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Corporate and International Tax Reform: Proposals for the Second Obama Administration (and Beyond)

Reuven S. Avi-Yonah*

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I. INTRODUCTION

The passage of the American Taxpayer Relief Act of 2012 (ATRA)[1] offers an opportune moment to consider proposals for corporate and international tax reform. With the debate over individual tax rates for the income and estate tax settled for the present, the President and Congress are free to consider broader reforms.

Few observers doubt that such reforms are sorely needed, for several reasons. First, the long-term budgetary outlook is unsustainable. Second, the U.S. corporate tax rate is the highest in the Organisation for Economic Co-Operation and Development (OECD).[2] Third, the current system raises relatively little revenue and large amounts of corporate income go untaxed.

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1. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (codified as amended in scattered sections of titles 2, 7, 16, 26, 42, 45, 46 U.S.C.A. (West 2013)).

2. *See* Org. Econ. Co-Operation Dev., *OECD Tax Database*, OECD. ORG, http://www.oecd.org/tax/taxpolicyanalysis/oecdtaxdatabase.htm#C_CorporateCapital (follow "C. Corporate and Capital Income Taxes" hyperlink; then follow "Basic (Non-Targeted) Corporate Income Tax Rates" hyperlink) (last visited Mar. 11, 2013).

Finally, the system is horrendously convoluted and imposes high transaction costs.

This Article will attempt to raise some proposals for U.S. corporate and international tax reform, beginning with long-term options (a ten year horizon), continuing with the medium-term (two to five years), and concluding with short-term options (one to two years).[3]

II. LONG-TERM PROPOSALS

In the long term (ten years and more), tax reform in the United States is dominated by dire budgetary prospects. Because of the impending retirement and health care costs of the baby boom generation, the U.S. faces the prospect of deficits exceeding $1 trillion per year for an indefinite period.[4] By 2043, under current projections, the debt-to-Gross Domestic Product (GDP) ratio will exceed 250%.[5] This picture is unsustainable because neither U.S. nor foreign savers would be willing to lend the U.S. government the necessary funds.[6]

Since drastic cuts to Social Security, Medicare, and Medicaid 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 unlikely and unwise, given that our main competitors have been steadily reducing those tax rates, that the corporate rate is the highest in the OECD, and that (after ATRA) the individual rates are the highest they are likely to go in our generation. Raising the funds by closing loopholes also seems unlikely, since ATRA once again showed Congress's appetite for regulating corporate and individual behavior via the tax code.

Thus, the only feasible solution in the long term is to follow the rest of the OECD and enact a value added tax (VAT). 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

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3. *See infra* Parts II–III.

4. ALAN J. AUERBACH & WILLIAM G. GALE, THE ECONOMIC CRISIS AND THE FISCAL CRISIS: 2009 AND BEYOND, AN UPDATE 3 (2009), *available at* http://www.brookings.edu/~/media/research/files/papers/2009/9/06%20fiscal%20crisis%20gale/06_fiscal_crisis_gale_update.pdf.

5. *Investment Strategy Group, Economic and Financial Markets Outlook—October 2012*, GOLDMAN SACH (Oct. 2012), http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&cad=rja&ved=0CDUQFjAA&url=http%3A%2F%2Fwww.atlantaactuarialclub.org%2Fdocuments%2F20121018%2FNeeti_Bahlia.pdf&ei=Ut1RUaabIeLgiAKhwID4Cw&usg=AFQjCNGQXttk9R_mGlbOZ-WBkO4E-ELulQ&sig2=IjcS5p2V-KvQ3zhdaO1aYA&bvm=bv.44342787,d.cGE.

6. *See* AUERBACH & GALE, *supra* note 4, at 23.

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 to replace the corporate tax (for competitiveness reasons).[7]

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 to higher transaction costs.

In addition, I think abolishing the corporate tax would be a mistake and would be 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.[8]

However, I do think that the corporate tax can be significantly simplified if we enact a VAT. Specifically, I would support permitting corporations to expense all capital expenditures. From an economic 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; 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—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—the U.K. made it when it introduced the VAT in the 1970s.

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7. MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE PLAN FOR THE UNITED STATES 67 (2008).

