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International Taxation and Competitiveness: Introduction and Overview

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

Nicola Sartori
University of Michigan Law School, nicola.sartori@hotmail.it

INTERNATIONAL TAXATION AND COMPETITIVENESS: INTRODUCTION AND OVERVIEW

Reuven S. Avi-Yonah[1] and Nicola Sartori[2]

1. Introduction

In February, 2012, the Treasury and White House unveiled President Obama's Framework for Business Tax Reform. A major proposal included in this Framework was to abolish the deferral on income earned by foreign subsidiaries of US corporations ("CFCs"). This proposal was justified as follows:

> income earned by subsidiaries of U.S. corporations operating abroad must be subject to a minimum rate of tax. This would stop our tax system from generously rewarding companies for moving profits offshore. Thus, foreign income deferred in a low- tax jurisdiction would be subject to immediate U.S. taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on that income paid to the host country. This minimum tax would be designed to balance the need to stop rewarding tax havens and to prevent a race to the bottom with the goal of keeping U.S. companies on a level playing field with competitors when engaged in activities which, by necessity, must occur in a foreign country.[3]

Thus, even the Obama proposal took into account competitiveness in designing international tax reform. At the other end of Pennsylvania Avenue, Chairman David Camp of the House Ways and Means Committee unveiled a proposal to almost completely exempt active income of CFCs, even when distributed to their

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[1] Irwin I. Cohn Professor of Law and Director, International Tax LLM, the University of Michigan.

[2] Post doctoral fellow, the University of Milan.

[3] The President's Framework for Business Tax Reform (February, 2012), 14.

parents as a dividend. This proposal was mostly justified by competitiveness considerations.[4]

The debate about whether to abolish deferral or to adopt territoriality has been going on ever since the Kennedy Administration first proposed ending deferral in 1961. The problem is that neither side has factual support for their argument about whether the U.S. tax system, including Subpart F, as currently enacted or with any of the proposed reforms, in fact negatively impacts the tax burden of US-based MNEs. Even the concept of competitiveness itself is unclear. Despite numerous claims, there has been no rigorous attempt that we are aware of to determine whether MNEs based in our major trading partners in fact have a tax advantage or disadvantage because of Subpart F or other rules.

In October, 2011, the American Tax Policy Institute sponsored a conference organized by Reuven Avi-Yonah and Jane Gravelle on "International Taxation and Competitiveness". This conference was designed to address these issues in a systematic way, and to form the basis for a better informed policy debate going forward. The articles included in this volume were first presented at this conference. What follows is an attempt to summarize their main conclusions.

2. The concept of competitiveness.

Before analyzing the liaison between competitiveness and international taxation, it is necessary to delineate the concept(s) of competitiveness, which is a rarely defined but frequently used term (especially in tax policy debates).

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[4] See Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income (October 26, 2011)

Economists use a macroeconomic concept of competitiveness, in order to make comparisons across nations, while they use a microeconomic concept of competitiveness in order to make comparisons among businesses and workers operating in different markets. On this regard, Michael S. Knoll specifies that "*For purposes of understanding how government policy affects competitiveness, microeconomic definitions have several advantages over macroeconomic definitions*". In fact, microeconomic definitions "*are more closely aligned with our intuitions about competitiveness*" and "*are capable of being given a more solid theoretical foundation because they can be integrated into standard economic models*".

The concept of competitiveness as a characteristic of an entire nation has been strongly criticized by Paul Krugman[5] (cited by both Michael S. Knoll and Jane G. Gravelle), because nations, which cannot be compared with corporations, are not competitors, since they "*do not go out of business*". While firms compete, countries trade. The U.S. can be better off or worse off (rather than competitive).

This is why the term competitiveness is very often associated to an industry rather than a nation.

There are two main definitions of competitiveness, with regards to industries.

Under the first definition, competitiveness focuses on the total output (both domestic and foreign) of the companies based in the U.S. An industry is competitive in the U.S. if U.S. multinationals have a strong ability to compete with foreign multinationals (both in domestic and foreign markets). The focus is on the nationality of the producing company (regardless of the place of production). Therefore, "*the U.S. corporate income tax will adversely affect the competitiveness of the U.S. … industry if it reduces the incentive for U.S.-based … manufacturers – relative to their foreign competitors – to own productive assets*" (Michael S. Knoll).

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[5] Paul Krugman, *Competitiveness: A Dangerous Obsession*, 73 FOREIGN AFFAIRS 28, (1994).

