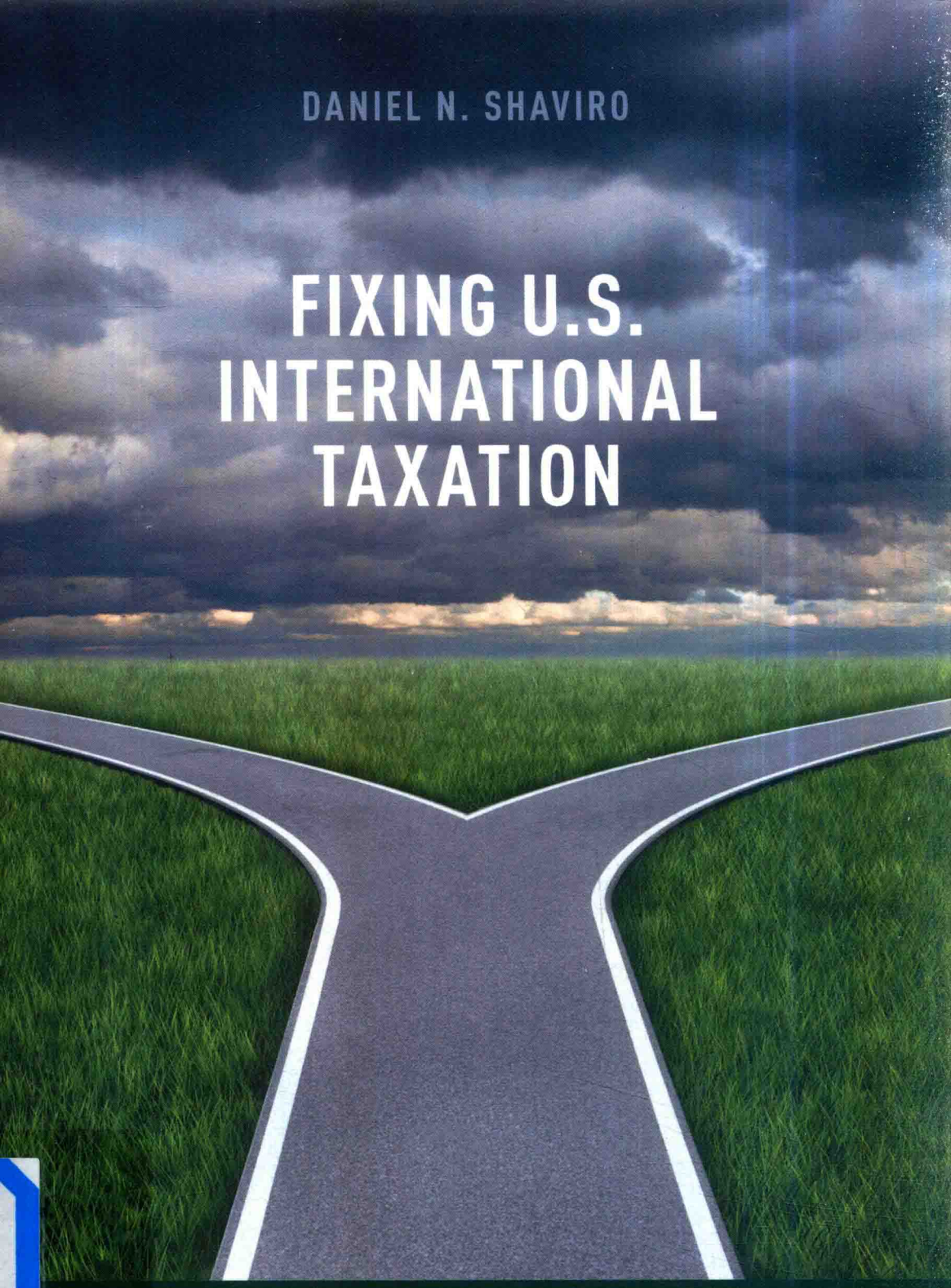
DANIEL N. SHAVIRO

# FIXING U.S. INTERNATIONAL TAXATION



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FIXING U.S. INTERNATIONAL TAXATION

*To My Wife, Patricia Ludwig*

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# Contents

# 1 Introduction and Overview

## A. A Fork in the Road?

Yogi Berra once offered the advice, "When you come to a fork in the road, take it." He could almost have been speaking about the U.S. international tax rules, which govern how we tax cross-border or multinational investment. For "outbound" investment, or that earned abroad by U.S. companies, the U.S. rules, for almost a century, have muddled along in the netherworld between two sharply etched approaches that dominate the literature: each intuitively appealing but utterly inconsistent with the other.

