ECONOMIC ANALYSIS

‘Stateless Income’ Is Key To International Reform

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Next time you hear multinationals talk about international tax reform — which they equate to an exemption system that does not deny deductions for expenses allocable to foreign income — notice that there is no mention of profit shifting. They routinely present a picture of a simple world in which there is no confusion about where income should be sourced. Income from French business is taxed by France. Income from Singaporean business is taxed by Singapore. In this sterilized characterization, because the United States taxes on a worldwide basis, U.S. companies cannot compete with Singaporean companies in Singapore. Moreover, because France has a territorial system, U.S. companies cannot compete with French companies in Singapore. In this world, the only tax advantages companies get are those from the movement of actual capital. This puts U.S. multinational corporations at a disadvantage in competing for investment.

Recent draft law review articles by Edward Kleinbard and *Tax Notes* columns by Michael Durst challenge this view. The authors observe that profit shifting from high- to low-tax countries is rampant, and rather than assuming it away, they put the phenomenon front and center in their analyses. Kleinbard calls profits shifted to tax havens where little or no business is conducted "stateless income." In the real world with stateless income, firms get tax advantages from the movement of actual capital *and* from widespread artificial profit shifting.

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"The pervasive presence of stateless income tax planning changes everything," Kleinbard writes. Primarily through the insufficiently compensated transfer of intangibles to low-tax subsidiaries and through excessive indebtedness in high-tax countries, including the United States, U.S. multinationals are able to shrink U.S. taxes on foreign income to a minimum and reduce tax on domestic income. Given this reality, U.S. multinationals doing business in a foreign location have an advantage over local firms. Further, they are not at a competitive disadvantage with foreign multinationals.

Kleinbard, a longtime private practitioner and now a professor at the Gould School of Law at the University of Southern California, was formerly chief of staff of the Joint Committee on Taxation. Durst, an attorney in Washington with three decades of experience, has been chief of the IRS advance pricing agreement program. Kleinbard's analyses can be found in two working papers. "Stateless Income" will be published in the *Virginia Tax Review*. "The Lessons of Stateless Income" will appear in the *Tax Law Review*. Current versions are available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791769 and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791783. (For Durst's columns, see *Tax Notes*, June 20, 2011, p. 1277, *Doc 2011-11835*, or *2011 TNT 118-7*; *Tax Notes*, May 16, 2011, p. 741, *Doc 2011-9331*, or *2011 TNT 95-4*; and *Tax Notes*, Jan. 24, 2011, p. 443, *Doc 2011-93*, or *2011 TNT 16-22*.)

An Alternative View

Kleinbard and Durst want to reform international tax rules as much as multinationals do, but their main concern isn't improving the competitiveness of U.S. multinational corporations. They want to eliminate stateless income and all the problems it causes. The following paragraphs, inspired mostly by Kleinbard's longer pieces, describe those problems.

U.S. multinationals have an unfair advantage over foreign firms that are not multinationals. U.S. multinationals can readily shift profits out of high-tax foreign countries to low-tax countries. This gives them a competitive advantage in foreign markets over foreign firms that operate only in their home economy. This is the opposite of the conclusion reached by the recent report from the President's Economic Recovery Advisory Board, which stated: "The [U.S.] worldwide/deferral approach to corporate taxation favors foreign firms operating in their own country compared to U.S. firms in that country."

U.S. multinationals do not suffer a significant competitive disadvantage with foreign multinationals. The

U.S. statutory corporate tax rate is second highest in the industrialized world, and other major economies continue to lower their rates. But the differential between the U.S. rate and the rates of major trading partners is not as large as commonly portrayed. More importantly, the combination of deferral and easy income shifting has allowed U.S. corporations to achieve low tax rates on their foreign income — including foreign income from investments in high-tax countries. The advantages of current law are so large that in many cases the U.S. worldwide system is more generous than other countries' territorial systems. Further, other countries with territorial systems often have tough controlled foreign corporation rules that help limit stateless income.

Multinationals have an unfair advantage over U.S. firms that are not multinationals. U.S. multinationals can shift profits out of the United States to low-tax countries. This gives them a competitive advantage in the United States over purely domestic firms without these profit-shifting opportunities.

