Stateless Income and Its Remedies

Multistate Tax Commission
Annual Meeting 2014

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International Tax Status Report

• Taxation of international operations is critical (and screwed up)
  – Entirely a corporate tax issue
  – “Competitiveness” complaints largely fact-free
  – Behavioral distortions rampant in current law
  – *Domestic* revenue base is at risk

• Only three obstacles to doing better at federal level
  – 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
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 country (relative to home country of group’s parent)
  – Taxed in foreign country other than country where factors of production are located or home country of group

• Invariably low-taxed income
  – Migration of high-taxed foreign income to low-tax jurisdictions
  – Software sales in Germany where profits end up in Ireland

• Parallel but not identical to avoidance of home country tax
  – Transfer pricing abuses, etc. relevant to both
  – Policy recommendations relevant to both
Reasons for Stateless Income

- Not just a synonym for transfer pricing abuse
  - Although consensus is that there is a lot of that going around
  - Related party interest / royalties (base erosion) + capitalization
  - PE avoidance and freedom in business opportunity siting
  - Ambiguity/conflict on source rules

- **Fundamental problem is treating each member of a unitary group as a lone wolf, hunting on its own:**
  - Separate capital structures
  - Separate risk appetites
  - Separate business agendas
  - No group synergies

- I say, Phooey!
Starbucks Example

• Starbucks is a paradigmatic high street retailer
  – Nothing intangible about being handed an iced latte by a barista
• Yet it paid very low UK tax for 15 years. Why?
  – Building up the business or stateless income planning?
  – Note role of opacity of tax information, and incomplete awareness by each tax authority of stories told to others
• Apparent sources of stateless income planning:
  – Royalties (the “Starbucks Experience”) paid to Dutch affiliate
  – Markups on coffee ultimately purchased from Swiss affiliate
  – Intercompany interest expense
• If Starbucks can generate stateless income, anyone can
  – (Kleinbard, Through a Latte Darkly: Starbucks’s Stateless Income Planning), 139 Tax Notes 1515 (2013)
Efficiency Consequences of Stateless Income for U.S.

• Distorts US firms’ investment/ownership preferences
  – Undercuts capital ownership neutrality story by creating “tax rents”

• Requires resources to make the tax magic happen

• Requires earnings to stay formally in foreign subs
  – “Lock-out”
  – Can lead to suboptimal foreign investments
  – Lock-out becomes lock-in: investors cannot optimize their portfolios

• Exposes US tax base to erosion through arbitrage
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 actual 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
Then Why So Many Inversions Now?

• Precisely because U.S. firms are hoist by the petard of their stateless income successes!
  – Minimal returns on cash hoards drag down EPS
  – Shareholders are itching to get their hands on the cash
  – Reports that auditors are getting uncomfortable with “permanently reinvested” fairy tales when earnings are in cash

• And because of despair over corporate tax reform
  – And now, the herd effect
  – Related concern that the door will slam shut soon

• Inversions set the stage for easy stateless income planning in the future if you think that foreign jurisdictions will continue their tax mercantilist policies
Part II: Current U.S. Federal Corporate Tax Reform Efforts
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
Can We 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 overall revenue targets

- Can business tax reform move separately?
  - Technical issues of distinguishing labor from capital income
  - Substantial differences in approaches to international income
  - Inversion transactions as motivation?
Disentangling Camp Personal vs. Business

• Personal taxes go down $590B over 10 years, while business taxes go up by about same amount
  – JCT (JCX-20-14): [Business tax reform – corp. AMT repeal + international + excise taxes]
  – While corporate rate goes down to 25%

• But this overlooks netting within unincorporated sector
  – Broader base from business changes, but lower rate on net business income on individual return
  – Net change in unincorporated business income burden unclear, but certainly much smaller than implied
  – Corporates do seem to be subsidizing personal rates over first 10 years, despite lower rate – perhaps to tune of $250B

• JCT presentation is quite unhelpful here
Camp Business Revenue Numbers

- Corporate rate reduction is expensive!
  - JCT: -$680B over 10yrs, with phasing in rate to 2019, but not counting repeal of corp. AMT (-$110B) or § 199 (+116)

