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The Ingenious Kerry Tax Plan

By Reuven S. Avi-Yonah

The tax plan proposed by Democratic presidential candidate John Kerry at Wayne State University on March 26 is an ingenious set of ideas to encourage domestic job creation. Its greatest strength, however, may be its contribution to long-term economic growth, fairness, and tax law simplification. In this article I will first describe the Kerry proposal, then analyze its advantages, and finally address some counterarguments.

I. The Kerry Proposal

Under current law, American multinationals have an incentive to invest in overseas operations because active business income earned by their foreign subsidiaries is generally exempt from current U.S. tax.1 Moreover, once the overseas investment is made, the multinationals have an added incentive to keep their profits offshore because they become subject to tax on repatriation back to the United States. Most deferred profits are earned in low-tax jurisdictions, so the foreign tax credit does not shield repatriations from U.S. tax. The resulting deferral of U.S. tax is equivalent to a significant reduction in the effective U.S. tax rate on foreign-source income, and results in a very low overall effective rate on that income because it can frequently be earned free of foreign tax.2

The Kerry proposal would limit deferral by subjecting subsidiaries of U.S. multinationals to current U.S. tax on income earned from foreign operations aimed at the U.S. market and markets other than the one in which the CFC is organized. That would eliminate the incentive to move operations offshore to the extent they produce goods or services aimed at the U.S. market and other export markets. U.S. multinationals would continue to enjoy the exemption from current U.S. tax on foreign operations aimed at foreign markets in which they are organized to preserve their competitiveness vis-à-vis foreign multinationals. The revenue raised by this proposal would be spent on reducing the overall corporate tax rate.

In addition, the Kerry proposal would eliminate the current incentive to leave profits abroad by offering a

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1Code sections 951-960 (subpart F).
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one-time opportunity to U.S. multinationals to repatriate income accumulated overseas at a low 10 percent tax rate. That is expected to result in significant repatriations, and the revenue gained would be used to offer all U.S. employers a tax credit for creating new domestic jobs. After this temporary opportunity expires, repatriations would not result in added U.S. tax to the extent paid out of profits subject to current U.S. tax because of the limitations on deferral outlined above.3

II. Kerry Proposal’s Long-Term Advantages

The Kerry proposal has obvious advantages regarding short-term job creation. It eliminates the current tax incentive for U.S. multinationals to move operations aimed at the U.S. market overseas. It also creates an incentive for U.S. multinationals to repatriate profits that are currently “trapped” overseas by the tax on repatriations, and to invest those funds in creating new U.S. jobs to benefit from the jobs tax credit.4 Finally, the reduction in overall corporate tax rates should also help in stimulating new job creation.5

But the biggest advantages of the Kerry plan are its long-term effects. First, it helps economic efficiency and growth by reducing the current tax incentive to invest in lower-yielding foreign operations rather than in U.S. activities with a higher before-tax yield. Second, it helps tax fairness by putting U.S. multinationals that sell into the U.S. market on the same level playing field as small, purely domestic businesses that are subject to U.S. tax on all their income. Third, it helps simplify the tax code by eliminating the incentive for U.S. multinationals to artificially move profits from U.S. operations offshore.

The efficiency argument, or the Kerry proposal, is based on capital export neutrality (CEN), which most economists would agree is still the best goal of U.S. international tax policy.6 CEN is based on the notion that overall welfare is increased if investors are free to make choices without regard to taxes. Thus, absent taxes, a U.S. investor should prefer a U.S. investment yielding 10 to a foreign investment yielding 7. Deferral, however, results in the U.S. investment being subject to current tax while the foreign investment is not taxed by the U.S. Thus, after taxes the investor would prefer the foreign investment (yielding 7) to the U.S. investment (yielding 6.5 after a 35 percent tax), resulting in welfare loss.

The fairness argument for the Kerry proposal is that it puts U.S. multinationals selling into the U.S. market on the same level playing field as purely domestic U.S. businesses subject to full U.S. tax. Under current law, tax on the income from those sales by the U.S. multinational can be deferred, resulting in a competitive advantage to the U.S. multinational over the small U.S. business. In addition, the Kerry proposal is in effect a tax increase on large U.S. multinationals to finance a tax cut for all U.S. corporations.

Finally, the simplification argument for the Kerry proposal results from its limitations on deferral. Given deferral, U.S. multinationals have an incentive to artificially shift profits offshore through transfer pricing. The IRS spends significant resources on combating those schemes. In fact, most transfer pricing cases litigated since 1980 involve U.S. multinationals rather than foreign multinationals. To the extent deferral is abolished, the U.S. multinationals will have no further incentive to adopt aggressive transfer pricing policies with their foreign subsidiaries on income earned from sales into the U.S. or other export markets (because the income will be subject to U.S. tax whether earned by the parent or by the subsidiary).

