Evaluating Reforms of the Taxation of Cross-Border Income

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Overview

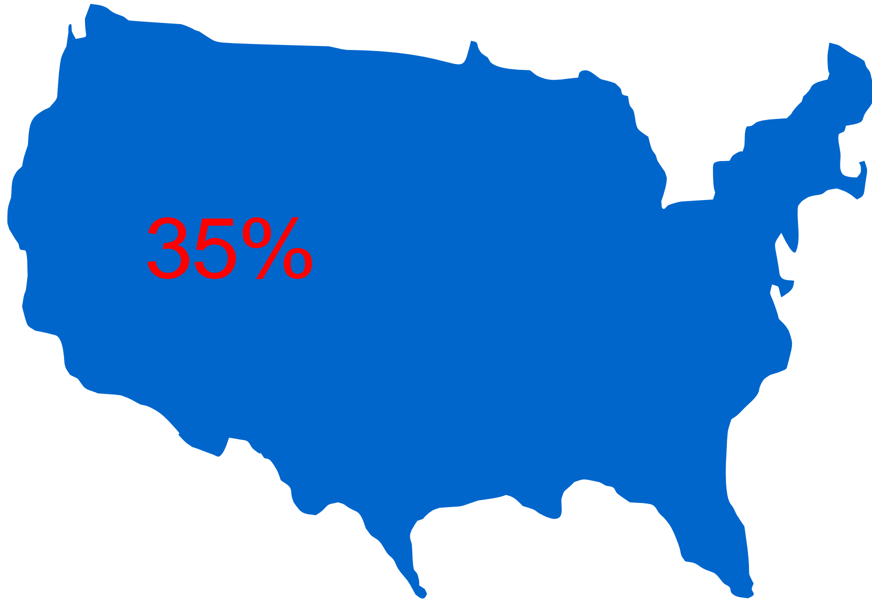
- Competitive firms and governments have put pressure on the corporate income tax
- How do we evaluate possible reforms?
  - What are the pitfalls?
  - What criteria should we use?
  - Use of effective tax rate simulations as part of evaluation of reforms

Roadmap of talk

- Brief background on U.S. system
- Evaluation criteria
- Effective tax rate simulations

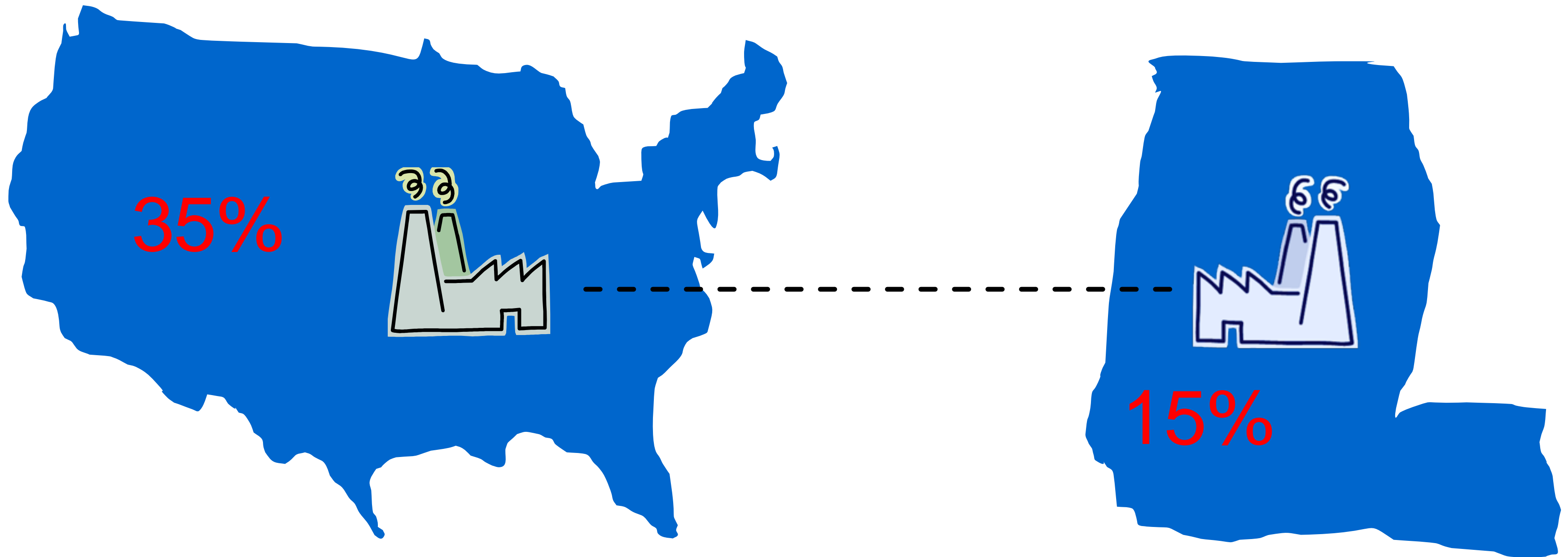
Brief background on how the U.S. system works…