- A lot of frontloading and backloading going on
  - Phase in of corporate rate backloads cost
  - Slower depreciation/amortization front loads savings
  - International “raises” $68B only because of one-time $170B transition tax

- Some reforms seem unrealistic even to this Democrat
  - Amortization of R&D and advertising ($360B over 10yrs)

- Many affluent individuals will have higher tax rates
The Growth Fairy Will Not Plug the Gap

- Camp bill is *not* revenue neutral in steady state
  - Assuming that to be the goal!
- JCT macro analysis does not portend an easy solution
  - Macro analyses do not predict perpetual compounding gains
  - Revenue neutral bill should imply only modest macro gains
  - New capital EMTR may well go up – investment goes down
  - 8 different results from different models because macro analyses are so uncertain
  - Largest gains come from least realistic models of behavior and budget policy
- JCT conclusions widely misunderstood
JCT Macroeconomic Conclusions

• JCT best case in their macro study was 1.6% greater real GDP in total over 10 years

• *Not a prediction of a 1.6 percent greater growth rate*
  – Predicted growth rate (CBO) = 2.5% for next 10 years
  – Imagine $100 GDP growing @ 2.5% for next 10 years
  – Total GDP over 10 years would = $1120
  – JCT best case here = total GDP of $1138 over 10 years
  – Assuming constant growth rate, this implies growth @ 2.84%
  – A nice pickup, but of course other estimates were lower

• JCT presentation here could have been clearer
Filling the Revenue Hole

• Camp bill is revenue-challenged even on its own terms

• What is the case for personal tax reduction and lower investment in the future (JCT macro analysis)?
  – Consumption does not fuel growth in perpetuity
  – What is EMTR on new capital investment in the USA under Camp? In hard capital? In intangibles?

• What is the case for $100 billion lower taxes on international corporate income?
  – This is going in the wrong direction!
  – Not required by “competitiveness”
Really Filling the Revenue Hole

• Revenue-neutral tax law underfunds government

• Fiscal cliff tax deal (2013) is the reason
  • 2012 official CBO “baseline” showed deficits largely disappearing over 10 years ($2.3 trillion total/10 years)
  • Deal added $4.6 trillion to 10-year deficit;
    • CBO Feb 2014 now projects $8 trillion deficit 2015 - 2024
    • And that forecast is optimistic relative to probable outcomes

• “Slashing spending” is an exercise in magical thinking

• Stay tuned for: We Are Better Than This: How Government Should Spend Our Money (Oct. 2014)
Rethinking Camp Bill Tradeoffs

• The bill plainly is too soft on international
  – Stronger anti-abuse rules?
  – E.G. country by country minimum tax?

• The bill perhaps is too hard on capital investment?
  – *Domestic* thin cap would be consistent with larger capital income tax neutrality principles

• The bill is too soft on labor income
  – Lower burden on personal income, with slightly higher rate on capital gains/dividend income at the very top, implies significantly lower taxes than 2013 schedules on labor income generally
  – But EITC scaleback moves in the wrong direction
Part II: Remedying Stateless Income (Federal)
International Policy Options

• Territorial systems rely on economic *nexus* of income
  – But geographic nexus is nearly impossible to pin down
  – Only positive nexus story is section 954(h), and no one is volunteering for more of that
  – OECD is holding back the sea with a broom

• Minimum tax and Baucus Option Z both point in the opposite direction, by addressing stateless income through *residence* taxation of corporation
  – Easier to police corporate residence than nexus of income
  – But is it economically rational, or just a pragmatic answer?
  – Corporate tax justifiable as a withholding tax on shareholders
  – U.S. (unlike others) still can treat a US corporation as a good proxy for US people [slide 27]
A territorial tax system requires decisions on two fundamental structural design issues
  – Company-by-company or group/unitary business?
  – Get source “right” or rely on Formulary Apportionment?

These are separate questions that often get muddled!

