades actively in the United States, is even more likely to evoke a large response given the ease today of accessing foreign exchanges.

Before considering the expatriation-inversion issue, it is first necessary to examine why corporate residence should be a concern to the United States and what tax factors
might be driving companies offshore. Addressing the possible losses to the United States and the tax motivations of the companies should lead to framing a better policy.

First, what should it mean to be a U.S. company? Presumably, a U.S. company is one that develops its intellectual property and takes its risk in the United States. The highly profitable companies we observe are the winners in the R&D and investment competition. The losses were deducted from the U.S. tax base. The winners’ initial successes are the platforms for subsequent development. The migration of U.S. intellectual property and risk premiums is, therefore, the main issue. This is mirrored in the fact that the United States derives much more revenue from royalties, inadequate as they may be, than from dividends. The transfer of headquarter services seems less significant except to the extent it embodies company know-how and leads to a transfer of R&D. Halliburton moved its corporate headquarters to Dubai from Houston in 2007 without changing its tax residence, and that has not evoked any great concern.

Companies apparently expatriate for several tax reasons. One is to avoid the current repatriation tax. The implicit cost of avoiding the tax may be high. Another reason is to be able to strip interest from the U.S. entity in view of the ineffective anti-stripping provisions in Section 163 (j) of the U.S. Internal Revenue Code. Those payments would be subject to current tax under Subpart F if the U.S. parent remained at the top of the MNC’s structure. Companies could also avoid the other provisions in Subpart F such as the tax on passive income and foreign base sales income. Finally, and probably most important, companies can in the long run attempt to move their subsidiaries out from under the U.S. entity and shift their U.S. developed intangibles outside the U.S. tax net.

Some of these tax considerations can be addressed straightforwardly. The widespread recognition that the repatriation tax on dividends raises little revenue and imposes a significant cost on U.S. MNCs will probably lead to some version of a territorial system. The earnings stripping rules in Section 163 (j) could be strengthened, or a general thin capitalization rule could be adopted. The migration of intangibles is the most difficult to address but various carrots and sticks could be considered. A lower tax rate on royalties and domestic intangible income, as in the Camp bill, is a possible carrot. A potential stick is more restrictive rules on the transfers of intangibles abroad and the cost sharing agreements that facilitate them.

III. CONCLUSION

In conclusion, Professor Shaviro provides an interesting discussion on many topics in international tax policy that will be valuable to experts and novices alike. His emphasis on giving U.S. companies an incentive to minimize foreign taxes under reform of the international tax system is particularly useful. While the goal of the book is not to draft a detailed reform to “fix” the system, the reality is that designing a coherent package also requires addressing the many serious issues discussed in this review.

2 The “foreign base sales” provision restricts the re-invoicing of goods routed through a tax haven.
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REFERENCES