The current U.S. system

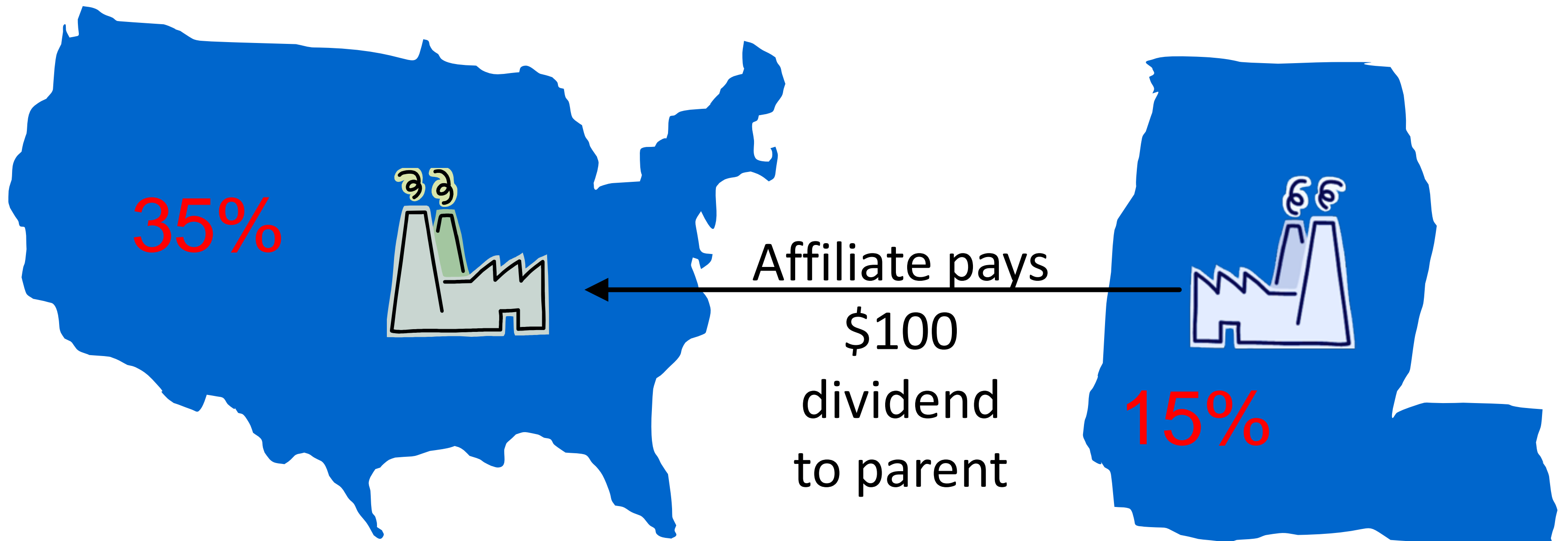


U.S. statutory corporate income tax rate (CIT) is 35%

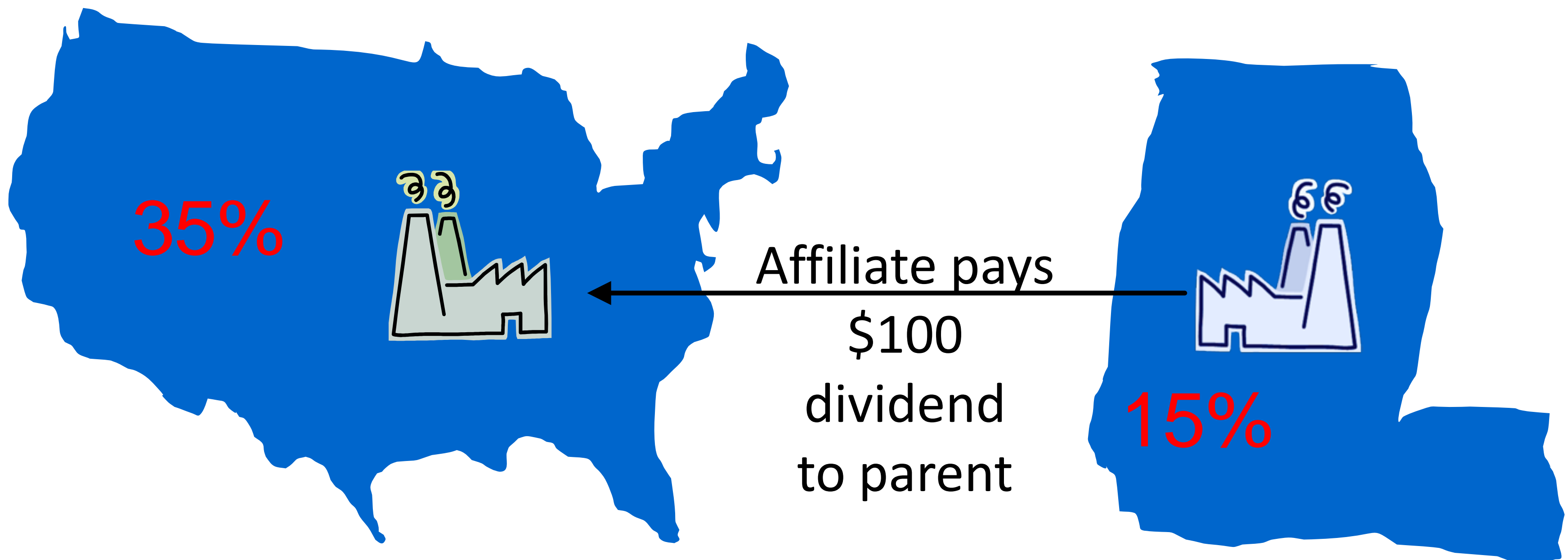
The Current U.S. System



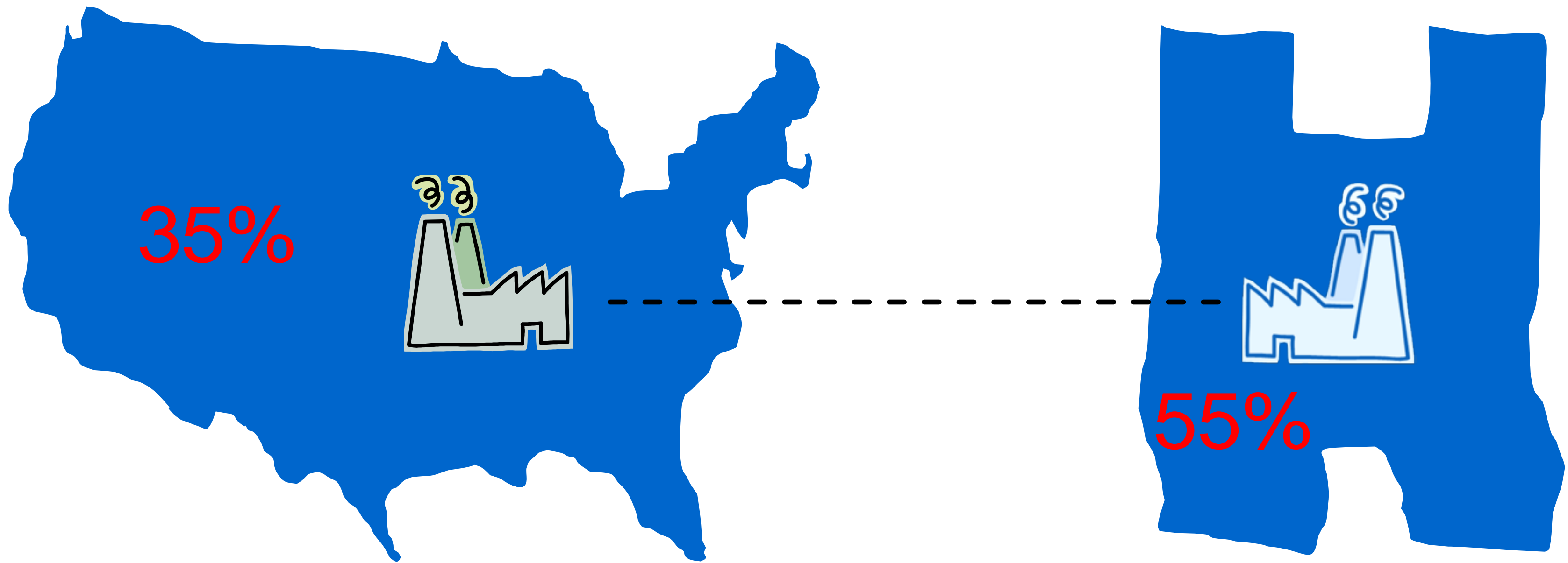
A U.S. corporation sets up an affiliate in country ("Lowland") with CIT=15%


35%
Affiliate pays
$100
dividend
to parent
15%
… affiliate earns $100
and pays $15 in tax
to Lowland

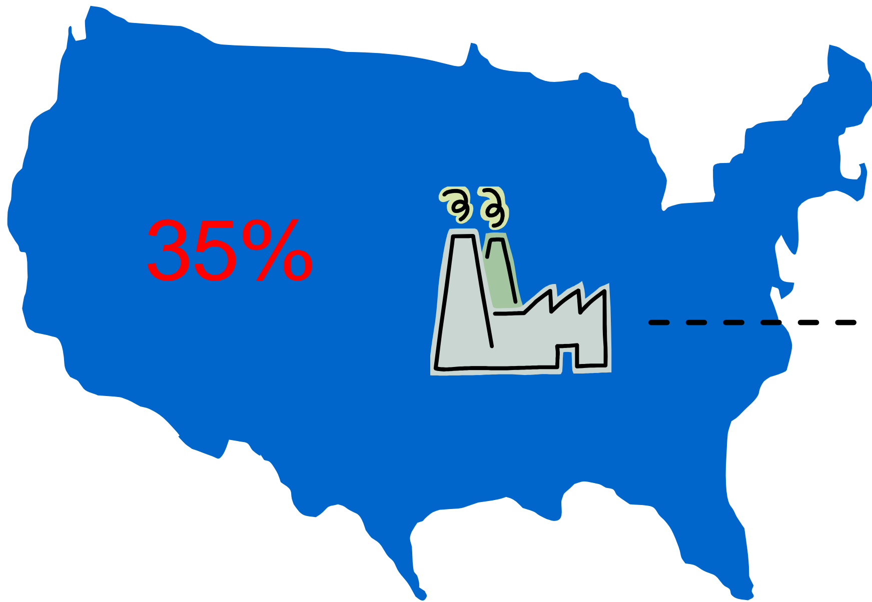
Worldwide tax with credit

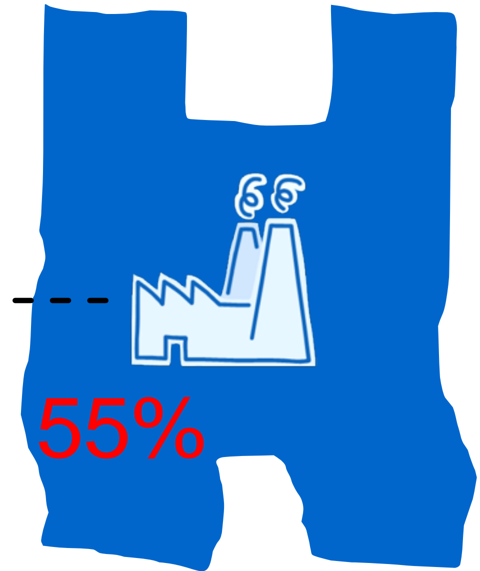


U.S. parent owes $35 to U.S.
– $15 credit for taxes
paid to Lowland
= $20 residual tax to U.S.

