Symposium on International Taxation and Competitiveness: Introduction and Overview

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

Recommended Citation
Avi-Yonah, Reuven S. "Symposium on International Taxation and Competitiveness: Introduction and Overview." N. Sartori, co-author. Tax L. Rev. 65, no. 3 (2012): 313-22.

Foreword

REUVEN S. AVI-YONAH* AND NICOLA SARTORI**

I. Introduction

In February, 2012, the Treasury and White House unveiled President Obama's Framework for Business Tax Reform. A major proposal was to abolish the deferral on income earned by foreign subsidiaries of U.S. corporations ("CFCs"). The administration justified the proposal with an argument about competitiveness:

> [I]ncome 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.[1]

At the other end of Pennsylvania Avenue, Chairman David Camp of the House Ways and Means Committee unveiled a proposal to almost completely exempt the active income of a CFC, even when distributed to the parent as a dividend. This proposal was also mostly justified by competitiveness considerations.[2]

---

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

** Post-Doctoral Fellow, the University of Milan.

[1] The President's Framework for Business Tax Reform 14 (2012), http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

[2] See Staff of the H. Comm. on Ways and Means, Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income (Oct. 26, 2011), available at http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_—_Ways_and_Means_Participation_Exemption_Discussion_Draft.pdf.

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.[3] But 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 U.S.-based multinational enterprises (MNEs). Even the concept of competitiveness itself is unclear. Despite numerous claims,[4] there has been no rigorous attempt that we are aware of to determine whether MNEs based in our major trading partners actually have a tax advantage or disadvantage because of subpart F or other tax 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. The articles included in this Issue were first presented at this conference. This Foreword summarizes their main conclusions.

II. The Concept of Competitiveness

In order to analyze the link between competitiveness and international taxation, it is useful to delineate the concept(s) of competitiveness, which is a seldom defined but frequently used term (especially in tax policy debates).

Economists use a broad, nation-wide concept of competitiveness in order to make comparisons across nations, while they use a market-oriented concept of competitiveness in order to make comparisons among businesses and workers operating in different markets. Michael Knoll argues that a market-oriented conception has several advantages over a nation-wide conception in understanding how government policy affects competitiveness.[5] He notes that market-oriented measures are "more closely aligned with our intuitions about competitiveness" and "are capable of being given a more solid theo-

---

[3] Federal Tax System—Message from the President of the United States, 107 Cong. Rec. 6456, 6458 (1961).

[4] See, e.g., 1, pt. 1 Nat'l Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century 33-145 (2001), available at http://www.nftc.org/default/tax/fip/NFTC1a%20volume1_part1.pdf; id. at 310 ("The comparison of anti-deferral rules in the NFTC Subpart F Report found that for every category of income considered, the United States imposed the severest regime.").

[5] Michael S. Knoll, The Connection Between Competitiveness and International Taxation, 65 Tax L. Rev. 349, 351 (2012).

retical foundation because they can be integrated into standard economic models."[6]

Paul Krugman (cited by both Michael S. Knoll and Jane Gravelle)[7] has strongly criticized the idea of competitiveness as a characteristic of an entire nation.[8] Krugman argues that nations cannot be compared to corporations because nations, unlike corporations, do not go out of business; while firms compete, countries trade.[9] The United States can be better off or worse off (rather than competitive). Thus the term competitiveness should be associated with an industry rather than a nation.

There are two main definitions of competitiveness, as applied to industries. Under the first definition, competitiveness focuses on the total output (both domestic and foreign) of the companies based in a given jurisdiction. An industry is competitive in the United States 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). As Knoll notes "the U.S. corporate income tax will adversely affect the competitiveness of [a] U.S. . . . industry if it reduces the incentive for U.S.-based [firms]—relative to their foreign competitors—to own productive assets."[10]

Under the second definition, competitiveness focuses on the total output of an industry regardless of the nationality of the producing company. A U.S. industry is competitive if U.S. and foreign multinationals invest in the United States, rather than in foreign countries. The focus is on the U.S. production (regardless of the nationality of the producing companies). Under this view, according to Knoll, the U.S. corporate income tax affects the competitiveness of a U.S. industry if it discourages investment in production in the United States relative to investment in production abroad.[11]

Reuven Avi-Yonah and Yaron Lahav believe that competitiveness "is primarily about the ability of the largest U.S. multinationals to compete with their counterparts based in other countries, and especially those based in the EU."[12] In other words, they adopt the first

[6] Id.

[7] Knoll, note 5, at 349 n.2; Jane Gravelle, Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?, 65 Tax L. Rev. 323, 325 n.7 (2012).