Under the second definition, competitiveness focuses on the total output of an industry in the U.S. regardless of the nationality of the producing company. An industry is competitive if U.S. and foreign multinationals invest in the U.S, rather than in foreign countries. The focus is on the U.S. production (regardless of the nationality of the producing companies). Therefore, "*the U.S. corporate income tax reduces the competitiveness of the U.S. … industry if it discourages investment in … production in the United States relative to investment in … production abroad*" (Michael S. Knoll).

Reuven Avi-Yonah and Yaron Lahav believe that "*The competitiveness issue is primarily about the ability of the largest US multinationals to compete with their counterparts based in other countries, and especially those based in EU*". In other words, they adopt the first definition of competitiveness, focused on the ownership of productive assets.

Also Brian J. Arnold implicitly adopts the first definition of competitiveness where he writes that "*claims have been made that US multinationals are at a significant competitive disadvantage compared to many foreign-based multinationals because the US Subpart F rules are broader and harsher than the CFC rules of other capital-exporting countries*".

As underlined by Jane G. Gravelle, the conflict between the two definitions also emerges by the objectives of the Fiscal Commission. Reading the report by the National Commission on Fiscal Responsibility and Reform, titled *The Moment of Truth*, December 2010, it is not clear whether the Commission wants more U.S. owned operations abroad or wants more foreign-owned operations in the U.S.

Finally, an operational definition of competitiveness (which resembles the second above mentioned definition rather than the first, but is also close to a macroeconomic notion) is adopted by Eric Toder, according to whom countries compete with other nations for: "*1) labor supply, 2) financial and physical capital, 3) intangible capital, 4) tax revenues, and 5) natural resources*". In other words, competitiveness, according to Eric Toder, means "*competition between nations for scarce and mobile resources*". Following this definition, taxation can affect the ability of countries to compete for workers, capital, and investment opportunities.

On this regard, it is worth noting that Kimberly A. Clausing has reviewed the effects of corporate taxation on labor, concluding that "*corporate taxation may lower wages, but the* preponderance *of evidence does not suggest any wage effects from corporate taxation*". Thus, "*while corporate taxation may discourage some types of investment, it may not have a large enough effect on* overall *investment to cause substantial reduction in wages*". This analysis is helpful to better understand the effects of corporate taxation on (the second definition of) competitiveness.

3. Competitiveness and the neutrality principles of international taxation (CEN, CIN and CON)

Michael S. Knoll has shown that while the first definition of competitiveness (U.S. multinationals competing with foreign multinationals) is consistent with the advocacy of "capital ownership neutrality" (or, alternatively, "capital import neutrality"), the second definition (U.S. competing with other countries for providing labor and capital to multinationals) is consistent with the advocacy of "capital export neutrality".

On one side "*the tax neutrality benchmark of CON as well as the benchmark of CIN (when the latter is understood as ownership neutrality) are closely associated with the first definition of competitiveness, which focuses on the ability of companies located in different countries to acquire productive assets. A tax system that satisfies CON is one in which companies, regardless of where they are based, compete on an equal footing in seeking to acquire productive assets. Tax considerations will not advantage or disadvantage any of them in their ability to acquire productive assets*" (Michael S. Knoll).

On the other side, "*the tax neutrality benchmark of CEN is closely associated with the second definition of competitiveness, which focuses on a state's ability to* *attract foreign investment. An international tax regime that satisfies CEN (i.e., universal adoption of worldwide taxation with unlimited foreign tax credits) will place all states on an equal footing in their ability to attract foreign investment. Tax consideration will not advantage or disadvantage any of them in their ability to attract investment*" (Michael S. Knoll).

As it is known, the neutrality concepts are strictly connected with the tax treatment of cross border income.

On this regard, Jane G. Gravelle reminds that:

- "*in territorial or source-based tax systems, income is taxed only by the country in which it is earned. It meets the standards of capital import neutrality in that each firm in a location faces the same tax rate…*".

- "*In residence systems, income is taxed only in the country of its nationality, so that U.S. firms' income would be taxed in the United States regardless of where the income is earned, and the United States would not tax income earned in its borders by foreigners…*". Residence systems "*will therefore satisfy the requirements of capital export neutrality….*"

- A worldwide system, which imposes taxes on both residents (on their worldwide income, with an unlimited foreign tax credit) and foreigners (on their source income), would also achieve capital export neutrality, even though "*the distribution of taxes is different, with more tax collected by net capital importers than in a straightforward residence system*."

