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COMMENT ON YIN, REFORMING THE TAXATION OF FOREIGN DIRECT INVESTMENT BY U.S. TAXPAYERS

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In this excellent article, George Yin addresses an important proposal by the President's Advisory Panel on Federal Tax Reform. The Advisory Panel proposed that the United States should permanently switch from taxing the parent corporation of U.S. multinationals on worldwide income to a modified territorial regime under which dividends paid out of active business income would be exempt from U.S. tax.[1] The Joint Committee on Taxation made a similar recommendation.[2]

Why should we abandon the idea that U.S. taxpayers should be taxed on all income "from whatever source derived," which has been a fundamental building block of our tax system since 1913?[3] The basic rationale for exempting dividends is based on Joel Slemrod's observation that the efficiency of a tax should be measured by the ratio of the revenue it collects to the behavioral change it induces in taxpayers.[4] In the case of the tax on dividends, the revenue collected is small, because, as Jim Hines has shown, U.S. multinationals repatriate only a small fraction of their overseas earnings.[5] On the other hand, the behavioral impact is large, as can be seen from Hines' data and

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[1] PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, FINAL REPORT 102–05 (2005).

[2] STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 186–97 (Joint Comm. Print 2005).

[3] I.R.C. § 61.

[4] Joel Slemrod, *A General Model of the Behavioral Response to Taxation*, INT'L TAX & PUB. FIN. 119–28 (2001).

[5] Mihir A. Desai, C. Fritz Foley, & James R. Hines, Jr., *Dividend Policy Inside the Multinational Firm*, 36 FIN. MGMT. 5–26 (2007).

even more vividly by the behavioral response to the one-year partial amnesty from the dividend repatriation tax. The enactment of this amnesty in 2004 resulted in over $300 billion in income being repatriated.

In addition, dividend exemption offers some simplification potential, because there will be no foreign tax credit available for exempt earnings. Since the credit will only be available for income that is in fact taxed by the United States (for example, under Subpart F), and this income is typically subject to lower rates of tax overseas, the credit will likely play a much more limited role, so the remaining "baskets" could be consolidated. On the other hand, deductions associated with exempt income will need to be limited, which will add complexity. Overall, since the anti-deferral rules (Subpart F and Passive Foreign Investment Company [PFIC]) will be retained, it is not clear that the dividend exemption proposal is a significant move toward simplification.

Another argument in favor of dividend exemption is that because most of our trading partners exempt dividends from active income, adopting the same rule helps our competitiveness. However, as Michael Knoll has shown, the competitiveness argument depends on some dubious assumptions (similar to those underlying the Unrelated Business Income Tax).[6] Moreover, the availability of unlimited deferral means that the current regime does not significantly affect competitiveness.

The main argument against the proposal is that, like any move in the direction of territoriality, it puts more pressure on the source rules and on transfer pricing. Currently, U.S. multinationals considering whether to shift income from the United States to foreign jurisdictions know that getting it back into the United States means paying a price, in the form of the dividend tax. The same data cited above show that this constraint is real and that the phenomenon of "trapped income" is significant. If we now abolish the tax on repatriation, U.S. multinationals should have every incentive to shift even more income overseas.

This issue would not be so problematic if our transfer pricing regime effectively prevented income shifting. But as Kim Clausing and I have shown, the current system is woefully inadequate for that task.[7] This is illustrated by Table 2 in Yin's article, which shows high

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[6] Michael Knoll, *Taxes and Competitiveness* 11 (U. Pa. Inst. of Law & Econ., Research Paper No. 06-28, 2006), *available at* http://ssrn.com/abstract=953074.

[7] Reuven Avi-Yonah & Kimberly Clausing, *Reforming Corporate Taxation in a*

concentrations of earnings and profits (E&P) in the Netherlands, Ireland, Switzerland, and Luxembourg. The following data, which show the top ten locations of profits of US multinationals in 2003, also illustrate the inadequacy of the current regime:[8]

FIGURE 1:WHERE WERE THE PROFITS IN 2003?