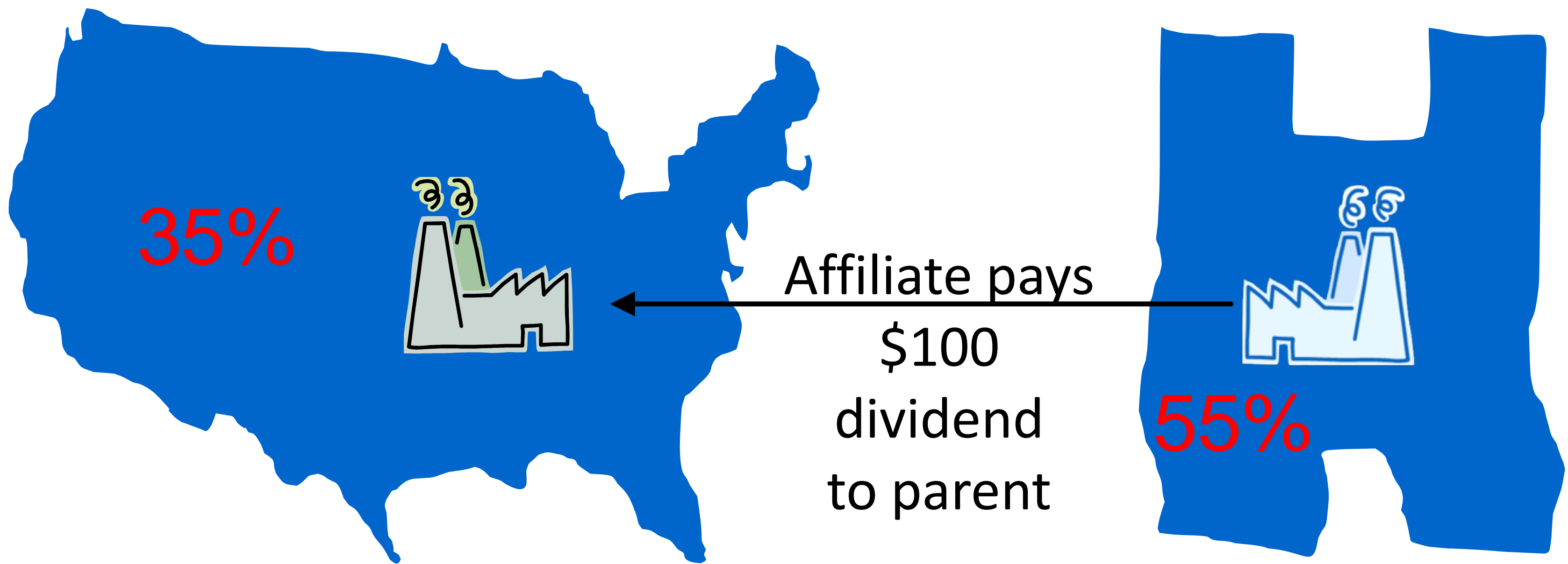


Corporation sets up an affiliate
in country (“Highland”) with CIT=55%





…earns $100 and pays $55 in taxes to Highland



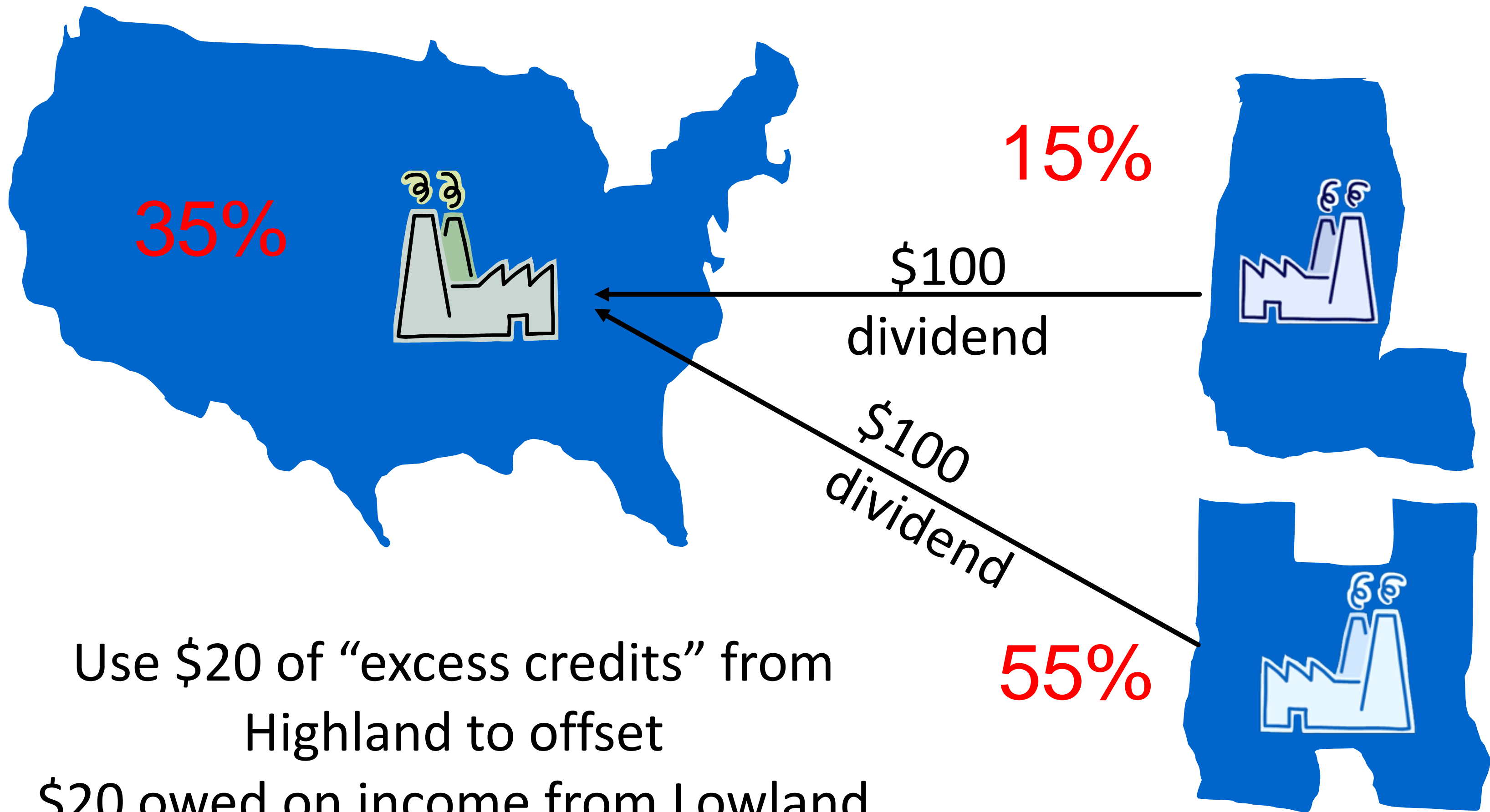
Owe $35 to U.S.