The first approach is called *worldwide* or *residence-based* taxation. Under it, the U.S. rules would impose tax at the same rate on U.S. companies' foreign source income (FSI) as on their domestic income. The great apparent virtue of this approach is that it would prevent the companies from reducing their U.S. tax liability by investing (or reporting income) abroad rather than at home.

The second approach is called *source-based* or *territorial* taxation. Under it, the United States, recognizing that foreign companies pay no U.S. tax when they invest abroad, would extend this same U.S. tax exemption for FSI to its own companies. (This approach is therefore also called *exemption*). The great apparent virtue of this approach is that it would avoid placing U.S. companies under a competitive disadvantage, as compared to their foreign rivals, when they invest abroad.

How could one possibly object to either approach? Surely no one wants the U.S. tax rules to encourage our companies to invest (or report income) abroad rather than at home. That would seemingly be self-defeating. Yet surely no one wants U.S. firms to face competitive handicaps when they invest abroad. Whether one favors a "level playing field"—long one of tax policy's most powerful and popular (if trite) metaphors—or is actively rooting for "our" home team firms to "win" their contests on the road, imposing a tax handicap on U.S. firms seems self-defeating as well.

Unfortunately, however, we cannot follow both of these approaches at once. For example, if we tax U.S. company General Electric (GE) when it invests at home, and do not tax GE's global rival Siemens when it invests in Germany, we simply cannot tax GE's German income both at the U.S. domestic rate and at our zero tax rate for Siemens' German income. Rather, we must choose one or the other, or else compromise with something in the middle that fully satisfies neither approach.

In stating the dilemma this way, I have diverged from the prevailing custom in international tax policy debate, which is to compare *all* countries' taxes on a given investment, rather than just those imposed by a given country (such as the United States). My reasons for describing the problem this way, rather than in the conventional way, will become clear later in this chapter and throughout the book. But even if one takes account of all countries' taxes when checking for tax bias, the same problem arises unless everyone charges the same rate. Thus, suppose the U.S. tax rate is 35 percent, while that in Germany is only 20 percent. In these circumstances, the U.S. tax system could not match GE's overall global tax rate, when investing in Germany, both to the 35 percent rate that it would pay domestically, and to the 20 percent rate that Siemens was paying in Germany.

Accordingly, whether one looks just at U.S. taxes or at all countries' taxes (where their rates differ), one faces the same dilemma. Under either formulation, concern about GE's tax minimization incentives suggests imposing U.S. tax (or at least a make-up tax) on its German income, while concern about the GE vs. Siemens differential suggests that the U.S. exempt non-U.S. source income. Yet, however intuitively appealing we might find each approach, we cannot follow them both.

Reflecting the evident awkwardness of this dilemma, the U.S. rules, for almost a century, have been suspended in the middle between the worldwide and territorial poles, taxing U.S. companies' FSI, but at a greatly reduced effective rate compared to that which applies domestically. Opposing political forces, backed by the rival approaches' offsetting intuitive appeal, have long battled to a stalemate that not only satisfies neither side, but is absurdly dysfunctional due to its elaborate Rube Goldberg-style structure. Not merely unaesthetic (though surely that as well), this structure makes it inevitable that the planning and compliance costs the system induces will be "disproportionately high relative to their role in the activities of the corporation," and "extremely high relative to the revenue raised by the U.S. government on this income" (Blumenthal and Slemrod 1996, 48).