8. Reuven S. Avi-Yonah, *Symposium on Designing a Federal VAT: Summary and Recommendations*, 63 Tax L. Rev. 285 (2010).

III. 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, since corporate residence is not very meaningful. However, we cannot do that without first tackling the knotty problems of defining the source of income and transfer pricing. Moving to pure territoriality without reforming transfer pricing is a recipe for increased shifting of profits outside the U.S. 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.[9] 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.[10] This formula favors the United States as an importing country, and one can imagine different formulas negotiated with the European Union (EU) if it goes ahead and adopts formulary apportionment for internal EU purposes, as the European Commission (EC) has proposed.[11]

The biggest advantage of adopting our proposal is that it will enable the U.S. to move in the direction of territoriality. Not only will dividends, interest, and royalties within a U.S.-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 U.S. will tax each multinational (whether U.S.- or foreign-based) only on the income that the formula assigns to the U.S. 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 United States' 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 United States (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 U.S. to finance a significant cut in the corporate tax rate.[12]

Tax competition in the form of incentives for multinationals would

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9. Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX. REV. 497 (2009).

10. *Id.*

11. *Id.* at 510.

12. *Id.* at 507–08, 511–12.

persist under pure source-based taxation based upon 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.[13] The data show that this form of tax competition is rampant (eight of the top ten locations for U.S.-based multinational profits had effective tax rates of 10% or less in 2010, and none of them had corresponding real investment).[14]

IV. SHORT-TERM PROPOSALS

In the short term, I believe the Obama proposal to apply a minimum tax to the foreign source income of U.S.-based multinationals is on the right track, because, as long as transfer pricing reform is not enacted, bolstering residence-based corporate taxation is a necessary backstop to source-based taxation. The Obama proposal is a cautious first step in this direction and is justified by the data showing massive under-taxation of the foreign profits of U.S.-based multinationals.[15] It is not inconsistent with adopting some form of dividend exemption after the minimum tax has been paid.[16]

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 U.S. tax rate is not particularly high, studies show that the marginal tax rate affects investment patterns, so that having the highest rate in the OECD is not advisable.[17]

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

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13. *Id.* at 516–17.

14. *Hearing on Transfer Pricing Issues: Hearing Before the H. Comm. on Ways & Means*, 111th Cong. 1 (2010) (testimony of Professor Reuven S. Avi-Yonah), *available at* http://waysandmeans.house.gov/media/pdf/111/2010jul22_aviyonah_testimony.pdf.

15. Reuven S. Avi-Yonah, *Vive la Petite Difference: Camp, Obama, and Territoriality Reconsidered*, 66 TAX NOTES INT'L 617 (2012).

16. *Id.*

17. *See, e.g.*, ERNST & YOUNG LLP, ROBERT CARROLL & GERALD PRANTE, LONG-RUN MACROECONOMIC IMPACT OF INCREASING TAX RATES ON HIGH INCOME TAXPAYERS IN 2013 (2012), *available at* http://waysandmeans.house.gov/uploadedfiles/ey_study_long-run_macroeconomic_impact_of_increasing_tax_rates_on_high_income_taxpayers_in_2013__2012_07_16_final.pdf.

First, to protect U.S. residence-based taxation from inversion transactions, the "managed and controlled" definition of U.S. corporate residence should be adopted.[18]

The Obama proposals increase the pressure on the distinction between U.S,- and foreign-based multinationals, and I believe the current anti-inversion rule in I.R.C. 7874 is insufficient.[19] When the U.K. beefed up its CFC rules in conjunction with adopting limited territoriality, some U.K. corporations nominally moved to Ireland,[20] but HMRC (HM Revenue & Customs) are challenging this purported move because they have the "managed and controlled" standard to rely on.[21] The IRS should have the same ability.

Second, 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 U.S. 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.

Third, we should abolish all "regular" outbound withholding on dividends, interest and royalties, as well as the branch profit tax.[22]

The need to impose withholding taxes arises from the need to protect the domestic U.S. tax on residents who pretend to be non-residents, but this has been adequately dealt with by the Foreign Account Tax Compliance Act (FATCA).[23] After FATCA, I see no need for regular withholding (as

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18. *See* Reuven S. Avi-Yonah, *Beyond Territoriality and Deferral: The Promise of "Managed and Controlled,"* 63 TAX NOTES INT'L 667 (2011); *see also* Steven H. Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71, 116 (2008) ("An alternative approach, used by many countries, looks to where the corporation is 'managed and controlled to determine whether it is a resident.'").