Foreign-to-foreign income shifting is a problem for the United States. The 1997 check-the-box rules took all the bite out of U.S. anti-deferral provisions. The retention of this unintended loophole has been vigorously defended by U.S. multinationals. They argue that the United States should not be concerned about income shifting from one foreign country to another, because the only effect of this phenomenon is a reduction in foreign taxes that allows U.S. multinationals to be more competitive in foreign markets. But that is not the only effect. Foreign-to-foreign income deflection is a stepping stone to the domestic-to-foreign shifting that erodes the U.S. tax base. Foreign-to-foreign shifting greatly reduces multinationals' overall foreign effective tax rates. This makes shifting profit out of the United States to almost any foreign location lucrative. Moreover, because foreign-to-foreign profit shifting allows large amounts of foreign earnings to be taxed at low rates, the lockout effect inherent in our deferral system is enlarged. With cash tied up overseas, there is more domestic borrowing (deductible at high U.S. tax rates), causing a further erosion of the U.S. tax base.

Profit shifting encourages U.S. multinational investment in low-tax countries. To save face, tax authorities like to see some real investment accompanying the large amounts of income booked into low-tax countries like Ireland and Switzerland. Multinationals have a strong incentive to invest in these tax havens "to create vehicles of a heft adequate to convince tax authorities in high-tax jurisdictions to respect the transactions into which the low-tax affiliate enters," according to Kleinbard. A toehold of real investment allows a truckload of profit to follow.

Profit shifting encourages U.S. multinational investment in high-tax countries. Our current system also provides a large tax incentive for U.S. multinationals to invest in high-tax countries. Among the multitude of observations from Kleinbard, this is perhaps his most intriguing. It follows from basic economics that when the tax rate in a jurisdiction is high, so is the before-tax rate of return. Multinationals that uniquely possess the ability to create stateless income can invest in this high-return capital and pay low taxes by shifting profits to tax havens. This creates "tax rents" available only to multinationals. And because it is easier to engage in stateless-income planning from foreign countries than from the United States, U.S. multinationals prefer investing in other major economies rather than at home.

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Profit shifting violates the public trust. Durst adds to the critique by arguing that more than economics is at stake when our multinationals pack profits into tax havens. The public perception that ordinary citizens cannot avoid taxes but powerful corporations can erodes confidence in the tax system and public institutions generally.

Policy Implications

What do these observations imply for international tax reform? Let's consider four alternatives.

(1) Territoriality 2005. In 2005 both the JCT and the President's Advisory Panel on Federal Tax Reform described a territorial system that would exempt active foreign-source income. The proposal is not attractive to multinational corporations for two reasons. First, it would disallow deductions for expenses — most importantly, interest expenses — allocable to exempt foreign-source income. Second, the exemption would not apply to royalties that are untaxed in foreign jurisdictions. This would be a tax increase on royalties because under current law they are sheltered from U.S. tax by foreign tax credits. The presence of these two features makes the proposal a revenue raiser relative to the generous features of the current system.

(2) Territoriality favored by multinationals. Because it would be a tax increase, multinationals vehemently oppose the 2005 territoriality proposal. They favor territoriality without a deduction disallowance for expenses related to exempt foreign income (and without the proxy for this disallowance, a

limitation on the exclusion — as in Japan — equal to 95 percent of active income). And they favor relief for royalties like the 10 percent rate soon to be available in the U.K. for patent box income. The addition of these two features to a territorial system would result in a tax reduction for multinationals.

Both of these proposals have the advantage of eliminating the lockout effect. This would take the shackles off internal corporate finance, and it would reduce the pressure to borrow domestically. But beyond that, there is little to recommend either plan, according to Kleinbard and Durst. The plans do not directly address the transfer pricing problem. And because deferral would be replaced by an exemption, there could even be an increase in stateless profits.

(3) Territoriality with teeth. To avoid the flaws of current law, a territorial system needs safeguards to prevent profit shifting. These safeguards could include limitations on earnings stripping and on deductions for excessive indebtedness, tougher CFC rules, and transfer pricing rules that rely less on the arm's-length method and more on formulaic approaches. If it were possible to stop aggressive profit shifting, stateless income would be minimized and U.S. multinationals would be unable to collect tax rents. This would eliminate their unfair advantages over competitors that are not multinationals. The U.S. tax base would not be eroded. The United States would put its multinationals on equal footing with those of other countries, like Japan, that have tough backstops to transfer pricing rules. And regarding countries that do not limit stateless income, why should we compete in a battle of subsidies beyond providing tax exemption? ''Those de facto subsidies must be borne by other Americans,'' Kleinbard explains. ''The positive externalities to the United States of fielding a team of successful U.S. multinationals (complementarity in U.S. job creation, for example) must be weighed against the costs of funding the subsidy and the social costs of distorted investment decisions.''