The years since this statement was made have only added to its truth, due to the development of all sorts of new tax planning tricks that empower U.S. companies to

lower their U.S. (and foreign) tax obligations at the cost of extra paperwork and convoluted internal cash flow management. Making things worse still, all of this "costly tax planning. . . necessitate[s] a significant amount of costly enforcement and compliance activities by the IRS" (President's Economic Recovery and Advisory Board 2010, 88). Given all this, "[m]ost experts agree that the current hybrid U.S. system. . . embodies the worst features of both a pure worldwide system and a pure territorial system from the perspective of simplicity, enforcement, and compliance" (88).

Imposing excessive tax planning and compliance costs relative to the revenue raised is bad enough. However, the problems with the existing compromise system for taxing U.S. companies' FSI do not end here. Supporters of worldwide residence-based U.S. corporate taxation complain that the current system encourages rampant tax avoidance by U.S. multinationals, undermining broader tax equity and causing the companies to be unduly tax-favored relative to their purely domestic competitors. Supporters of exempting FSI complain, not only about the potential disadvantages of being a U.S. rather than a foreign multinational when one invests abroad, but also about the problem of "trapped" foreign earnings under our current rules, which may stay abroad for U.S. tax reasons even if they otherwise would come straight home to fund U.S. investments or be distributed to U.S. shareholders. Despite the seeming tension between these two accounts, both are largely correct.

Unfortunately, near-universal consensus that the existing U.S. international tax system is horrendously bad has failed to induce change, given the continuing dissensus about what to replace it with. An obvious solution might involve moving decisively to one of the two poles, by more fully adopting some version of either worldwide taxation or territoriality. This, however, has been impeded by the fact that, in politics no less than trench warfare, it is easier to defend one's own position than to advance through the enemy's.

Of late, there have been some signs of a possible shift toward territoriality. Long a Republican goal, there were occasional hints during the first Obama administration that Democrats might embrace it as well.[1] Factors encouraging the shift, beyond a generally pro-business and anti-tax political environment, include the rising pressures of global tax competition, and the fact that peer countries, such as the United Kingdom and Japan, have recently made their international tax systems more territorial. As a political matter, it is plausible that the United States would already have shifted to a territorial system if not for budgetary concerns. A recent Treasury estimate found that enacting a simplified territorial system without safeguards might reduce U.S. revenues by $130 billion over ten years (President's Economic Recovery Advisory Board 2010, 90). Moreover, while a package of international tax law changes that included exemption could, on the whole, pay for itself or even raise revenue, depending on the other items in the package, this might kill all the fun, so far as exemption's main political supporters are concerned.

Among the factors that have boosted exemption's political prospects is a shift in the intellectual climate of debate among U.S. international tax policy experts. Worldwide residence-based taxation used to be considered clearly superior by most experts—better

for the world, and better for the United States. However, recent theoretical and empirical work has destroyed this consensus, and for a while seemingly raised the prospect of an emerging opposite consensus, in which a purely territorial tax was seen as better both for the world and for us. The main concern that continues to get in the way has less to do with taxing FSI as an end in itself, than with the view that worldwide taxation is indispensable to combating profit shifting by U.S. companies, which have become ever more adept at treating large shares of their U.S. (and other) profits as having arisen in tax havens for official reporting purposes (see, e.g., Kleinbard 2011a).

## B. The Need for a New Framework

No matter how the short-term politics plays out—continued stalemate that might perhaps include tougher limits on multinationals' tax planning opportunities, or shift toward exemption—ongoing disputes concerning how the United States ought to tax domestic and foreign multinationals are unlikely to recede any time soon. Consider the episodes of media excitement in recent years over aggressive tax planning by such iconic U.S. companies as Apple, GE, and Google. The continuing rise of both global economic integration and tax planning technology, along with ongoing anxieties about U.S. job levels that both sides in the U.S. international tax debate invoke as favoring their preferred approaches, will keep these issues prominent indefinitely. Thus, it would be desirable to have a clear intellectual framework on hand. Best of all, of course, would be to find consensus "right answers" to all of the hard issues in the field. Even short of that, however, there is a need for better guidance regarding how to think about the main tradeoffs.

