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Stateless Income and Its Remedies

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Part I: U.S. International Corporate Tax System Status Report

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 *residenc*e 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]

Territorial Consolidated Base and Source

- 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)

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States Are Bleeding Revenue

- One study (US PIRG) claims $1billion/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