A Challenging Time for International Tax Policy

By Kimberly A. Clausing

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This article discusses options facing policymakers in the taxation of multinational firms. Clausing expresses concerns about adopting a territorial tax system without due consideration of the effects on U.S. economic activity and the corporate tax base.

By any measure, the U.S. system of taxing multinational corporations is broken. Because corporations can postpone paying U.S. taxes on foreign profits indefinitely as long as they keep those profits abroad, the current system encourages firms to move factories and jobs to low-tax destinations and to keep their profits reinvested abroad. Because the corporate tax code is full of loopholes that allow firms to book income from U.S. operations as if it came from operations in low-tax countries, corporate tax revenues are significantly reduced. I recently estimated that income shifting by multinational firms costs the treasury about $90 billion a year.[1] That shifting of economic activity abroad has real costs for American workers.

Because nearly everyone agrees that the system is broken, debates over reform are intensifying. Two main approaches have emerged. The first seeks to reduce the incentive to locate economic activity and income abroad. For example, the Obama administration is proposing a minimum tax on foreign income earned in tax havens and a crackdown on corporate practices in which income from an economic activity is booked in low-tax countries while the deductions and credits associated with the same activity are booked in the United States. The bipartisan tax reform proposal by Sens. Ron Wyden, D-Ore., and Daniel Coats, R-Ind., takes a similar approach and would reduce the incentive to locate jobs and income abroad. Both of the proposals couple tighter international tax rules with a lower corporate tax rate to encourage economic investment and jobs in the United States.

Others are pushing a different approach. They would move the United States to a territorial system in which the foreign income of U.S. multinational corporations is completely exempt from U.S. taxation. That approach would significantly increase incentives for U.S. firms to move economic activity abroad. U.S. tax payments for the income from foreign operations of U.S. multinational corporations would not simply be deferred; they would be completely erased. That would eliminate constraints on shifting income abroad.

Advocates of a territorial system argue that because many of our trading partners have moved to a territorial system, we need to follow if our multinational corporations are to remain competitive. Yet most countries with territorial systems have hybrid versions of territoriality that are far different from the version being suggested for the United States. Those hybrid systems include tough antiabuse provisions that discourage the shifting of income and employment to low-tax havens; the result is often a higher tax on foreign income than applies in the United States. Under U.S. law, foreign income is not taxed until it is repatriated to the United States, and foreign tax credits are allowed for taxes paid to foreign governments. Under typical territorial systems in other countries, some foreign income is taxed currently, even if it is not repatriated. For example, Japan taxes foreign income currently when the foreign tax rate is less than 20 percent; in other countries, foreign income is taxed currently if the host country tax rate is less than one-half or three-quarters of the home country rate.[2] Thus, the hybrid systems used by our largest trading partners

[1] Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, Mar. 28, 2011, p. 1580, *Doc 2011-4859*, *2011 TNT 61-9*, updating Clausing, "Multinational Firm Tax Avoidance and Tax Policy," 62 *Nat'l Tax J.* 703 (Dec. 2009).

[2] *See* Joint Committee on Taxation, "Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income," JCX-33-11 (May 20, 2011), *Doc 2011-11045*, *2011 TNT 99-76*.

have more in common with the reforms suggested by the Obama administration and by Wyden and Coats than they do with a pure territorial system.

What would the effects be if the United States shifted to a pure territorial system? First, it would eviscerate the U.S. corporate tax base by eliminating any constraints to shifting income abroad. Second, it would encourage job creation abroad instead of at home.

Based on my research and that of other experts in international taxation, it is possible to estimate how many jobs are at stake in this debate. In 2008 U.S. multinational firms employed 10 million workers in affiliated firms abroad.[3] Under a pure territorial tax system, the tax incentive to locate jobs in low-tax countries would increase significantly, which I calculate would increase employment in low-tax countries by about 800,000 jobs.

The method for that calculation involves several steps:

1. First, I use the employment tax response elasticity from Table 3 of my 2009 article.[4] That study uses data from U.S. multinational operations between 1982 and 2004.

2. I assume that under a territorial system elasticity would rise by 0.98, which is the difference in foreign direct investment tax elasticities between territorial and worldwide system countries in a comprehensive 2008 meta-analysis by Ruud A. de Mooij and Sjef Ederveen.[5]

3. Using 2008 data for U.S. multinational operations from the Bureau of Economic Analysis, I use actual employment and effective tax rate data for U.S. affiliates in countries surveyed. The effective tax is calculated as the ratio of foreign taxes paid by U.S.-owned affiliates in a country to their net pre-tax income. Those are the most recent (nonpreliminary) data.