Making this more difficult is the fact that the international tax policy literature, despite a more than fifty-year history of frequently intensive academic study by exceptionally talented and knowledgeable economists and lawyers, at some point went badly off the rails. For many decades, its main terms of debate have too often reflected crucial misunderstandings of key issues and distinctions, along with a misguided focus on concepts that verge on being completely unhelpful.[2] We need therefore, to start again from first principles—albeit, principles that are routinely used elsewhere in public economics. To begin demonstrating the need for a new approach, consider the following five conceptual problems in the existing international tax policy literature:

## C. First Problem: What *Is* the Problem? Is It Double (and Non) Taxation?

Popular and academic writers on international taxation—albeit lawyers more than economists—are largely at one in defining the basic problem that the rules in the field must try to address. It supposedly is "double taxation," which may arise when cross-border investment faces both a residence-based tax in the home country and a source-based

tax in the country where the investment is made. Preventing double taxation from occurring—along with double nontaxation, which occurs when cross-border income is taxed nowhere—is thus identified as the supreme task of international tax rules.

To illustrate what "double taxation" is taken to mean, suppose that Acme Products, a U.S. company, earns $100 in Germany, and that the U.S. rate is 35 percent, while the German rate is 20 percent. Taking it as given that Germany will in fact charge Acme $20 of tax, the U.S. is thought to have only two legitimate alternatives. The first is to apply exemption, so that Acme's German income is only taxed in Germany. The second is to charge U.S. tax—it always is assumed, at the same 35 percent statutory rate that applies domestically—but to provide foreign tax credits, or a dollar-for-dollar reduction of the U.S. tax due by reason of the German taxes paid.

Under this second approach, the $35 of U.S. tax liability that Acme would otherwise have owed on its (pre-German tax) German income is reduced to $15 by reason of the allowable credits. Thus, while Acme is literally paying tax to two countries, it is not viewed as being "double-taxed," because the U.S. credits entirely wash out the burden on Acme of having to pay the German tax. Thus, it is just as if Acme had only been taxed by the United States, but with a side payment from the U.S. Treasury to the German Treasury, wholly compensating the latter for its forbearance.

Accordingly, the U.S. tax on Acme's German income ostensibly must be either zero or $15, as opposed to anything in between. This alone should excite suspicion. One would normally expect policy assessments to exhibit greater continuity. Given, for example, that raising the tax from zero to $1, or lowering it from $15 to $14, seems unlikely to change dramatically its practical effects (such as on the central tax policy concerns of efficiency and distribution), it is surprising to witness the evident assumption that everything in the middle must be ruled out.

Why is aversion to double taxation—leading to the assumption that the home country must either exempt foreign source income or offer foreign tax credits—so prevalent? The reasons appear to be several. First, there evidently is some sort of inchoate moral intuition lying behind it—although, as we will see, the intuition proves upon closer examination to be incoherent and formalistic.

Second, bilateral tax treaties, such as the existing one between the United States and Germany, invariably use the concept of avoiding double (and non) taxation as a coordinating device between overlapping tax systems. In the bilateral setting of a treaty, this concept may indeed be convenient and useful. But the United States is not operating in the treaty setting when it more generally determines how it should tax outbound investment.

The third ground for treating aversion to double taxation as a fundamental principle should help make its misdirectedness—as well as its relationship to what actually are serious concerns—somewhat clearer. Suppose, in the prior example, that the United States taxed Acme's $100 of German income at the full 35 percent rate, with the German taxes of $20 merely being deductible. Then Acme would end with only $52 after paying both German and U.S. taxes. Its overall global tax rate, on this income,

of 48 percent would compare quite unfavorably with the global rates (i.e., just the domestic rates) that U.S. and German companies would face when investing at home. And German companies, of course, would face the same 48 percent global tax rate when they invested in the United States, if Germany taxed its residents' foreign source income at the full domestic rate, with U.S. taxes merely being deductible. The result would likely be significant discouragement of cross-border investment by U.S. and German firms.

The prospect of such discouragement is indeed relevant to U.S. policy making, whether we are setting our international tax policy rules unilaterally or engaged in strategic interaction with other countries. However, the use of such examples to support an anti-double tax principle confuses two distinct questions. The first is "How much?" The second is "How many times?"