(4) Worldwide taxation with a low rate. As much as he would like them to work, Kleinbard dismisses the possibility that meaningful safeguards can be put in place to prevent profit shifting. ''The eradication of stateless income in the field is a highly implausible scenario,'' he says. That belief leads him to conclude that probably the only workable and acceptable method of taxing multinational corporations is a worldwide system — a system in which profit shifting is meaningless and stateless income cannot exist. Durst does not share Kleinbard's pessimism. He believes profit shifting has a chance to be contained if Congress has the will. Nevertheless, Durst is not averse to a low-rate worldwide system. He praises the Wyden-Coats plan that would broaden the base and repeal deferral, allowing the corporate rate to fall to 24 percent. Durst believes 24 percent is not low enough and proposes increasing the capital gains rate to 28 percent and the dividends rate to 35 percent to pay for a rate reduction to 20 percent. (Under Wyden-Coats, those rates would be raised from 15 percent to 22.5 percent.)

Plans 3 and 4 both eliminate the lock-in effect. Unlike plans 1 and 2, both address the problem of stateless income. They deserve a lot more attention than they have been getting.

Directions for the Future

If multinationals are allowed to create stateless income, they receive advantages that skew investment patterns in unproductive ways. Stateless income should not be an afterthought when designing a tax system. The core design of a tax regime should take into account the tremendous incentive multinationals have to shift profits when tax rates differ. Most discussion of international tax reform simply ignores the existence of aggressive transfer pricing and earnings stripping. The main contribution of Kleinbard and Durst is to thrust it back into the middle of the debate.

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Any proposed territorial alternative should include fundamental design features to prevent profit shifting. The international tax roof should be slanted, not flat. That means building a territorial system will require a lot more careful thought about limiting stateless income. It will probably entail a combination of strengthened CFC rules, tough thin capitalization rules, and a completely overhauled set of transfer pricing rules that relies more on formulary methods.

But even if a deal could be struck whereby those features were part of a plan to move the United States to a territorial system, the political pressure on the IRS and Congress to water down antiabuse rules would be well funded and unceasing. If the reform actually made it through the gauntlet of technical lobbying, Senate floor colloquies, IRS hearings, comment letters, and threats of congressional revision, the rules finally promulgated would be difficult for the IRS to enforce. And then there is always the threat of literalist judges who pounce on the lack of foresight on the part of Congress and the IRS. Kleinbard correctly warns that if there is a move toward untried formulary methods, ''their susceptibility to gaming once released into the field is an important unknown."

The only true fail-safe against stateless income is a worldwide system. That possibility is so far off the policymaking radar right now it is almost invisible. But that hardly disqualifies it as a topic of rational discussion. Kleinbard and Durst make well-informed and well-reasoned arguments. Logically there are only two requirements to bring worldwide taxation back into consideration: recognition that stateless income is a critical problem and recognition that antiabuse rules cannot keep the problem adequately contained.

That logical sequence might interest a few policy specialists. But it is hard to see how it translates into a rallying cry for an effort to fundamentally overhaul U.S. tax rules, especially when it would move the United States in the opposite direction of where the rest of the world is headed.

Perhaps the path to political realism does not have to be so convoluted. Throw out the aforementioned logic and consider the possibilities of the Wyden-Coats corporate reform as modified by Durst. It has a 20 percent corporate rate. We know from history that if rates are low enough, something strange can happen: The conventional opposition to ending tax breaks can melt away. A corporate rate cut to 20 percent might convert many opponents of tax reform into advocates. The beneficiaries of the current system — mostly pharmaceutical, high-tech, and other intangible-intensive multinationals — would be the only losers. But with a 20 percent rate, their complaints about lack of competitiveness in the U.S. tax system would have a hollow ring to the public.

The Durst modification of Wyden-Coats also has another attractive feature for big business. Unlike Obama-style revenue-neutral corporate tax reform, it is an overall corporate tax cut. The tax cut is funded by an increase in capital gains and dividend rates. Opposition from the investment community to these rate increases could be neutralized by support from large bank holding companies that would gain enormously from a 20 percent rate.

A move in the direction of worldwide taxation is probably too much for the political system to process. Perhaps, as a practical matter, it is a distraction. But putting the spotlight on stateless income is still extremely useful. Kleinbard and Durst make crystal clear a point that never gets meaningful attention: Any move to a territorial system should be accompanied by anti-shifting rules with real teeth.

Understanding and implementing a corporate rate cut is as easy as pie. Saving a territorial system from the ravages of stateless income is much more difficult. It is an arduous, technical task. A good starting point for Treasury and congressional staffs would be an exhaustive review of CFC rules in other countries. They should use their considerable brainpower to develop their own ideas with a boldness that has been absent — that is, without regard to offending the sensibilities of multinationals or violating the arm's-length standard. The tougher the plan, the lower the new corporate tax rate can be. ■