[8] Paul Krugman, Competitiveness: A Dangerous Obsession, Foreign Aff., Mar./Apr. 1994, at 28.

[9] Id. at 31.

[10] Knoll, note 5, at 358.

[11] Id. at 359.

[12] Reuven S. Avi-Yonah & Yaron Lahav, The Effective Tax Rates of the Largest U.S. and EU Multinationals, 65 Tax L. Rev. 375, 377 (2012).

definition of competitiveness, focusing on the ownership of productive assets.

Brian Arnold also implicitly adopts the first definition of competitiveness. His comparative review of CFC provisions responds to claims that have been made that "U.S. multinationals are at a significant competitive disadvantage compared to many foreign-based multinationals because the U.S. subpart F rules are broader and harsher than the CFC rules of other capital-exporting countries."[13]

Others seem to adopt both perspectives simultaneously. As Jane Gravelle notes,[14] the report of the National Commission on Fiscal Responsibility and Reform includes language decrying the effect of the Code on the ability of U.S. business to compete abroad as well as the attractiveness of the United States for foreign investment.[15] In its concern for competitiveness, it is not clear whether the Commission wanted more U.S.-owned operations abroad or wanted more foreign-owned operations in the United States.

Finally, Eric Toder adopts an operational definition of competitiveness (which resembles the second definition rather than the first, but is also close to a nation-wide notion), pointing out that countries compete with other nations for labor supply, financial and physical capital, intangible capital, tax revenues, and natural resources.[16] In other words, competitiveness, according to Toder, is "competition between nations for scarce and mobile resources."[17] Following this definition, taxation can affect the ability of countries to compete for workers, capital, and investment opportunities.

III. Competitiveness and the Neutrality Principles of International Taxation

A second issue is the relationship of the two definitions of competitiveness to the various neutrality principles of international taxation. These neutrality concepts determine the tax treatment of cross-border income.

Knoll shows that the first definition of competitiveness (U.S. multinationals competing with foreign multinationals) is consistent with capital ownership neutrality (CON) or, alternatively, capital import

[13] Brian J. Arnold, A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules, 65 Tax L. Rev. 473, 473 (2012).

[14] Gravelle, note 7, at 323 ns. 1, 2.

[15] Nat'l Comm'n on Fiscal Responsibility & Reform, The Moment of Truth 29, 32 (2010), available at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf

[16] Eric Toder, International Competitiveness: Who Competes Against Whom and for What?, 65 Tax L. Rev. 505, 509 (2012).

[17] Id. at 533.

neutrality (CIN) when CIN is understood as ownership neutrality. "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."[18] Gravelle explains that territorial or source-based tax systems where income is taxed only by the country in which it is earned satisfy the CIN standard because each firm in a location faces the same tax rate.[19]

The second definition (United States competing with other countries for providing labor and capital to multinationals) is consistent with capital export neutrality (CEN).[20] "An international tax regime that satisfies CEN (that is, 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 considerations will not advantage or disadvantage any of them in their ability to attract investment."[21] As Gravelle points out, a system that imposes taxes on residents on their worldwide income with an unlimited foreign tax credit and foreigners on their source income achieves CEN, even though "the distribution of taxes is different, with more tax collected by net capital importers than in a straightforward residence system."[22] Gravelle also notes that a worldwide system residence-based system with a deduction for foreign taxes "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."[23]

IV. 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 authors), tax rules affect competitiveness in the sense that they affect the ability of U.S. multinationals to compete for investments and for people. Several authors investigated whether U.S. multinationals are actually at a competitive disadvantage compared with foreign (mainly European and Japanese) multinationals in order to test the veracity of competitiveness arguments made by U.S. multinationals about the effect of U.S. tax rules.

---

18 Knoll, note 5, at 368.
19 Gravelle, note 7, at 329.
20 Knoll, note 5, at 364.
21 Id.
22 Gravelle, note 7, at 329.
23 Id. at 329–30.