To illustrate the distinction between these two questions, suppose the United States treated German taxes as merely deductible, but lowered its tax rate for FSI to 15 percent. Acme would now be getting double taxed, since the U.S. rules would no longer be entirely negating the separate impact of the German tax. But Acme's U.S. tax bill on its FSI would have declined from $15 under the full rate/foreign tax credit system, to just $12 (i.e., 15 percent of $80). So Acme's outbound investment would actually be *less* tax discouraged than previously, and the "crime" of double taxation would evidently be victimless.

Even Germany, while it could point to a clear treaty violation, would face no adverse consequence apart from one that actually is unrelated to double taxation as such. The change in U.S. policy might indeed make Germany worse off, since U.S. firms that were effectively subject to the U.S. worldwide tax would no longer be able to credit their German taxes against those levied at home. Thus, U.S. multinationals might be more eager than previously to minimize their German tax liabilities, whether through tax planning or actual shifts in where they operate. But they would likewise have this incentive if the United States, consistently with its tax treaty obligations, simply exempted those companies' FSI from the prospect of facing any residual U.S. tax. Indeed, under exemption they would care *more* about avoiding German taxes than under a worldwide/foreign tax deductibility approach with, say, a 15 percent U.S. tax rate on FSI, since the latter would reduce their after-U.S. tax cost of paying a dollar of German taxes from one full dollar to 85 cents.

This example helps to show that exemption is what I call an implicit deductibility system. That is, it has the same effect on U.S. companies' incentives, in trading off foreign tax liabilities against other foreign expenses (or forgone income), as would the adoption of explicit foreign tax deductibility with a positive U.S. tax rate (whether, say, 0.00001 percent or 35 percent) for foreign source income.

In sum, while there may be good reason to care about high versus low taxes on cross-border activity, or about even versus uneven taxes at a given margin, this does not imply that there is any direct normative reason to care about the *number* of taxes that are

being levied on a given taxpayer or transaction. After all, most of us would rather be taxed twenty times at a 1 percent rate each time than once at 35 percent.

If double taxation is not objectionable as such, what about double non-taxation? Consider in particular the "stateless income" (Kleinbard 2011a) that multinationals are increasingly adept at locating for tax reporting purposes in tax havens where little productive activity occurs. As it happens, the point that zero is not a magic number is already widely accepted. Anti-tax haven rules (both actual and proposed) for resident companies' FSI, in the United States and elsewhere, generally do not provide any escape hatch for charging a very low tax rate that is not quite zero. However, a further issue about global tax minimization through the use of tax havens remains inadequately recognized.

Suppose we observe that Acme Products, in addition to having operations, affiliates, and taxable income in the United States and Germany, also has an affiliate in the Cayman Islands that purports to earn a significant percentage of Acme's global profits. We may reasonably suspect that little of Acme's global economic activity is actually taking place in the Caymans, and thus that this is "stateless income," relocated from either the United States or Germany by means of tax planning games. Suppose further that, despite having a nominally worldwide system, the United States does not get to tax Acme's Caymans income. (We will soon see why, under existing U.S. rules, this may be a realistic assumption.) What should U.S. policy makers think about this phenomenon?

A principle holding that everything should be taxed somewhere once would suggest unconditionally objecting to Acme's profit shifting to the Caymans. But in evaluating what has happened, there are two distinct possibilities to keep in mind. The first is that profits were shifted out of the United States, and that Acme has therefore used tax planning to avoid the source-based U.S. tax. The second possibility, however, is that Acme shifted profits out of Germany, thus avoiding the German rather than the U.S. tax. In practice, these two scenarios may be extremely difficult, and perhaps indeed impossible, to tell apart—and one might expect Acme's reported Caymans profits to include some of each.

But should U.S. policy makers regard the two scenarios as equivalent? To answer this question, we must turn to the second big problem with the existing international tax policy literature, which is its general failure to distinguish between domestic and foreign taxes even though they are very different from the standpoint of a given country.