(profits as a percentage of the worldwide total)

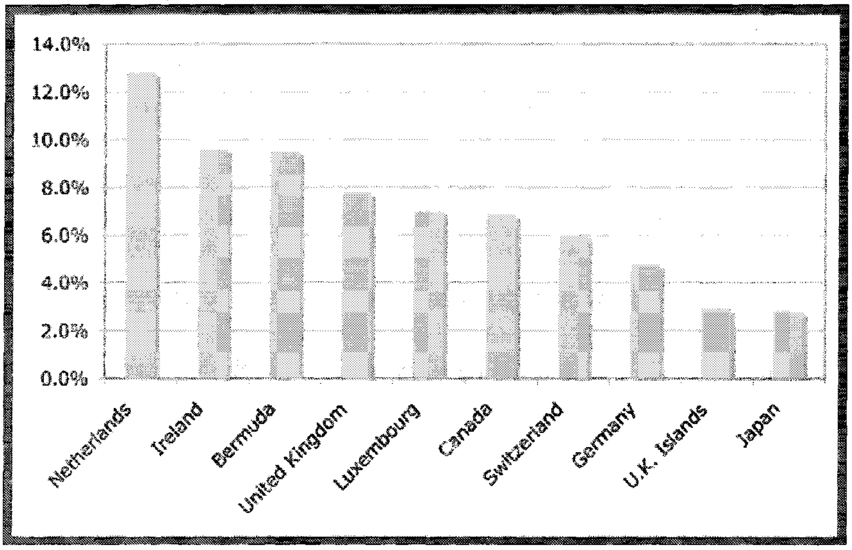

TABLE 1:EFFECTIVE TAX RATES OF SELECTED COUNTRIES

COUNTRY	EFFECTIVE TAX RATE
Netherlands	5.3%
Ireland	6.1%
Bermuda	1.7%
United Kingdom	20.1%
Luxembourg	-1.8%
Canada	23.5%
Switzerland	4.5%
Germany	8.2%
U.K. Islands	1.3%
Japan	36.9%

In a world in which a third of the foreign profits of U.S.-based multinationals are in countries with effective tax rates of less than 10%, it seems dangerous to increase the incentive to shift profits by

Global Economy: A Proposal to Adopt Formulary Apportionment (The Brookings Institution, Jun. 2007), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2007/06corporatetaxes_clausing/200706clausing_aviyonah.pdf.

[8] *Id.* at 8.

removing the one real disincentive to doing so: the knowledge that repatriation would bear tax.

Yin recognizes that this is a real problem, and states that "one modification Congress should consider is to require exempt income to be subject to tax somewhere."[9] The question is how to achieve this goal, which I fully support, as it is consistent with what I call the "single tax principle."[10] Yin proposes that we achieve this by applying the dividend exemption only to countries with which we have tax treaties. However, this would include a lot of jurisdictions with very low effective tax rates (see Table 2, which includes in the list Austria, Barbados, Cyprus, Ireland, Luxembourg, the Netherlands, and Switzerland). Of the top ten destinations in Figure 1, only two (Bermuda and the U.K. Islands) would not qualify for exemption under this modification.

Therefore, if we are to adopt the exemption proposal, we must grant exemptions only when the actual effective tax rate in the source jurisdiction is high enough (for example, ninety percent of the U.S. rate). This is consistent with what our trading partners do as well as with the original intent of Subpart F.[11] It should not pose insurmountable administrability obstacles, since U.S. multinationals already have to report both the current E&P and the actual tax paid by each Controlled Foreign Corporation [CFC] (see Yin's Table 2). It is similar to the "franking" mechanism that countries with dividend imputation systems use to show that exempt dividends are paid out of income that was in fact subject to corporate-level tax.

In the long run, however, neither the Advisory Panel nor Yin goes far enough. The key question is whether U.S.-based multinationals are sufficiently different from foreign-based multinationals to justify taxing the former but not the latter on worldwide income. Even if we adopt the dividend exemption proposal, we will still be taxing U.S.-based multinationals differently; for example, only they will be subject to Subpart F. The inversions saga illustrates that this will cause pressure to shift parent corporations out of the United States. Given the positive externalities associated with headquarters locations, this is unfortunate.

Ultimately, the current distinction on the basis of where the

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9 George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 2008 TNT 5-22 (Jan. 8, 2008).

10 REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 8–9 (2007).

11 Reuven Avi-Yonah, *U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective*, 16 TAX NOTES INT'L 1797, 1800 (June 8, 1998).

parent is incorporated is obsolete. Corporations do not have meaningful residency and therefore should be taxed purely on a source basis. Moreover, distributions within multinational groups (whether in the form of dividends, interest, royalties, or transfer prices) are meaningless and should be ignored, and Subpart F should be abolished.

If we adopt this view, it is clear that we need a better system for establishing the source of income, or else all corporate income will be shifted to low-tax jurisdictions. Therefore, I consider global formulary apportionment the only regime appropriate for the 21st century.[12] Luckily, because of the progress made within the EU on the Common Consolidated Corporate Tax Base, the prospect that the OECD will agree on a formula is not as far-fetched as it once seemed. In the long run, pure source-based taxation of multinationals is the solution.

[12] Avi-Yonah & Clausing, *supra* note 7, at 12–18.