- Finally, a worldwide system, which imposes taxes on both residents (on their worldwide income, with a deduction for foreign taxes paid) and foreigners (on their source income), "*maximizes a country's welfare because the rate of return received by the country (either in its firms profits or in its own taxes) is equal*".

4. The State of the art: empirical data on the competitiveness of U.S. multinationals.

Adopting the most common definition of competitiveness (at least among the panelists), tax law rules affect competitiveness in the sense that they affect the ability of U.S. multinationals to compete for investments and for people.

As a starting point, some panelists have investigated whether U.S. multinationals, as a matter of fact, are in a competitive disadvantage compared with foreign (mainly European and Japanese) multinationals. This analysis has been conducted to explore whether the competitiveness arguments that U.S. multinationals raise with regards to U.S. corporate tax law are true. The analysis concerns effective tax rates and takes into account CFC legislations.

According to Reuven Avi-Yonah and Yaron Lahav, "*US-based multinationals do not face a tax induced competitive disadvantage in competing against EU-based multinationals*". In fact, "*Even though the US statutory rate is ten percentage points higher than the average corporate statutory rate in the EU, the effective US corporate tax rate is the same or lower than the effective EU corporate tax rate for largest US and EU multinationals.*" This is because European corporate tax base is larger than U.S. corporate tax base, due, for example, to tougher CFC rules. In fact, "*a comparison of the CFC rules of the US … and the major EU jurisdictions … indicates that the EU CFC rules tend to be tougher than Subpart F because (a) they take into account the effective tax rate in the source country in deciding whether to tax income from a CFC, and (b) they take into account whether the CFC has a real presence in the source country*".

This evidence is confirmed by Melissa Costa and Jennifer Gravelle analysis, where they conclude that "*Even though a significant amount of foreign income is subject to the U.S. tax, the ability to defer taxes on foreign income and low average foreign rates on CFC income suggests the U.S. tax systems has strong territorial aspects, with a nominal residual average tax on foreign earnings*". Therefore, "*U.S. corporations are likely not being negatively impacted by the U.S. corporate tax rate*".

Brian J. Arnold, summarizing a few other papers presented at the conference, compares CFC legislations of nine different countries[6], and concludes that "*the US Subpart F rules are not noticeably broader than the CFC rules of other countries, with the exception perhaps of the slightly broader concept of base company income under the US rules*". The comparative analysis of CFC rules confirms the outcomes of Reuven Avi-Yonah and Yaron Lahav research.

In conclusion, it seems that, as a matter of fact, the argument that U.S. corporate tax rules make U.S. multinationals less competitive in foreign markets compared with European and Japanese multinationals is generally wrong.

5. Residence vs. worldwide based taxation: competitiveness issue

Depending on the definition of competitiveness adopted, it is possible to argue in favor of territorial or worldwide taxation principles.

The argument made by some scholars that the U.S. tax system, based on the worldwide taxation principle, should move to territoriality, in order to enforce the ability of U.S. corporations to compete abroad, has been investigated by some panelists.

On this regard, Eric Toder believes that a tax reform that adopts a territorial system (lowering the corporate tax rate and broadening the tax base at the same time) "*will improve the competitiveness of U.S. multinational corporations*" (first definition of competitiveness), but will raise "*the cost of investing in the United States*" (second definition of competitiveness). In other words, territoriality helps U.S. multinationals to compete with foreign multinationals, but concomitantly has a negative impact on the capability of U.S. to attract investments.

On the other hand, a tax policy that eliminates deferral (lowering the corporate tax rate and broadening the tax base as well) "*will make U.S.-based multinational*

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[6] For a comparative analysis of CFC legislations see also R. Avi-Yonah and N. Sartori, *US Sub-part F Legislative proposals: A Comparative Perspective*, INTERNATIONAL TAXATION, 2011, n. 11, 428-437.

corporations less competitive, but reduce the cost of investing in the United States". In other words, pure residence taxation would increase the ability of the U.S. to attract investments, but would reduce the ability of U.S. multinationals to compete with foreign multinationals.

The variety of modified territorial, modified worldwide or mixed territorial and worldwide systems are analyzed by Jane G. Gravelle in terms of competitiveness.

A comparative analysis underlines that "*a territorial tax, a tax system generally aimed at the international competitiveness objective, is more commonly used around the world, although there are restrictions imposed by most countries. As well, the United States, the only major country to currently use a worldwide tax, has deferral provisions that may move it closer to a territorial tax*".