## D. Second Problem: How Should We Think about Foreign Taxes?

One of the most bizarre aspects of international tax policy analysis is its frequent indifference to the question of whether tax revenues go to the home country that is deciding what international tax rules to apply, or to some other country. As an analytical matter, such indifference is a necessary precondition to focusing exclusively on global rather than

domestic tax rates as the key variable. It is at least implicit in the practice of offering foreign tax credits to resident multinational firms. And it is verging on explicit if we do not treat reciprocity as a precondition for offering foreign tax credits. That is, if we allow domestic taxpayers to credit, against their U.S. liability, the taxes levied by countries that do not similarly reimburse their taxpayers for paying U.S. taxes—such as by reason of offering exemption, which (again) is an implicit deductibility system—then we are effectively making a gift of the revenue to foreign Treasuries.

From a unilateral national welfare perspective—that is, one in which we care only about the welfare of domestic individuals rather than everyone in the world, and ignore or assume away other countries' strategic and other responses to our rules—it is clearly erroneous to treat foreign and domestic taxes as interchangeable. After all, the reason we typically regard taxpayers' incentive to reduce or avoid domestic taxes as socially suboptimal is that *we get the money* from those taxes.

Thus, in the purely domestic context, suppose I would decide whether to work for an extra hour based on how much of the earnings I would get to keep after-tax, and that I viewed the tax on these earnings as no less a cost to me than, say, the extra commuting expenses that I would incur if I accepted the assignment. From the social standpoint, this is an externality problem. I am ignoring the benefit to the domestic individuals who would reap the gain if this extra money went into the public fisc. Analytically, it is the same problem as if I were to ignore the pollution costs that my factory would impose on other individuals by releasing noxious fluids into an adjoining river. With respect to foreign taxes, however, *we don't get the money*—instead, it goes to foreign individuals, whose welfare we commonly disregard in making domestic policy choices (for example, in deciding whether to fund schools at home or abroad).

As noted above, this analysis is incomplete unless we assume, not just that we are exclusively concerned with domestic individuals' welfare, but also that there are no relevant strategic and other interactions between what we do and what other countries do. If, for example, all other countries were resolved to credit our taxes when paid by their own residents if and only if we credited their taxes in the reciprocal setting, then it is possible (depending on further information) that treating domestic and foreign tax payments as effectively equivalent would offer, at least, a plausible rough rule of thumb.

But the fact that there may be important interactions between our foreign tax rules and those in other countries does not establish that we generally should treat domestic and foreign taxes as if they were equivalent after all, from a domestic national welfare standpoint. All it means is that we need to think about those interactions. Viewing our treatment of foreign taxes as potentially relevant to how other countries treat our taxes is *not* the same thing as concluding that they are all effectively the same. Consider, for example, that our peer countries have generally shifted toward exemption, and thus toward an implicit deductibility system for the U.S. taxes that their resident companies pay. One can hardly argue that they would abandon foreign tax creditability if we did, when they have already done so without waiting for us to go first.

As we will see, from a purely unilateral national welfare standpoint, mere foreign tax deductibility—including that which results implicitly from having an exemption system for foreign source income—is clearly the right answer, unless and until some further consideration emerges to complicate the analysis. After all, when U.S. people pay foreign taxes, it truly is just an expense from our standpoint, no less than when they pay foreign fuel bills or labor costs, given that we don't get the money.[3]

There is, however, one last complication that we need to keep in mind. Recall the earlier example where Acme Products, a U.S. firm with domestic and German operations, reported significant profits as having arisen in the Cayman Islands, most likely due to tax planning games that shifted them, for official reporting purposes, out of the U.S. and/or Germany. Despite the ambiguity of from where the profits were shifted, there may be greater reason to suspect that true U.S. income is showing up in the Caymans than that it is showing up in Germany. After all, if U.S. profits are being shifted for official reporting purposes, the taxpayer has more to gain by placing them where the tax rate is actually zero. In addition, as we will see, shifting U.S. profits to a relatively high-tax country such as Germany may simply be the first step, for planning purposes, toward re-shifting them to a tax haven, which often is harder to do directly from home.