III. Some Objections

A. It’s Better to Abolish Deferral Altogether

The most cogent objection to the Kerry proposal is that it goes only halfway: Deferral is abolished only to the extent U.S. multinationals sell into the U.S. market or other export markets. It is certainly true that abolishing deferral altogether would enhance both the efficiency and simplification advantages of the proposal. But that runs into the political reality that abolishing deferral altogether is not a plausible outcome because it arguably puts U.S. multinationals at a competitive disadvantage vis-a-vis foreign multinationals in selling to foreign markets. While that argument may be overstated (because, for example, our trading partners in fact have antideferral rules that are quite similar to subpart F), it sells.7

The Kerry proposal is an ingenious way to draw the line between deferral and current taxation, where it makes most sense from a competitiveness point of view. To the extent U.S. and foreign multinationals sell into the U.S. market, we can make sure both are fully

3It could be argued that this temporary amnesty penalizes multinationals that have repatriated at a higher tax cost, but this is a small group.

4This problem is currently more acute because of the added pressure on U.S. multinationals to distribute dividends as a result of the 2003 tax cuts.

5Economists generally agree that tax rate cuts result in economic growth to the extent they are not debt-financed. This distinguishes the proposed Kerry corporate tax cut, which is paid for, from the irresponsible tax cuts of the Bush administration.

6CEN is superior to its rival capital import neutrality (CIN) as long as the elasticity of the demand for capital (investment location) is higher than the elasticity of the supply of capital (savings rate) in response to tax differentials, which most economists would agree is the case. See U.S. Treasury, Subpart F: A Reconsideration (2000); Harry Grubert and John Mutti, “Do Taxes Influence Where U.S. Corporations Invest?” 53 Nat’l Tax J. 1 (2002).

7While none of our trading partners have abolished deferral altogether, several eliminate it on all foreign income subject to a low effective foreign tax rate, which amounts to the same result because deferral is meaningless for income subject to high taxes at source. Moreover, if we abolished deferral, it is likely that our trading partners would follow suit (just as they adopted CFC rules in response to the enactment of subpart F). See Avi-Yonah, “Tax Competition and Multinational Competitiveness; The New Balance of Subpart F,” Tax Notes International, Apr. 19, 1999, p. 1575.
taxed. To the extent the foreign multinationals sell to foreign markets in which they are organized, they may be exempt, and therefore U.S. multinationals should enjoy deferral for those sales. Neither the current line drawn by subpart F (largely between active and passive income) nor other proposed lines (for example, between income subject to high and low foreign tax) achieve that goal in the same way, and that is the most ingenious and significant innovation in the Kerry proposal.

B. Administrability Issues

Drawing any line in tax law raises administrability issues, and for the Kerry proposal the issue is how to distinguish between income from sales into the U.S. (and other export sales) and income from overseas sales in the jurisdiction in which the CFC is organized. To do that, subpart F must segregate those two pools of gross income and then apportion deductions between them. That is hard, but not harder than segregating subpart F income from other income under current law.

C. Inversions and M&A

The most common objection to the Kerry proposal is that it will encourage inversions — moving the parent corporation of a U.S. multinational offshore to avoid the new expanded subpart F regime. That may be true, but it can be addressed by combating inversions. There are proposals pending in Congress to do that, but my favorite remains to redefine U.S. corporate residence to include a U.K.-style managed and controlled test. That would take care of the problem unless management is actually willing to move to Bermuda. Similarly, the threat of 50/50 joint ventures with foreign partners can be addressed by lowering the threshold of what it takes to be a CFC (the French, for example, just require 10 percent ownership, not control).

Another argument traditionally made against expanding subpart F is that it will encourage foreign takeovers of U.S. multinationals. That assumes that the antideferral rules of our trading partners are more lax, which I would dispute. But even if that were true, the Kerry proposal would not encourage takeovers since both foreign and U.S. multinationals will be treated the same: Taxed in full if selling into the U.S., exempt from current tax if selling overseas in the jurisdiction they are organized in.

IV. Conclusion

In 1961 President Kennedy proposed to tax U.S. multinationals on all income earned by their foreign subsidiaries, while reducing overall corporate tax rates. The Kerry proposal is a worthy descendant of that tradition, updated to suit current market conditions. It would reverse a decade-long erosion of subpart F, which has been steadily contracted by Republican-dominated congresses since 1994. Implementing that proposal would both help job creation in the short run, and improve the overall efficiency, fairness, and simplicity of U.S. tax law in the longer run.

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8This assumes that foreign multinationals can be taxed on income from U.S. sales deriving from both production and distribution activities. I believe that is possible; see the proposal developed in Reuven S. Avi-Yonah, “Globalization, Tax Competition and the Fiscal Crisis of the Welfare State,” 103 Harv. L. Rev. 1573 (2000).

9They may also be exempt when selling to other foreign markets, but since there is no clear nontax reason not to organize a subsidiary in the market you sell into, it seems appropriate not to extend deferral to those cases. See the base company rules.


11The example usually given of tax-driven M&A is Daimler/Chrysler, but this is a canard since German section 367-type rules made it impossible for Chrysler to take over Daimler (and see also Juergen Schrempp’s testimony in the Kerkorian litigation that he always viewed this as a Daimler takeover of Chrysler, so that a structure in which Chrysler remained on top was never seriously considered).