# Corporate and International Tax Reform: Long-, Medium-, and Short Term Proposals

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# CORPORATE AND INTERNATIONAL TAX REFORM: LONG-, MEDIUM-, AND SHORT TERM PROPOSALS

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The current controversy surrounding President Obama's international tax proposals seems like an opportune moment to try to consider them in context. How do these proposals fit in with an agenda for US corporate and international tax reform?

Few observers doubt that such reforms are sorely needed, for several reasons. First, the long-term budgetary outlook is unsustainable. Second, the US corporate tax rate is among the highest in the OECD. Third, the current system raises relatively little revenue and large amounts of corporate income go untaxed. Finally, the system is horrendously convoluted and imposes high transaction costs.

This paper will attempt to raise some proposals for US corporate and international tax reform. It will begin by asking why we need to tax corporations at all, since the rationale for the corporate tax is important for assessing reform proposals. It will then discuss options for corporate and international tax reform, beginning with long-term options (a 10 year horizon), continuing with the medium term (2-5 years) and concluding with short-term options like the Obama proposals (1-2 years).

## 1. Why Tax Corporations?

The problem with justifying the corporate tax is that the incidence of the tax is murky. For economists, the one thing that is clear is that corporations, as legal entities, do not bear the burden of the corporate tax. Taxes must be born by people, not legal fictions, but after fifty years of research into this issue economists are still undecided about who bears the burden: the corporation's shareholders, all capital providers, labor or consumers.

I do not have a view on this economic issue, nor am I sure it will ever be definitively resolved (it seems likely that the incidence will constantly shift depending on market conditions, which determine the ease of imposing the burden on someone other than the shareholders). However, I have argued elsewhere that in a meaningful way the corporate tax can be seen as a tax on the corporation itself, i.e., on the people who manage the affairs of the legal entity at any given moment. The original rationale for the corporate tax was to regulate and limit the power of

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corporate managers that results from controlling large concentrations of capital, and I believe this rationale is still the best justification for taxing corporations.[2]

If the corporate tax is seen as falling on the corporation itself, several conclusions follow. First, the payment of the corporate tax can be seen as an aspect of corporate social responsibility. To the extent that the state and not corporations bears the burden of addressing problems created in part by corporate actions, like environmental issues or unemployment, the corporation is responsible for paying taxes to give the state the resources it needs to meet this burden.[3] In that sense corporate management have the same responsibility to pay their fair share of taxes that individual citizens do.

Second, if the corporate tax is seen as a payment for the costs imposed by corporate activity on society, then it is not based on the ability to pay theory that underlies the modern individual income tax. Instead, the corporate tax is based on the older exchange theory: it is a payment for the costs imposed on the state by corporate activity and for the benefits received by the corporation in the form of defense, infrastructure, education, and other forms of government activity.

Third, it follows from the second point that from an international perspective, when there is more than one taxing jurisdiction, the corporate tax should be primarily source-based. This is congruent with the international tax regime that assigns the primary right to tax active business income to the source jurisdiction. It also reflects the fact that corporate residence is not very meaningful and that corporations do not vote. Moreover, given the uncertainty about the incidence of the corporate tax, it should not be seen as a vehicle for progressive taxation or redistribution. Residence-based corporate taxation is only justified as a backstop to source-based taxation.

## 2. Long-Term Proposals

In the long term (ten years and more), tax reform in the United States is dominated by the dire budgetary prospects. Because of the impending retirement and health care costs of the baby boom generation, we face the prospect of deficits exceeding $1 trillion per year for an indefinite period. By 2019, under current projections, the debt to GDP ratio will exceed 80%. This picture is unsustainable because neither US nor foreign savers would be willing to lend the US government the necessary funds.[4]

Since drastic cuts to Social Security and Medicare are both unjustified and politically unacceptable, this means that taxes will have to be raised at some point in the next decade to pay for at least part of the deficit (the rest can perhaps be covered by restraining the growth in health care costs). Raising the existing individual and corporate income tax rates, or the existing payroll tax, seems both politically very

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[2] Avi-Yonah (2004).
[3] Avi-Yonah (2007).
[4] Auerbach and Gale (2009).

unlikely and unwise, given that our main competitors have been steadily reducing those tax rates.

Thus, in my opinion the only feasible solution in the long term is to follow the rest of the OECD and enact a value added tax. A VAT enacted in addition to the existing individual and corporate income taxes can be a normal credit-invoice, destination based tax, like the VATs in use in over 130 other countries. It is a proven revenue raiser even at relatively low rates, as shown by the Japanese and Canadian experience (both of whom have a rate of less than 10%).