Unitary business approach is clearly right
  – Make-believe separate juridical personality of corporate subsidiaries is a principal driver of stateless income
  – FA can’t reach income that isn’t in the base in the first place
  – The only mystery is, why is OECD so resistant to something so obvious?

Best approach to determining source is uncertain
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
But No Appetite for Territorial + Formulary

• A territorial system that can’t get source “right” must look to formulary apportionment
  – OECD won’t accept premise, remains opposed as a general solution
  – US also seems opposed; neither W&M or SFC has shown any interest

• Maybe FA is just too rough in its justice
  – State formulae and groups to which the formulae apply have evolved over time, so no universally acceptable implementation
  – Different industries have different profitability drivers

• And FA might lead to large revenue losses for the USA
  – Big tech companies have global sales but brains in US, so one-factor FA might be good for France and bad for US
  – Udell and Vashist argue that base broadening compensates
    • Udell and Vashist, Sales-Factor Apportionment of Profits to Broaden the Tax Base, Tax Notes 7/14/14
Antiabuse Rules = Residence Taxation

• Many antiabuse proposals are really ersatz residence based corporate tax systems
  – CFC rules, C-b-C 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
    • Not true for many other jurisdictions
What Will BEPS Do For Us?

- OECD BEPS project is fundamentally an effort to address stateless income by shoring up source rules
  - On the quicksand of company-by-company taxation
- Of course entirely optional for US to adopt or not
- 15 Actions in the Action Plan, for countries to adopt “in a coordinated and comprehensive manner to address the sources of base erosion and profit shifting”
- First deliverables 9/2014, including responding to digital economy, hybrid mismatches, and first cut at revamping transfer pricing “to prevent BEPS by moving intangibles among group members.” Drafts already released.
- All sounds grand, but US has been an ambivalent participant
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 C-b-C minimum tax?
The U.S. – Embrace Residence Taxation

- Full inclusion but low rate = Baucus Option Z++
  - WW tax consolidation – foreign losses are utilizable in US
  - One tax rate (25%?) for net global income
  - Full FTC utilization, no 864(e) expense allocation
  - Simpler than Camp FBCII *and is the basis of anti-abuse rules*

- 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
  - No need for rough justice of single factor FA here

- 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 through BEPS etc

- And move capital income taxation to individual level

- And that is what the Business Enterprise Income Tax does . . . .
Part III: Remedying Stateless Income (State)
One study (US PIRG) claims $1 billion/year in forgone state corporate tax revenues.

States largely have settled on single-factor sales formulae for determining source – that’s not the problem.

Problem is definition of combined group.

Responses to stateless income/base erosion to date:
- Most states: deer in headlights
- Montana/Oregon “throw-in” rule adds back tax haven income
- Seemingly inspired by injunctions of Reagan era Worldwide Unitary Taxation Working Group report, exactly 30 years ago.
States Have Constitutional Constraints

• States of course must have a nexus basis for tax
  – But if base is being eroded through transfer pricing or earnings stripping to members of a unitary group arbitrarily excluded from the base, there can be nexus without an appropriate base
  – One-factor sales apportionment does not address this problem

• Worldwide combined reporting is constitutional
  – There is no issue on this
  – Businesses are even more globally integrated than 30 years ago; WW combined reporting is even more persuasive now
  – Stateless income data demonstrate the need for action
  – And federal government has not lived up to its promises from 30 years ago to police transfer pricing and stateless income on behalf of the states
States: Throw Off Reagan Era Shackles!

- Single-factor sales formulae change political calculus
  - Threat to withhold factories from WW states no longer as terrifying when apportionment is not driven by that factor
  - Threat not to sell to consumers in a state rings hollow . . . .

- Some EU countries and BEPS point in similar direction
  - Constructive PEs, etc, to capture digital economy sales
  - Idea again is to let single factor sales formula determine *both* right to tax and revenues allocable to such jurisdiction

- Federal and state systems can differ (as they do today)

- So adopt *WW combined reporting for unitary businesses*
  - With single-factor sales apportionment
  - Highly imperfect, but constitutional and the best that can be done under the circumstances