– $35 credit for taxes paid to Highland

= $0 residual tax

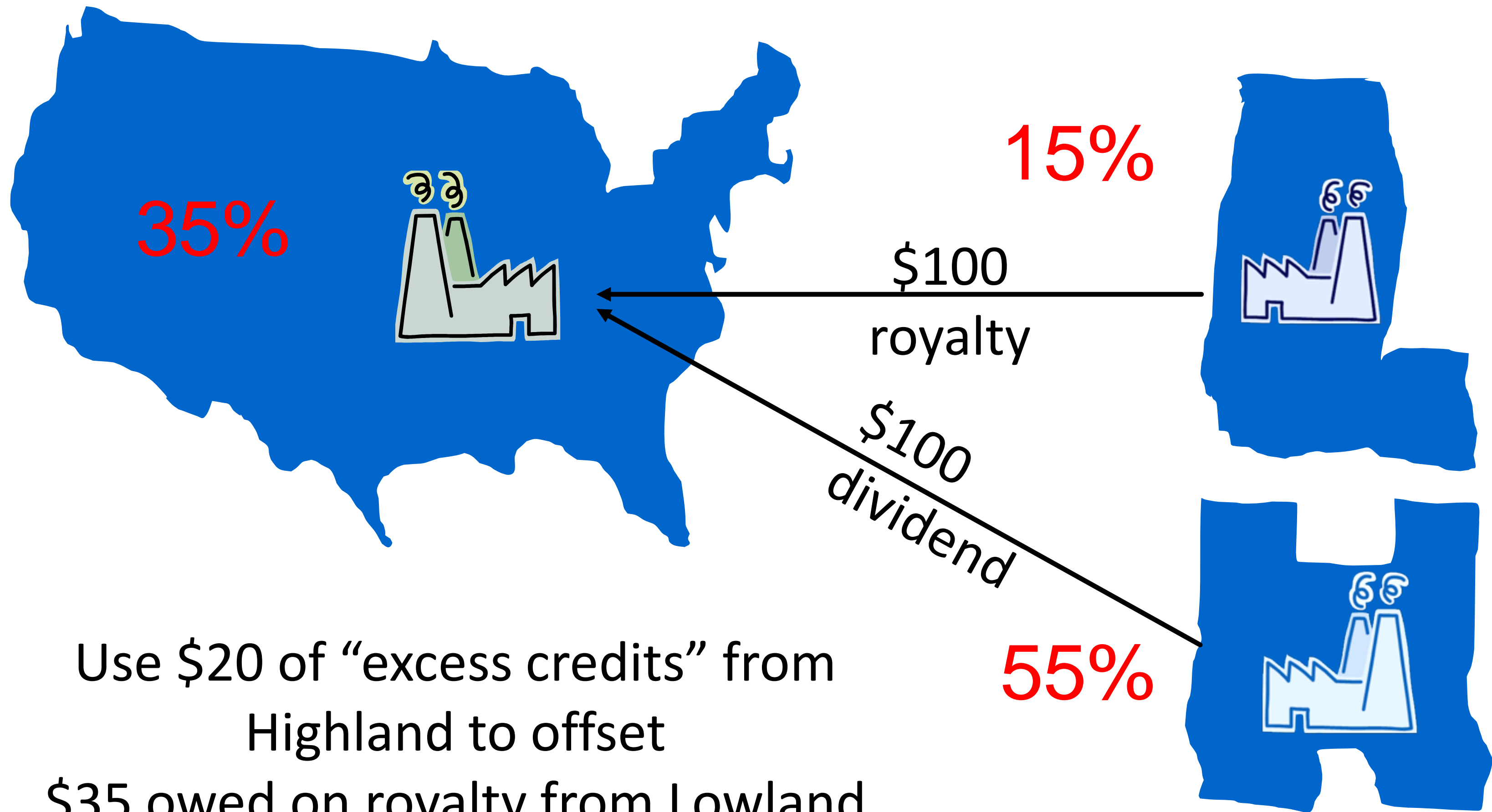
and $20 of “excess credits”

Cross-crediting in U.S. system



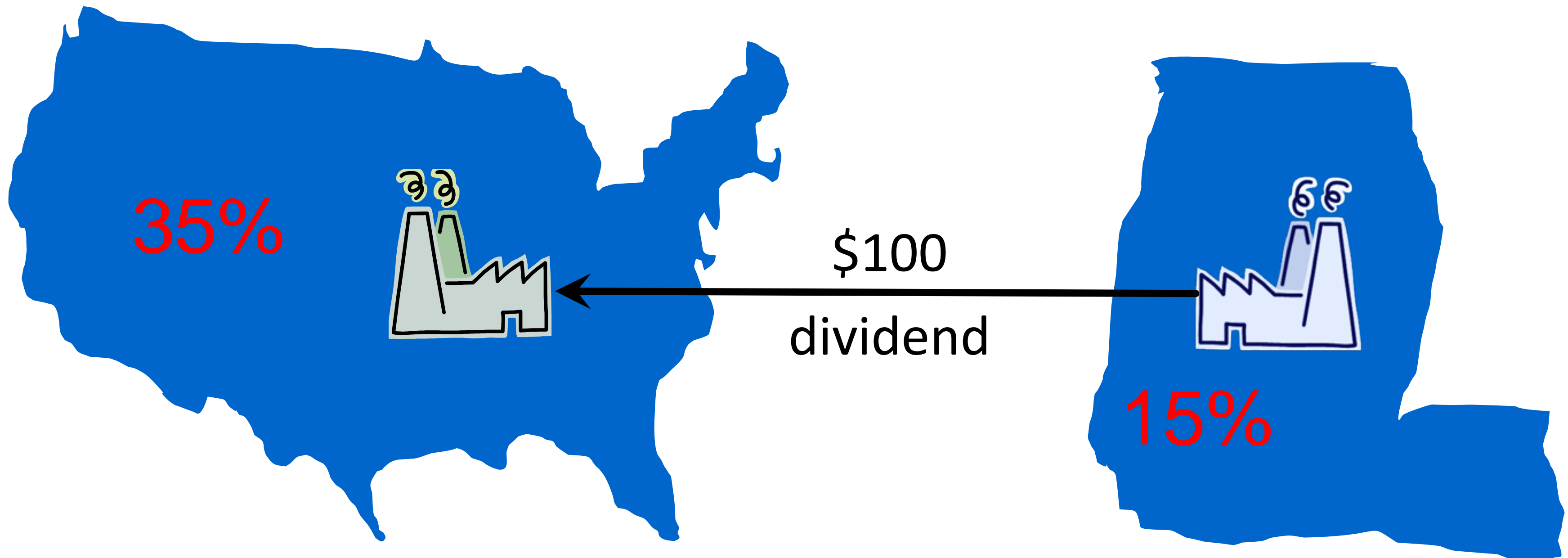
Use $20 of “excess credits” from Highland to offset
$20 owed on income from Lowland
= $0 residual tax

Cross-crediting in U.S. system



Use $20 of “excess credits” from
Highland to offset
$35 owed on royalty from Lowland
= $15 residual tax on royalty payment