However, as many scholars have suggested, it would also be possible to enact a VAT at a higher rate and use the revenue to replace part of the individual and corporate income tax. Michael Graetz, for example, has suggested using the VAT revenues to exempt income up to $100,000 from individual income tax (for simplification purposes) and for replacing the corporate tax (for competitiveness reasons).[5]

I am doubtful that we can go as far as Graetz recommends. We need the added revenues, and the Graetz proposals are designed to be revenue neutral. Nor do I think it is advisable to raise the VAT rate too high. Experience in Europe has shown that high VAT rates, like high income tax rates, lead to more evasion and avoidance and higher transaction costs.

In addition, I think abolishing the corporate tax would be a mistake (and unlikely to fly politically). Enacting a VAT in lieu of the corporate tax would tempt politicians to see the VAT as a form of corporate tax and load it with entity-based exemptions designed to regulate corporate behavior and encourage desired activities. These functions are best left to the existing corporate tax. The VAT should be as clean as possible, with a low flat rate and a broad base.[6]

However, I do think the corporate tax can be significantly simplified if we enact a VAT. Specifically, I would support in that case permitting corporations to expense all capital expenditures. From an economics perspective this turns the corporate tax into a cash flow or consumption tax. This change leads to significant simplification because corporations will not have to account for basis and will dispense with taxable and tax-free realization events, but it should not be a major revenue loser because the resulting tax only exempts the risk-free rate of return on capital, while economic rents remain taxable. Most corporate income consists of economic rents, and those are the kinds of income that justify the corporate tax because the state makes them possible (risk-free returns can be earned in many locations but rents are more unique). The revenue loss can be made up with the VAT. Nor is this change unprecedented, because the UK made it when it introduced the VAT in the 1970s.

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[5] Graetz (2008).
[6] Avi-Yonah (2009).

## 3. Medium-Term Proposals

In the medium term, it would be desirable to move the corporate tax more in the direction of a pure source-based tax, for the reasons explained above. However, we cannot do that without first tackling the knotty problems of defining the source of income and transfer pricing. Moving to territoriality without reforming transfer pricing is a recipe for increased shifting of profits outside the US taxing jurisdiction.

My colleagues Michael Durst and Kimberly Clausing and I have developed a detailed proposal to reform transfer pricing and the source rules by adopting formulary apportionment.[7] Our proposed formula is based on the current profit split regulations and assigns normal returns to where the costs of producing income are incurred, while residuals are assigned based on the destination of sales. This formula favors the US as an importing country, and one can imagine different formulas negotiated with the EU if it goes ahead and adopts formulary apportionment for internal EU purposes, as the European Commission has proposed.

We believe that we have adequately addressed the various objections raised to our proposal, and that the benefits far exceed the costs. One particular objection, that formulary apportionment violates our treaty obligations, has been weakened by the recent Ninth Circuit decision in *Xilinx* (in which the court held that the saving clause in US treaties exempts all US resident corporations from the arm's length standard, and this would apply to subsidiaries of foreign multinationals as well).

The biggest advantage of adopting our proposal is that it will enable the US to move in the direction of territoriality. Not only will dividends, interest and royalties within a US-based multinational be exempt from tax, but in principle we could go further and abolish both Subpart F and the foreign tax credit. Conceptually, formulary apportionment means that the US will tax each multinational (whether US or foreign based) only on the income that the formula assigns to the US, and on no other income. We do not believe this will result in more double taxation than the current arm's length system even if other countries do not follow the US lead, but we also think that other countries will in fact follow our lead because otherwise multinationals will find it too easy to shift income to the US (where booking it will have no tax consequences under the formula).

One potential downside to eliminating residence-based corporate taxation in this way would be that tax competition might be enhanced. We do not have a problem with tax competition per se; countries should be free to set their general corporate tax rate as low as they choose, and we have estimated that adopting formulary apportionment would enable the US to finance a significant cut in the corporate tax rate.

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[7] Avi-Yonah, Clausing and Durst (2009).

Tax competition in the form of incentives for multinationals would persist under pure source-based taxation based on formulary apportionment, but we do not regard that form of competition as necessarily harmful, as long as it is based on a careful analysis of the costs and benefits of the tax incentive. However, formulary apportionment would take care of the worst form of tax competition, in which profits are shifted arbitrarily without any real consequences. The data show that this form of tax competition is rampant (eight of the top 10 locations for US multinational profits had effective tax rate of 10% or less in 2005, and none of them had corresponding real investment).