Although the United States has the second highest statutory corporate tax rate in the OECD, it is the effective tax rate that directly affects U.S. competitiveness with other multinationals. Avi-Yonah and Lahav studied the overall effective tax rates of the largest 100 U.S.-based multinationals and compared them to the 100 largest EU multinationals. They conclude U.S.-based MNEs do not face a tax-induced competitive disadvantage in competing against EU-based MNEs.[24] They found that although the U.S. statutory rate is ten percentage points higher than the average EU corporate statutory rate, the effective U.S. corporate tax rate is the same or lower than the effective EU corporate tax rate for largest U.S. and EU MNEs.[25] Avi-Yonah and Lahav believe this is because the European corporate tax base is larger than U.S. corporate tax base due in part to tougher CFC rules. Their comparison of the CFC rules of the United States and major EU countries shows that the EU CFC rules tend to be more stringent than subpart F because they use the effective tax rate in the source country in determining whether to tax CFC income and they take into account whether the CFC has a real presence in the source country.[26]

Arnold undertakes a comparative analysis that confirms this supposition. He compares the CFC legislation of nine different countries,[27] and concludes that "the U.S. 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 U.S. rules."[28]

An analysis by Melissa Costa and Jennifer Gravelle also suggests that the popular conclusion that U.S. taxes impede the ability of U.S. MNEs to compete does not withstand analysis.[29] They provide estimates of the average tax rates of U.S. CFCs by industry and updated estimates of U.S. average tax rates on foreign and domestic income of multinational corporations. An important contribution of their work is that their measure of average tax rates addresses the impact of deferral on the rate assessed on the total foreign income of MNEs.

They show that although a significant amount of foreign income is subject to U.S. tax, the ability to defer taxes on foreign income cou-

---

[24] Avi-Yonah & Lahav, note 12, at 383.

[25] Id.

[26] Id. at 384.

[27] For another comparative analysis of CFC legislation, see Reuven Avi-Yonah & Nicola Sartori, U.S. Sub-part F Legislative Proposals: A Comparative Perspective, 5 Int'l Tax'n 428-37 (2011).

[28] Arnold, note 13, at 496.

[29] Melissa Costa & Jennifer Gravelle, Taxing Multinational Corporations: Average Tax Rates, 65 Tax L. Rev. 391, 408 (2012).

pled with low average foreign rates on CFC income suggests that the U.S. tax system has strong territorial features, with a nominal residual average tax on foreign earnings.[30] Their conclusion is that "U.S. corporations are likely not being negatively impacted by the U.S. corporate tax rate."[31]

As Toder notes, nations compete for various resources, one of which is labor supply.[32] Thus, one way in which corporate taxes might affect competitiveness is if they have an effect on labor supply. Kimberly Clausing's study reviewed the effects of corporate taxation on labor. Contrary to most studies she found that although "*some* evidence suggests that corporate taxation may lower wages . . . the *preponderance* of evidence does not suggest any wage effects from corporate taxation."[33] She notes that corporate tax incidence is very hard to model and speculates that there are a number of possible explanations for the difference in results among the studies. For example, while corporate taxes may discourage some investments, they may not have a large enough effect on overall investment to substantially reduce wages.[34] Another possibility is that the tax burden may fall predominately on economic profits, which would reduce the rents of shareholders and others who share their rents.[35]

These articles suggest that the argument that U.S. corporate tax rules make U.S. MNEs less competitive in foreign markets compared with European and Japanese MNEs is generally wrong.

The statutory tax rates that multinational corporations are subject to vary from the effective rates because MNEs are able to utilize various mechanisms to lower their worldwide corporate income taxes. Kevin Markle and Douglas Shackelford explore the extent to which MNEs use leverage, intangibles, and tax havens to accomplish that, testing for correlations between effective tax rates and these instruments.[36] They find strong evidence that many multinationals use all three avoidance methods.[37] Their conclusion is that compared to foreign firms, U.S. multinationals appear to use debt to avoid taxes more

---

[30] Id.

[31] Id.

[32] Toder, note 16, at 509.

[33] Kimberly A. Clausing, In Search of Corporate Tax Incidence, 65 Tax L. Rev. 433, 468 (2012).

[34] Id.

[35] Id.

[36] Kevin S. Markle & Douglas A. Shackelford, Cross-Country Comparisons of the Effects of Leverage, Intangible Assets, and Tax Havens on Corporate Income Taxes, 65 Tax L. Rev. 415, 415 (2012).

[37] Id. at 431.

than firms in other countries but do not exploit intangibles and havens as much.[38]

V. Territorial vs. Worldwide Based Taxation and Competitiveness

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

Several articles considered the argument made by some scholars that the U.S. tax system should move from worldwide taxation to territoriality in order to facilitate the ability of U.S. corporations to compete abroad.

Toder posits that a revenue-neutral tax reform that lowered the corporate tax rate, broadened the base, and adopted a territorial system would improve the competitiveness of U.S. MNEs (first definition of competitiveness), but would raise the cost of investing in the United States (second definition).[39] In other words, territoriality would help U.S. MNEs to compete with foreign MNEs, but would also have a negative impact on the capability of the United States to attract investment.