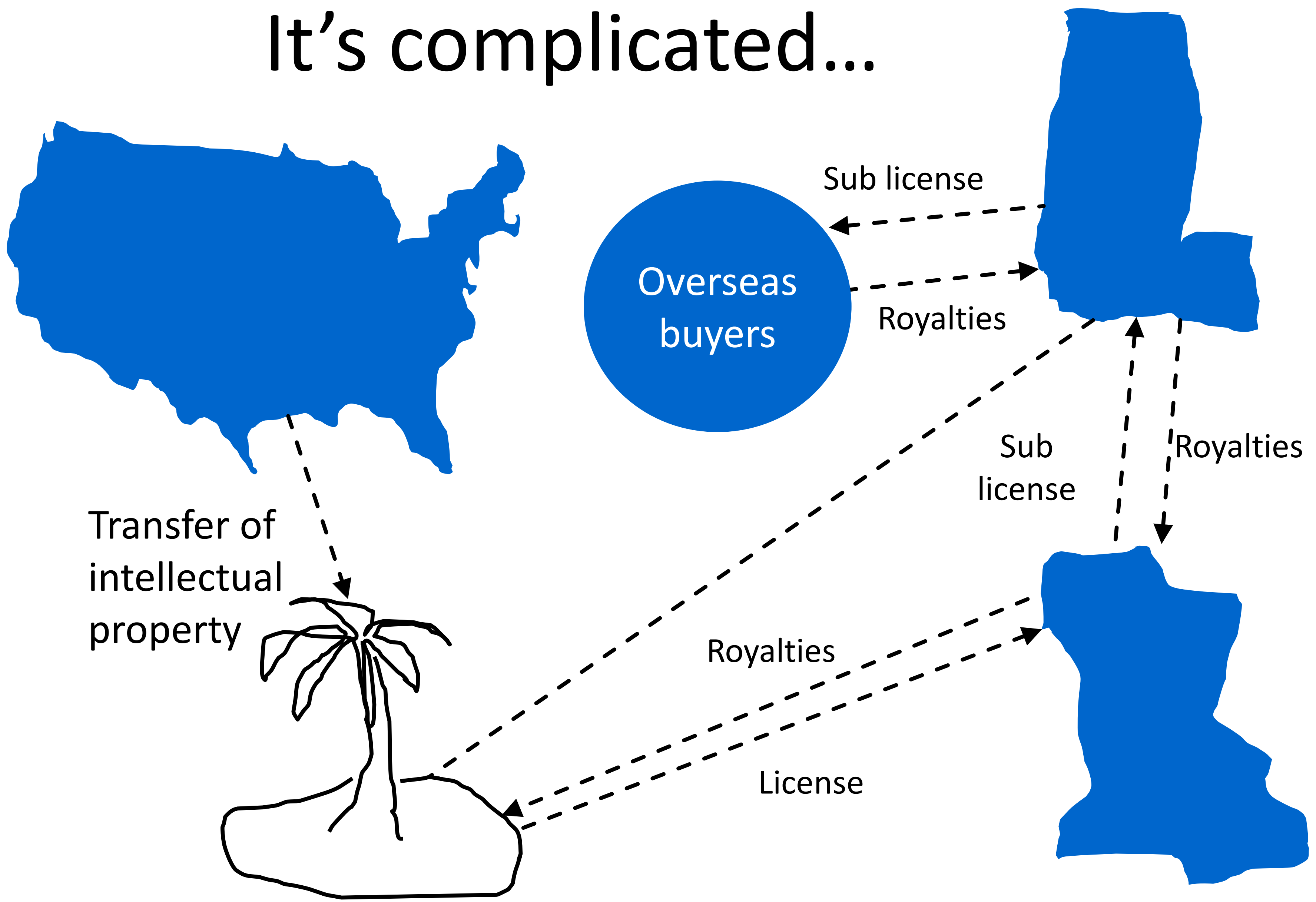
When is Tax on Foreign Earnings Paid?



Owe $20 residual tax to U.S.
on earnings in Lowland
ONLY when the $100
is repatriated
(DEFERRAL)

The U.S. worldwide credit and deferral system creates many avenues for tax planning

It's complicated…

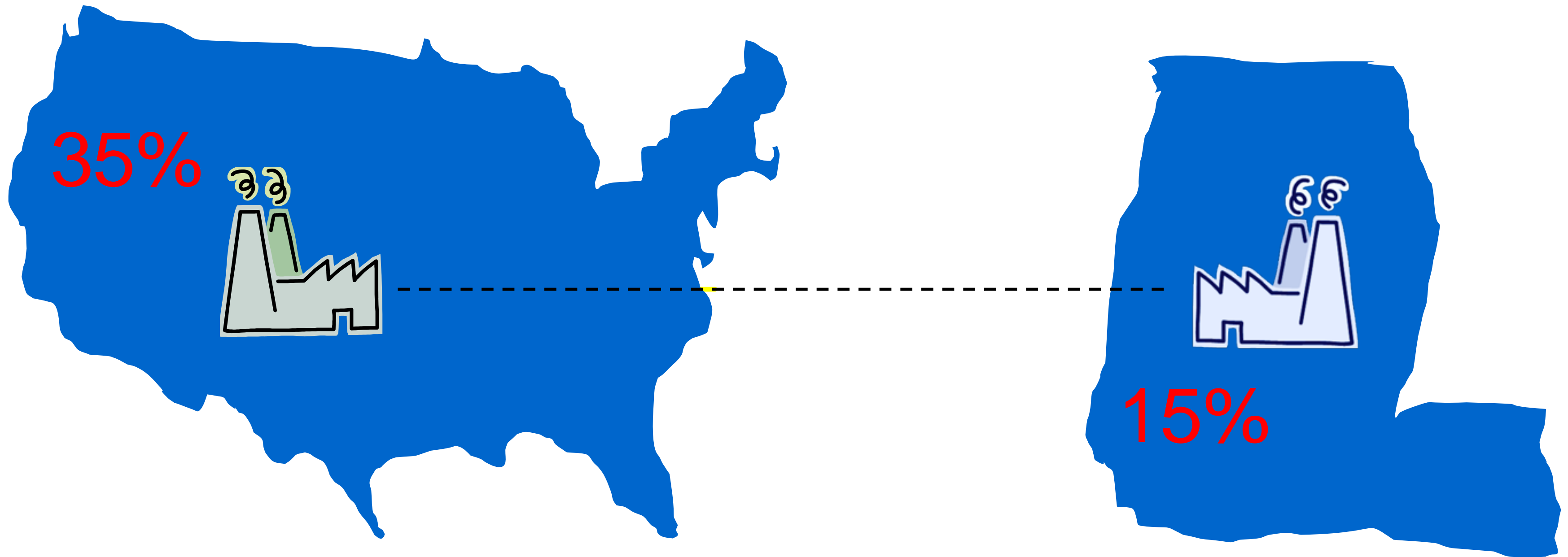


Problems with current U.S. system*

- Taxes due to U.S. Treasury when profits are sent home creates “lockout effect”
- Incentive to shift income to low-tax location erodes U.S. tax base and effects location decisions and revenue
- Complexity
- May put U.S. MNCs at a competitive disadvantage
- Raises little revenue