## 4. Short-term Proposals

In the short term, I believe the Obama proposals are on the right track, because as long as transfer pricing reform is not enacted bolstering residence-based corporate taxation is necessary as a backstop to source-based taxation. The Obama proposals are a cautious first step in this direction and are justified by the data showing massive under-taxation of the foreign profits of US-based multinationals.

However, I also believe that some additional proposals might be helpful. Specifically, I would argue that some of the added revenue should be used to finance a cut in the corporate tax rate to bring it more into line with those of our trading partners. Although the effective US tax rate is not particularly high, studies show that the marginal tax rate affects investment patterns, so that having the second highest rate in the OECD is not advisable.

If the Obama proposals for multinational taxation are adopted, the following further ideas should be implemented in the short run:

1. To protect US residence-based taxation from inversion transactions, the “managed and controlled” definition of US corporate residence from the Stop Tax Haven Abuse Act should be adopted as well.

   The Obama proposals increase the pressure on the distinction between US- and foreign-based multinationals, and I believe the current anti-inversion rule in IRC 7874 is insufficient. When the UK beefed up its CFC rules in conjunction with adopting limited territoriality, some UK corporations nominally moved to Ireland, but HMRC are challenging this purported move because they have the managed and controlled standard to rely on. The IRS should have the same ability.

2. The foreign tax credit ideas should be implemented in conjunction with full cross-crediting (i.e., no distinction between the active and passive baskets).

The need for baskets depends on how many US multinationals are in an excess credit position, because if they are in excess limit there is no incentive to invest overseas. Since our tax rate is now higher than our trading partners' this is an unlikely outcome and the added complexity of having even two baskets is unjustified.

3. If we adopt the refundable withholding tax on non-QI portfolio investment, then we can abolish all "regular" outbound withholding on dividends, interest and royalties, as well as the branch profit tax.

   The need to impose withholding taxes arises from the need to protect the domestic US tax base, but this is adequately dealt with in the Obama proposals by a combination of information exchange and refundable withholding. If those are enacted I see no need for regular withholding. We do not withhold on portfolio interest, royalties and capital gains, and dividend withholding is easily avoided by using derivatives. The only meaningful withholding is on direct dividends, and even that is eliminated by some of our recent treaties. I do not believe we need withholding for treaty negotiation purposes since we already have treaties with low withholding rates with all OECD members, and non-OECD countries are uninterested in reducing US withholding on portfolio investments. Thus, we can save a lot of transaction costs at little revenue cost by eliminating regular withholding and the branch profit tax.

4. On the other hand, we should tighten up the earning stripping rules by applying the IRC 7874 standards to all foreign corporations, and extend them to royalties as well.

   These provisions are needed as added protection for the US corporate tax base. In the absence of transfer pricing reform foreign multinationals (and inverted US multinationals not caught by 7874, like grandfathered ones) have too much ability to strip income out of the US via interest and royalty payments, as the current Glaxo litigation shows.

5. Finally, I would abolish FIRPTA and replace it with a tax on capital gains on large participations (to the extent consistent with our treaty obligations).

   It never made sense to tax foreigners on US real estate, which cannot be exported, and the tax can be avoided by using foreign holding corporations. FIRPTA also imposes transaction costs whenever there is uncertainty about whether over 50% of corporate value is in real estate, even for small portfolio shareholders. On the other hand, when a foreign multinational acquires a US-based one, it can export valuable intangibles at will, and that should be reflected by taxing it on dispositions, as many countries do. The tax can be enforced because any buyer of large participations wants to register shares in its name and obtain voting rights. We should not override treaties, but should renegotiate our existing ones if they do not allow such a tax (and many do).

## 5. Conclusion

Some form of tax reform seems inevitable, at least in the long run. In the short run, if there is going to be any non-tax legislation that costs additional money, it seems quite likely that tax provisions would be attached to it, and that taxing multinationals and US residents who evade their tax obligations is more politically acceptable than taxing the middle class.

For these reasons, I think that despite the current torrent of criticism, some form of the Obama proposals will be enacted in 2009. The preceding has been an attempt to offer some additional suggestions for short-, medium- and long-term reform of US corporate and international taxation. If we want to keep taxing corporations (and I believe we should, for the reasons set out in the beginning), some form of reform along these lines would seem necessary to prevent the corporate tax base from being completely eroded by shifting profits overseas, while keeping the US economy competitive with our trading partners.

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