4. I assume a U.S. effective tax rate of 27.1 percent, as reported by Jane G. Gravelle.[6]

5. For each country with an effective tax rate below the U.S. rate, I calculate the implied number of additional low-tax-country jobs resulting from the larger employment elasticity.

The estimates are uncertain. The direction of possible bias of each is discussed below.

1. The older data may bias those estimates downward, since foreign activity tax responses have been rising over time.[7]

2. The elasticity difference between territorial and nonterritorial countries was estimated using data from the actual territorial and nonterritorial systems in place around the world during the previous decades. A pure territorial system would entail even larger tax responsiveness than the hybrid territorial systems that are typically used. Thus, this consideration also suggests that 800,000 could be an underestimate of the increase in jobs in low-tax countries.

3. The analysis assumes that the U.S. effective tax rate is 27.1 percent, and it considers only the difference between tax responses under territorial and nonterritorial systems. If the U.S. effective tax rate were to fall because of changes in the tax code, the calculated job responses would be lower.

4. Foreign effective tax rates have been decreasing since 2008; accounting for that would raise the magnitude of the estimates.

Table 1 illustrates the countries that would have the largest job increases in response to a territorial system, according to these calculations. While most of those countries are not tax havens, they do have lower effective tax rates than the United States. The higher tax response under a territorial system would generate increased economic activity.

Table 1

Country	New Jobs
Canada	150,000
China	73,000
The Netherlands	65,000
Germany	52,000
Mexico	39,000
France	37,000
Singapore	31,000
Taiwan	28,000
India	26,000
Belgium	26,000

A similar calculation can be done for the increased income shifting that would occur under a territorial system. Table 2 shows the top 10 countries receiving additional profits (gross income) under a territorial system. Most of those are low-tax

[3]This is the most recent year with revised data from the Bureau of Economic Analysis. *See* http://www.bea.gov/scb/account_articles/international/iidguide.htm#page5.

[4]*See* Clausing, *supra* note 1.

[5]De Mooij and Ederveen, "Corporate Tax Elasticities: A Reader's Guide to Empirical Findings," 24 *Oxford Rev. of Econ. Pol'y* 680 (2008).

[6]Gravelle, "International Corporate Tax Rate Comparisons and Policy Implications," Congressional Research Service R41743 (Mar. 31, 2011), *Doc 2011-7074*, *2011 TNT 65-32*.

[7]*See* de Mooij and Ederveen, *supra* note 5.

havens and are the locations where disproportionate amounts of income are booked now.

Table 2	
Top 10 Countries: Increased Profits	**Effective Tax Rates of U.S. Affiliates Abroad**
The Netherlands	2%
Luxembourg	0.4%
Ireland	4.3%
Bermuda	0.6%
Switzerland	3.2%
United Kingdom Islands, Caribbean	1%
Canada	13.6%
Singapore	3.5%
Belgium	8.6%
Germany	18.9%

If U.S. unemployment rates are low, jobs abroad need not displace jobs at home, although the composition of jobs may change (and multinational corporate jobs are often good, high-wage jobs). In this economy, however, those new, low-tax-country jobs could displace jobs at home. With high unemployment rates, why further tilt the playing field in favor of jobs in low-tax countries? And given today's budget climate, avoiding further erosion of the corporate tax base should be a priority.

The Case Against E-Filing

By Jay Starkman

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The author argues that e-filing creates tax complexity, higher compliance costs, and the risk of audit and penalties, and it encourages cheating so extensive that tax fraud is now the third largest theft of federal funds.

Intuitively, it seems that e-filing has benefits for all stakeholders in tax compliance, particularly from the efficiency it brings through lower operating costs. But in many ways, that's not true.

E-filing has added to tax complexity, increased compliance costs, raised penalties, created a higher audit potential, and facilitated cheating so extensive that tax fraud is now the third-largest theft of federal funds after Medicare/Medicaid and unemployment insurance fraud.

The Justice Department website lists one conviction a day for tax fraud, but few concern boiler room e-file fraud and rarely for thefts over $1 million, while the fraud totals in the billions. The problem is so widespread that the IRS has set a $100,000 threshold before investigating and prosecuting these cases.[1] Its Criminal Investigation division in 2011 initiated just 276 identity fraud cases, with 81 convictions. Meanwhile, classes of 50 to 100 people at a time are being taught how to file

[1]"Tax Fraud by Identity Theft: Hearing Before the Subcomm. on Fiscal Resp. & Econ. Growth, S. Fin. Comm." (Mar. 20, 2012) (statement of Detective Sal Augeri, Tampa Police Department), *Doc 2012-5822*, *2012 TNT 55-44*.