According to Jane G. Gravelle (who adopts the first definition of competitiveness), territorial taxation is inefficient because "*it causes the relative after tax returns to be higher in the lower-tax country and thus encourages capital flow into the low tax jurisdictions. As that occurs, the pre-tax return will rise in the high tax country as capital is less abundant, will fall in the zero tax country and capital because more abundant, and could either rise or fall in the low tax country. The shift in capital will occur until after tax returns are equated in all jurisdictions… . Countries' firms still compete in every location but the capital-labor ratios are distorted and the outcome is inefficient*".

Moreover, in her opinion, competitiveness, and therefore territoriality, would undermine Subpart F and would greatly enable profit shifting from high tax jurisdictions to low tax jurisdictions for mere tax reasons.

6. Reduction of corporate tax rates, tax cuts and other possible reforms.

As noted by Bret Wells and Cym Lowell, "*any reform proposal that creates a tax handicap for US MNEs poses the risk of contributing to the trend of US MNEs being acquired by foreign MNEs or expatriating, actually or practically, because of the tax advantages afforded to foreign ownership*".

For these reasons, any reform proposals must take into account competitiveness issues.

Reuven Avi-Yonah and Yaron Lahav, for example, conclude that the "*US can in fact reduce its corporate tax rate to the EU average in a revenue neutral fashion without affecting the competitiveness of US-based multinationals… . Specifically, as many observers have recommended, it should be possible to abolish deferral altogether if the US rate were reduced sufficiently*". Alternatively, "*it should be possible to amend Subpart F to take the source country rate into account*".

Eric Toder analyzes the most important effects on competitiveness[7] of various tax cuts. His main conclusions are the following:

- "*cuts in marginal personal income tax rates have the most direct effect on increasing competitiveness for skilled and internationally mobile workers.*

- "*Cuts in taxes on capital gains and dividends and in estate taxes are the tax policy changes that have the most direct effect on the choice residence of wealthy individuals*".

- "*Cuts in the effective marginal tax rate on new corporate investments are the cuts that have the most direct effect on capital invested in the United States*".

- *Cuts in the taxation of foreign-source income of U.S. multinationals directly reduce investment in the United States by giving these companies an incentive to invest more overseas ..., however proved benefit for U.S. – resident corporations, reducing their tax burden relative to taxes imposed on profits of corporations that are resident in other countries*".

However, as Bret Wells and Cym Lowell exposed, any tax reforms, other than competitiveness, should achieve "*the fundamental Policy Objectives: (i) Fiscal Responsibility via the raising of revenue; (ii) Neutrality, including addressing the Homeless Income arising from US origin profits and Base Erosion problems and, as a result, the perceived "tax gap;" (iii) Consistency with US treaty obligations; and (iv) Administrability*". In order to meet the "Policy Objectives", their proposal

[7] As seen, Eric Toder adopts a functional definition of competitiveness, which is partially different than the one adopted by other panelists.

is that “*domestic transfer pricing principles should be revised to require that cross-border payments from a US payor to a foreign entity should be subject to a base protecting surtax (the “Base Protecting Surtax”), unless the US payor reaches agreement with the Internal Revenue Service … that a lower or no Base Protecting Surtax is required after evaluating the global income of the foreign entity and the US payor in light of the overall business and the functions and risks performed in the United States by the US payor (a “Base Clearance Certificate”*). Any tax reforms should also take into account the fact, shown by Kevin S. Markle and Douglas A. Shackelford, that multinationals lower their domestic corporate tax bases by issuing long-term debt, relying on intangibles, and establishing subsidiaries in tax havens. Their conclusion is that “*compared with firms from abroad, U.S. companies appear to favor debt more than other countries to avoid taxes but do not exploit intangibles and havens as much*”.

7. Conclusion

In summary, the major conclusions of the articles in this volume are as follows:

1. The concept of competitiveness is unclear and there are open questions regarding its usefulness as a metric for determining US international tax policy.
2. There is no good empirical evidence supporting the view that current US tax law adversely affects the competitiveness of US-based MNEs.
3. The CFC rules of our major trading partners are not significantly less onerous than Subpart F.

   In our opinion, this means that competitiveness should not be a major consideration in reforming US international tax policy. Other considerations, such as the various neutralities (CEN, CIN, CON) and the impact of tax rules on actual behavior by US-based MNEs (e.g., the decision whether to repatriate income) and on whether future MNEs will be based in the US are more important.