The bottom line that this suggests is a bit complicated, and thus needs to be stated carefully. On the one hand, if we regard foreign taxes, unlike domestic taxes, as purely a cost from the social as well as the taxpayer's individual standpoint, then presumably we should be glad when U.S. companies, owned by U.S. individuals, avoid German taxes by shifting their German profits to the Caymans for German reporting purposes. But on the other hand, when we observe U.S. companies reporting Caymans income, we may have reason to regard this, relative to their reporting German income, as effectively a statistical "tag" that is likely to be correlated with profit shifting out of the United States.

There indeed appear to be big numbers attached to this problem. Kimberly Clausing (2011, 1580) estimates that, in 2008, "the income shifting of multinational firms reduced U.S. government corporate tax revenue by about $90 billion." This estimate includes a 35 percent gross-up of the overall dollar amount to account for income shifting by non-U.S. firms that were outside the data set. Such firms are beyond the reach of the U.S. rules for taxing resident firms' FSI. However, even if one eliminates foreign firms from the revenue estimate, it suggests that profit shifting by U.S. firms reduced their 2008 U.S. tax liability by about $67 billion.

Against this background, if we want U.S. companies to treat foreign taxes as equivalent to any other cost that is incurred abroad, but also want to reduce the incentives for profit shifting out of the United States, we face a tradeoff. The former consideration calls for mere foreign tax deductibility, whether the statutory U.S. tax rate for FSI is 0 percent, 35 percent, or anything in between. But the latter consideration may call for treating low-taxed FSI less favorably than that which is higher taxed abroad, even though lowering foreign taxes on a fixed amount of FSI is exactly what we should want U.S. companies, if owned by U.S. individuals, to do.

It is in the nature of the tradeoff that we cannot advance the latter objective without undermining the former objective. After all, we reduce the reward that U.S. companies reap from overseas profit shifting if we treat it (in some cases, mistakenly) as evidence of domestic-to-foreign profit shifting. Nonetheless, given that this is a tradeoff between competing considerations, it would be a considerable surprise if the unilaterally optimal solution involved having, at any given margin, a company's U.S. taxes increase by a dollar when it reduced its foreign taxes by a full dollar (i.e., the creditability result, whether or not it formally reflects offering foreign tax credits). Instead, the optimal solution might involve companies reaping a worse-than-deductibility, albeit better-than-creditability, marginal result from reporting profits in tax havens.

## E. Third Problem: The Issue of Multiple Margins

In thinking about international tax policy, issues of efficiency are widely agreed to belong at center stage, although distributional issues pertaining to individuals matter as well. But if there is one fundamental rule of clear thinking that one must follow, in order to analyze efficiency in an intellectually coherent fashion, it is that one must proceed, at least initially, by analyzing just *one margin at a time*.

Traditional international tax policy analysis has failed to satisfy this elementary maxim. Instead, a practice of obliviously conflating distinct and separable margins has, at least until recently, reigned as unchallenged orthodoxy in the field. Almost everyone seems to agree that the fundamental choice lies between worldwide/foreign tax credit systems, and those that are territorial. This, however, is a compound choice that sloshes together differences at two distinct margins. The first margin concerns *tax rates on foreign source income*. The second concerns *reimbursement rates for foreign taxes paid*.

*Tax rates (both average and marginal) on foreign source income*—The first, and more obvious, difference between worldwide and territorial systems lies in the tax rates that they impose on FSI. Under a worldwide approach as commonly conceived, the official statutory tax rate for FSI is the same as that for domestic source income. By contrast, under a territorial system, the tax rate for FSI is zero. Intermediate statutory rates are not so much consciously rejected as ruled out from the start, almost as if they were (for some unknown reason) logically impossible.

As it happens, the scope of the disjuncture may be less than it initially seems, if the worldwide system allows foreign tax credits. Thus, recall the earlier example in which Acme Products' operations and reported income were confined to the United States and Germany, with the U.S. rules taxing FSI at 35 percent but allowing foreign tax credits, while the German rate was 20 percent. If Acme earns $100 of German income (as determined by both systems) then, after paying $20 of German tax, it will owe only an additional $15 of U.S. tax. Thus, its actual average or effective U.S. tax rate on German source