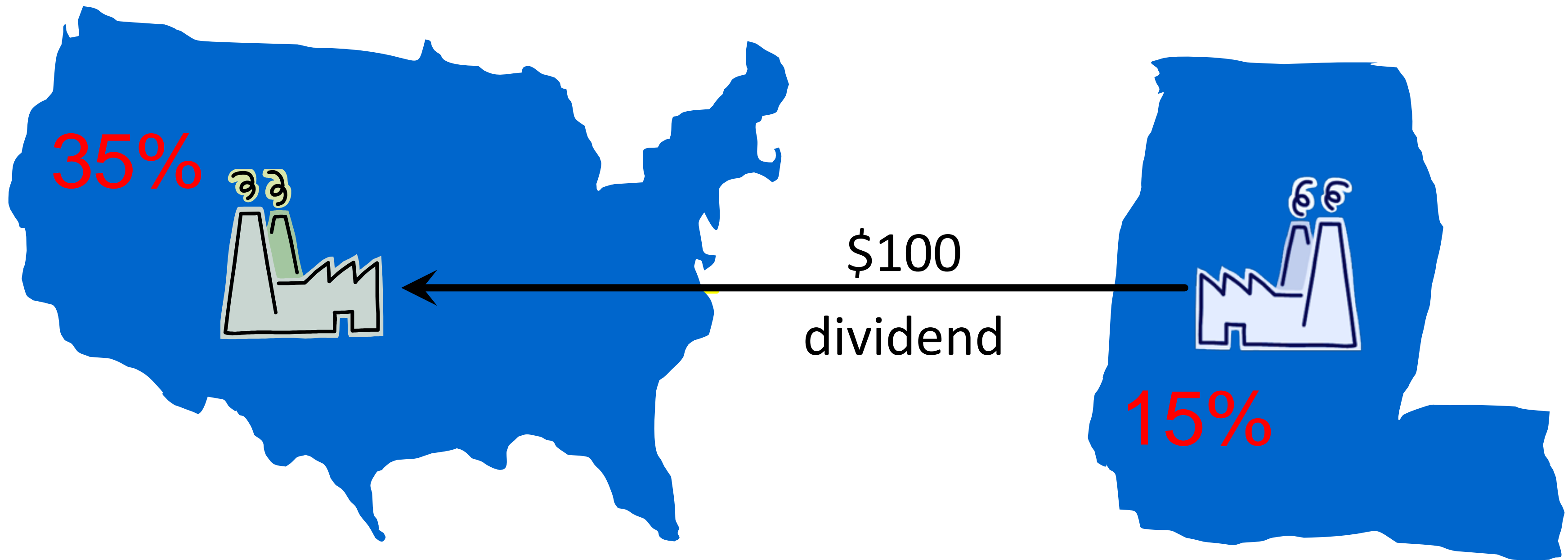
*See Grubert and Altshuler (*National Tax Journal*, Sept. 2013) for further discussion.

How do territorial systems work?



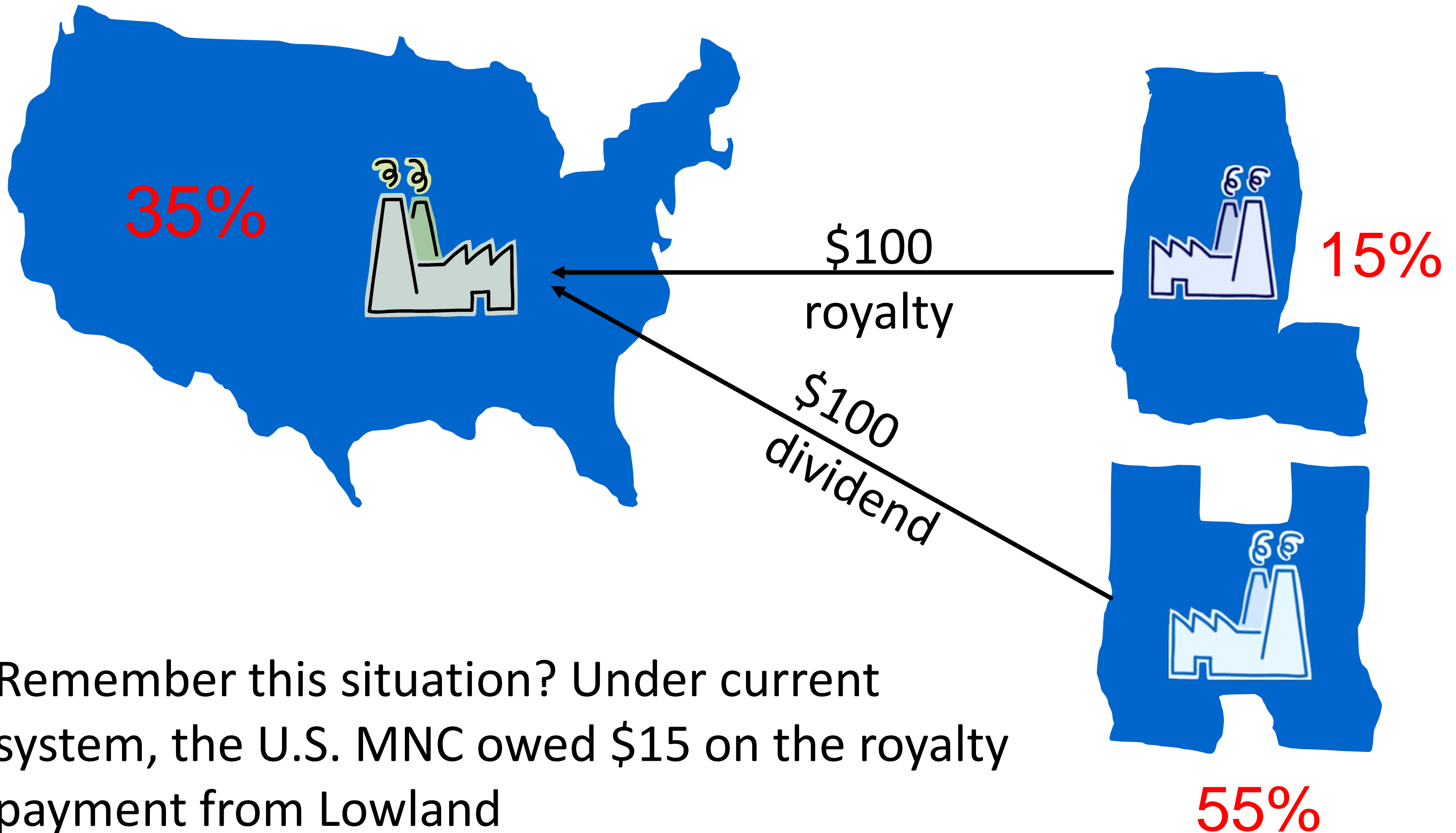
... earns $100
and pays $15 in tax
to Lowland

Territorial taxation through dividend exemption



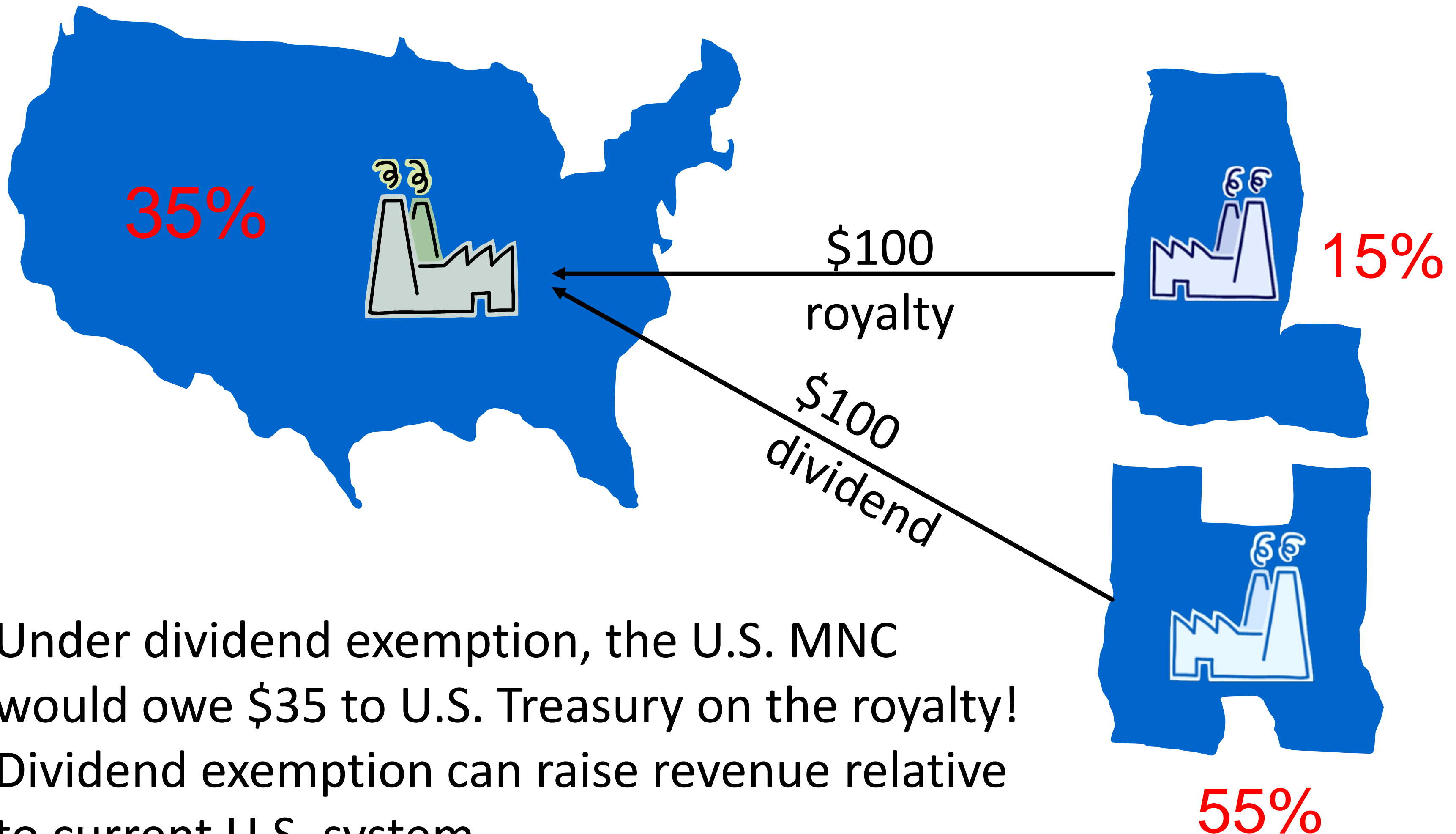
No tax due upon repatriation => no “lock-out” effect