19. I.R.C. § 7874 (2006); *see* Nicola Lostumbo & Garry Stone, *How Much is Corporate America Worth? Corporate Tax Reform and Firm Valuation*, 24 J. INT'L TAX 41, 42–46 (2013).

20. *See UK in Trouble with EC Again over CFC Rules*, PEARCE TRUST BLOG, http://www.pearse-trust.ie/blog/bid/62932/Uk-In-Trouble-With-EC-Again-Over-CFC-Rules (last visited on Feb. 13, 2013).

21. *See id.*; *see also* Avi-Yonah, *Beyond*, *supra* note 18.

22. *See Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends: Before the Permanent Subcomm. on Investigations, Comm. On Homeland Sec. & Governmental Affairs*, 110 Cong. 778 (2008) (statement of Professor Reuven S. Avi-Yonah), *available at* http://www.google.com/url?sa=t&rct=j&q=testimony%20for%20hearing%20on%20dividend%20tax%20abuse%3A%20s.%20permanent%20subcommittee%20on%20investigations%20(2008)%20(statement%20of%20prof.%20reuven%20s.%20avi-yonah).&source=web&cd=1&ved=0CDIQFjAA&url=http%3A%2F%2Fwww.hsgac.senate.gov%2Fdownload%2Freport_dividend-tax-abuse-how-offshore-entities-dodge-taxes-on-us-stock-dividends&ei=cSpTUePMN6zsiQKRyoEQ&usg=AFQjCNEaNa6JvpTRFLVQKjZAK8q-tjb4jw&bvm=bv.44342787,d.cGE.

23. Foreign Account Tax Compliance Act, I.R.C. § 6038D (2006) (enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, Pub. L. No. 111-147, 124 Stat 71 (codified

opposed to penalty withholding on noncompliant foreign financial institutions, as imposed by FATCA).[24] We do not withhold on portfolio interest, royalties, and capital gains.[25] Dividend withholding imposes an unnecessary second level of tax on inbound investment. 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 U.S. withholding on portfolio investments.[26] Thus, we can save a lot of transaction costs at little revenue cost by eliminating regular withholding and the branch profit tax. We should, however, consider refundable withholding (taxes refunded upon showing income was reported to residence jurisdiction) as a way of helping other countries combat tax evasion.[27]

On the other hand, we should tighten up the earning stripping rules by applying the I.R.C. 7874 standards to all foreign corporations, and extend them to royalties as well.[28]

These provisions are needed as added protection for the U.S. corporate tax base. In the absence of transfer pricing reform foreign multinationals (and inverted U.S. multinationals not caught by I.R.C. 7874, like grandfathered ones) have too much ability to strip income out of the U.S. via interest and royalty payments.[29]

Finally, I would abolish the Foreign Investment in Real Property Tax Act (FIRPTA)[30] 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 U.S. 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

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as amended in scattered section of the I.R.C.).

24. *See id.*

25. *See Federal Income Tax Withholding and Reporting on Other Kinds of U.S. Source Income Paid to Nonresident Aliens*, IRS, http://www.irs.gov/Individuals/International-Taxpayers/Federal-Income-Tax-Withholding-and-Reporting-on-Other-Kinds-of-U.S.-Source-Income-Paid-to-Nonresident-Aliens (last visited Feb. 16, 2013).

26. *See id.*

27. Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductible Payments*, 119 TAX NOTES 993 (2008).

28. I.R.C. § 7874 (2006).

29. *See id.*; *see also* John Mutti & Harry Grubert, *The Effect of Taxes on Royalties and the Migration of Intangible Assets Abroad* 114–16, *in* INTERNATIONAL TRADE IN SERVICES AND INTANGIBLES IN THE ERA OF GLOBALIZATION 114–16 (Marshall Reinsdorf & Matthew J. Slaughter, eds. 2009).

30. Foreign Investment in Real Property Tax Act of 1980, I.R.C. §§ 897, 6039C (2006) (enacted as part of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599).

uncertainty about whether over 50% of corporate value is in real estate, even for small portfolio shareholders.[31] On the other hand, when a foreign multinational acquires a U.S.-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 (which many do).

V. CONCLUSION

The preceding has been an attempt to offer some suggestions for long-, medium-, and short-term reform of U.S. corporate and international taxation. If we want to keep taxing corporations (and I believe we should), 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 U.S. economy competitive with our trading partners.

31. *See id.*