Conversely, Toder points out that a reform that lowered corporate tax rates, broadened the base, and eliminated deferral would make U.S.-based MNEs less competitive, but would reduce the cost of investing in the United States.[40] In other words, pure residence taxation would increase the ability of the United States to attract investment, but would reduce the ability of U.S. MNEs to compete with foreign multinationals.

Jane Gravelle (who adopts the first definition of competitiveness) argues that territorial taxation is inefficient because it results in the relative after-tax returns being higher in a low-tax country and thus capital will flow into those jurisdictions. The pretax return will then rise in high-tax countries as capital becomes less abundant, will fall in zero-tax countries as capital becomes more abundant, and could either rise or fall in low-tax countries. This capital shift will continue until after-tax returns are the same in all jurisdictions.[41] Her conclusion is that "firms still compete in every location but the capital-labor ratios are distorted and the outcome is inefficient."[42] In her opinion, actions taken in the name of competitiveness have undermined sub-

38 Id.
39 Toder, note 16, at 533.
40 Id.
41 Gravelle, note 7, at 336.
42 Id.

part F and have enabled profit shifting from high-tax jurisdictions to low-tax jurisdictions.[43]

VI. Reduction of Corporate Tax Rates, Tax Cuts, and Other Possible Reforms

Those who are concerned with competitiveness often argue that certain reforms of the U.S. international tax system are desirable. Others support specific reforms in part because they would not affect the competitiveness of U.S. MNEs.

Avi-Yonah and Lahav, for example, conclude that the United States could reduce its corporate tax rate to the EU average in a revenue neutral way without affecting the competitiveness of U.S.-based multinationals.[44] They point out that many observers have noted that it should be possible to abolish deferral if the U.S. rate were reduced sufficiently.[45] "Such a move would have tremendous simplification potential since it would be possible to get rid of both subpart F and outbound transfer pricing enforcement, and it would eliminate the 'lock out' problem as well. . ."[46] Alternatively, they suggest that it should be possible to alter subpart F to take the source country rate into account.[47]

Toder analyzes the most important effects on competitiveness of five tax cuts that might be part of any reform proposal. He concludes that a cut in the marginal personal income tax rate would have the most direct effect on increasing competitiveness for skilled and internationally mobile workers.[48] Choice of residence for wealthy individuals would be affected most by a change in the rate of taxes on capital gains and dividends as well as the estate tax, although these effects might be negligible.[49] Cuts in the effective marginal tax rate on new corporate investments would have the most direct effect on capital invested in the United States but only if they are not accompanied by offsetting base broadening.[50]
A decrease in the taxation of foreign source income would reduce investment in the United States by giving U.S. multinationals an incentive to increase investment abroad. That might be offset, however, if that capital outflow raised pretax returns in the United States and resulted in an inflow of investment from foreign-based multinationals.

---

43 Id. at 347.
44 Avi-Yonah & Lahav, note 12, at 384.
45 Id.
46 Id.
47 Id.
48 Toder, note 16, at 526.
49 Id.
50 Id. at 527.

Bret Wells and Cym Lowell review the post-World War I international tax policy debates in order to determine how the United States got in a position where its international tax system was so flawed.[51] They argue that the foundational premise that the residency country should be allowed to tax residual income coupled with inappropriate transfer pricing approaches resulted in the development of base-erosion techniques that created untaxed "homeless income."[52] To reverse this result, they propose that a base-protecting surtax be adopted. They call for revision of domestic transfer pricing principles to require that cross-border payments from a U.S. payor to a foreign entity be subject to the tax unless the U.S. payor reaches agreement with the IRS that a lower or no surtax is required, which they call a "base clearance certificate."[53] This procedure would evaluate the global income of the foreign entity and the U.S. payor, taking into account the overall business and the functions and risks performed in the United States by the U.S. payor.[54] They argue that their proposal would achieve broadly embraced policy objectives and would enhance international tax policy reform proposals currently on the table.

VII. Conclusion

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

- The concept of competitiveness is unclear and it is an open question whether it is useful as a metric for determining U.S. international tax policy.
- There is no good empirical evidence supporting the view that current U.S. tax law adversely affects the competitiveness of U.S.-based MNEs.
- 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 U.S. international tax policy. Other considerations, such as the various neutralities (CEN, CIN, CON) and the impact of tax rules on actual behavior by U.S.-based MNEs (for example, the decision whether to repatriate income) and on whether future MNEs will be based in the United States are more important.

[51] Bret Wells & Cym Lowell, Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin, 65 Tax L. Rev. 535 (2012).

[52] Id. at 538.

[53] Id. at 539.

[54] Id.