Territorial taxation through dividend exemption



Remember this situation? Under current system, the U.S. MNC owed $15 on the royalty payment from Lowland

Territorial taxation through dividend exemption



Under dividend exemption, the U.S. MNC would owe $35 to U.S. Treasury on the royalty! Dividend exemption can raise revenue relative to current U.S. system.

OECD countries

Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovenia, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States

Territorial tax systems

Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Slovenia, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom,

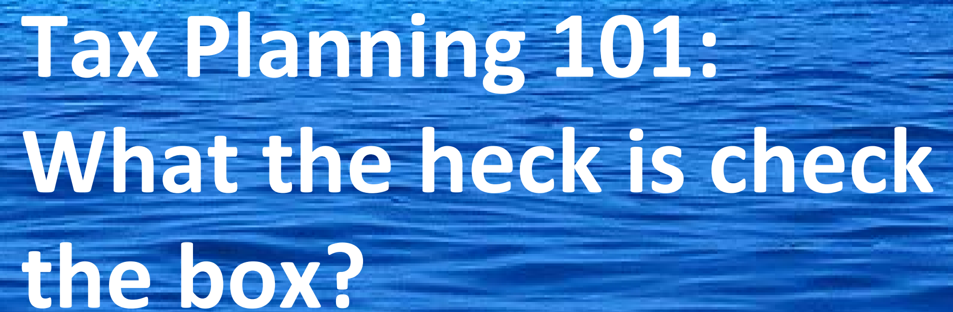
Worldwide tax systems

Chile

Ireland

Israel Korea Mexico

United States

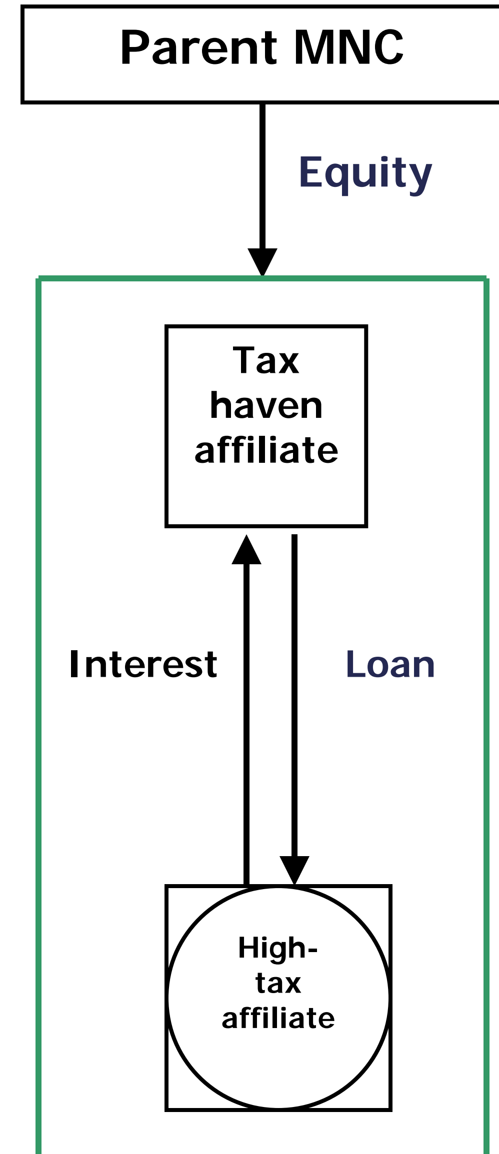

Tax Planning 101:
What the heck is check
the box?

Check the box

- Parent sends equity to tax haven
- Tax haven lends to high-tax affiliate
- High-tax affiliate makes interest payments
  - Interest taxable in US under our rules

- Check the box on the high-tax affiliate!
  - Transaction invisible to U.S. which regards tax haven-high-tax operation as a consolidated corporation

- Interest payment escapes U.S. tax
- Interest deduction in high-tax country
- Income deferred in tax haven
- Interest payment not taxed anywhere!



More tax planning strategies with check the box

- Move income across locations without tax implications through payment of inter-company dividends
- Shift income from intellectual property like patents to tax havens
- Grubert (*National Tax Journal*, 2012) concludes that the check the box rules may account for up to 2 percentage points of an approximate 5 percentage point reduction foreign ETRs between 1996 and 2004

U.S. company foreign profits relative to GDP, 2010

	Profits as a percent of GDP
Canada	3.3
France	0.6
Germany	0.4
Italy	0.3
Japan	0.4
UK	2.1
Weighted average, G-7	0.7

	Profits as a percent of GDP
Cyprus	13.6
Ireland	41.9
Luxembourg	127.0
Netherlands	17.1
Switzerland	12.3
Panama	0.1
Singapore	4.7
Hong Kong	2.6

Larger countries on tax haven lists and Netherlands

Source: Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, 1/15/2015

U.S. company foreign profits relative to GDP, 2010

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Canada	3.3
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	Profits as a percent of GDP
Cyprus	13.6
Ireland	41.9
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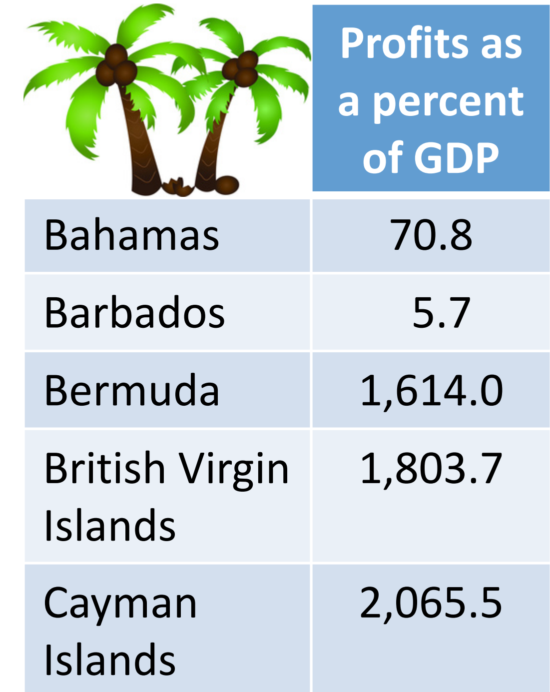
Switzerland	12.3
Panama	0.1
Singapore	4.7
Hong Kong	2.6



	Profits as a percent of GDP
Bahamas	70.8
Barbados	5.7
Bermuda	1,614.0
British Virgin Islands	1,803.7
Cayman Islands	2,065.5

Smaller countries on tax haven lists

Source: Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, 1/15/2015

Race to the bottom

- Focus on host countries using statutory tax rates and tax incentives, for example, to compete for mobile capital neglects role of
  - corporate tax planning by MNCs
  - home governments that facilitate this planning through their tax codes

- There are three parties in the race to the bottom!
  - host governments, home governments, and MNCs
  - tax havens play a passive role only

Evaluating Reforms

- Must consider many behavioral margins
  - Lockout effect (if any)
  - Changes in incentives to shift income
  - Distortion of investment incentives
  - Tax revenue
  - Complexity
  - Tax planning incentives beyond income shifting
  - Changes in incentives to expatriate through inversions or mergers with foreign companies
  - Reaction of foreign governments

Evaluating Reforms

- Choice of baseline for comparison
- Choice of reforms to analyze
- Transition issues
- In looking at efficiency, what criteria to use?
- Distributional consequences

An Efficiency Criteria for Foreign Investment?

- Capital export neutrality, capital import neutrality, capital ownership neutrality?
- Evaluation of reforms relative to these norms not helpful
  - Each based on very special assumptions
  - None address taxation of excess returns and royalties, income shifting, and allocation of expenses to foreign income

Effective Tax Rate Simulations

- The impact of the proposals on investment location, income shifting, repatriation planning, repatriation incentives and revenue
- Remaining slides on ETR simulations are based on Grubert and Altshuler (*National Tax Journal*, Sept. 2013)

Effective Tax Rate Simulations

- Two foreign countries, one with a 5% corporate tax rate, another with 25% corporate tax rate
- U.S. with 30% corporate tax rate
- A pure tax haven (no corporate tax)

Effective Tax Rate Simulations

- Subsidiary in low tax country produces a high tech good using a U.S. developed intangible asset
  - Earns excess return before paying royalties to parent for contribution of its intellectual property
  - Own contribution to worldwide profits is just the normal return to its capital

Effective Tax Rate Simulations

- Routine investment in high tax location earns normal return to capital
- Income shifting before and after check the box
  - Before
    - Underpayment of royalties from low tax subsidiary
    - Income shifting from high to low tax subsidiary
  - After
    - Income shifting to tax haven from both high and low tax subsidiary

ETR Simulations

- Calibration informed by analysis of data from the tax returns of U.S. multinational corporations and other sources
- Assume that the cost of shifting intangible income from the U.S. is a quadratic function of the amount shifted relative to the investment
  - Calibrated based on profitability and royalties paid in low tax countries

ETR Simulations

- Assume that the burden of the repatriation tax in low tax country under current law is 5 percent of income. Already existing accumulations.
  - Based on estimated burden that takes response to 2005 tax holiday into account

ETR Simulations

- Add up all taxes paid on a new discrete investment of one unit of capital in low-tax country or high-tax country
- Divide total taxes by normal return to capital
- ETR is 30% under full inclusion (no deferral)

Alternative Reforms

- Evaluate relative to current system
  - Dividend exemption
  - Full inclusion (no deferral)
  - Dividend exemption with a Japanese type base erosion backstop
    - ETR test on a country by country basis. We consider a 15% rate.
    - If subsidiary fails test it is subject to full home country tax (a cliff) but can escape if it passes an active business test.

Reforms

- Per country minimum tax at 15%
  - If ETR below threshold, subsidiary pays the difference. Then dividend exemption.
- Per country minimum tax with expensing
  - Real investment currently deductible from U.S. tax base in location. U.S. tax only on excess return.
- Overall foreign minimum tax at 15%
- Overall foreign minimum tax with expensing
- Repeal of check the box

Low tax investment
Statutory rate = .05

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	-.182	-.236
Dividend exemption	-.236	-.295

Opportunity for income shifting under current law results in large tax subsidy for investing in low tax country. CTB increases the subsidy. The removal of the repatriation tax under dividend exemption lowers ETR even further.

Low tax investment
Statutory rate = .05

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	-.182	-.236
Dividend exemption	-.236	-.295
Japan minimum tax (15%)		-.236

Japanese type dividend exemption is equivalent to repeal of CTB. No hybrids used. Cliff effect.

Low tax investment
Statutory rate = .05

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	-.182	-.236
Dividend exemption	-.236	-.295
Japan minimum tax (15%)		-.236
Per country minimum tax (15%)		.056
with expensing		-.044

The per country min tax results in an ETR much closer to the undistorted country rate. Income is taxed at 15% regardless if shifted to haven. The min tax offsets increased income shifting under pure dividend exemption. With expensing the tax on the normal return is 5%, not 15%.

High tax investment
Statutory rate = .25

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	.242	.130
Dividend exemption	.214	.107

CTB has major impact in lowering ETR in high tax country.
Dividend exemption lowers ETR before and after CTB.

High tax investment
Statutory rate = .25

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	.242	.130
Dividend exemption	.214	.107
Japan minimum tax (15%)		.214

Japanese type dividend exemption equivalent to repeal of CTB. Only shifting to tax haven affected. Cliff effect. No hybrids used.

High tax investment
Statutory rate = .25

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	.242	.130
Dividend exemption	.214	.107
Japan minimum tax (15%)		.214
Per country minimum tax (15%)		.121

Under the per country min, the tax haven is still used for high tax country income because 15% is better than the local 25%. No cliff.

High tax investment
Statutory rate = .25

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	.242	.130
Dividend exemption	.214	.107
Japan minimum tax (15%)		.214
Per country minimum tax (15%)		.121
with expensing		.121

Expensing has no effect since not subject to minimum tax in high tax country.

Overall Minimum Tax

- All additional income is taxed at 15% if the parent is below the threshold.
  - No longer any incentive to shift foreign income to the haven or from the high tax country to the low tax.
  - The ETR is slightly higher than under the per country min tax
- If parent above threshold, we are back to dividend exemption

Low tax investment (statutory rate = .05)

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	-.182	-.236
Dividend exemption	-.236	-.295
Per country minimum tax (15%)		.056
with expensing		-.044
Overall minimum tax for parent with ETR<15%		.060
Overall minimum tax for parent with ETR>15%		-.295
Overall minimum tax for parent with ETR<15% with expensing		-.040
Overall minimum tax for parent with ETR>15% with expensing		-.295

High tax investment (statutory rate = .25)

	Before Check-the-box	After Check-the-box
Current law (with 30% rate)	.242	.130
Dividend exemption	.214	.107
Japan minimum tax (15%)		.214
Per country minimum tax (15%)		.121
Overall minimum tax for parent with ETR<15%		.150
Overall minimum tax for parent with ETR>15%		.107
Overall minimum tax for parent with ETR<15% with expensing		.000
Overall minimum tax for parent with ETR>15% with expensing		.107

Evaluation of Reform Alternatives

- Progress can be made in several directions relative to current U.S. system with the minimum tax:
  - ending the lockout effect
  - Improving efficiency of investment location
  - reducing income shifting and tax planning
  - increasing revenue

Concluding remarks

- Many components to evaluation of reforms
- Competitive firms and competitive governments add important complications
- Must compare any alternative to current system in place
- Must take income shifting associated with intangibles and havens into account
- Carefully constructed and parameterized ETRs can be illustrative