voluntary that may be for a U.S. branch (12 C.F.R. section 204 and FR 2900, section E). Regulators want banks to lend to each other freely, so the system has liquidity. When liquidity dries up and banks start asking questions about counterparty credit, there is a meltdown like the one in 2008.

Back to TAM 201325012. Hedge funds are very active acquirers of loans, and, as claimed foreign residents, keen to avoid being deemed to be in a U.S. lending trade or business. Their advisers nervously encourage their clients to allow banks to age loans and not to get mixed up in negotiations. Hedge funds take the position that if they wait 48 hours to commit to buy a loan after an agent bank commits to make that loan, they can avoid ECI.

To those advisers, the TAM might mean that acquisition of a loan soon after it is made by the lender will not involve a fund in the U.S. lending business, assuming it had no role in negotiating the loan. The TAM seems to imply that pre-subscribing to a loan is the equivalent of buying it on the public market. It also seems to imply that the hedge funds actively acquiring U.S. loans have no U.S. customers in the form of the banks that fob off their loans.

“The holding of the TAM clarifies that a loan acquired in the interbank market, even if acquired pursuant to a commitment prior to the origination of the loan, should not be considered to have been acquired in a lending business,” Mark Leeds of Mayer Brown LLP wrote in a client note.

But he contrasted AM 2009-010, in which the IRS stated that the actions of an agent put a foreign hedge fund in a lending trade or business in the United States. Leeds argued that the differentiating factor is that the bank branch in the TAM is not being tagged with origination. He didn’t say that the TAM is wrong and there really is no differentiating factor.

Hedge funds that are tagged with origination might want to rely on the TAM to put their purchased loans in a separate investment box that is not ECI. A hedge fund deemed to be in a U.S. lending trade or business would fall under reg. section 1.864-4(c)(5), because no banking license is required under that regulation. That means that they would have interest income from originated loans treated as ECI, but could argue that purchased loans were investments unconnected with origination.

ECONOMIC ANALYSIS

Behind the GAO’s 12.6 Percent Effective Corporate Rate

By Martin A. Sullivan — martysullivan@comcast.net

There are as many ways to calculate an effective tax rate as there are ways to order coffee at Starbucks. So when you hear reports about an effective tax rate, it can mean a lot of different things. Small changes in what may seem obscure details make a big difference. And because effective tax rates are widely used as summary statistics for tax burdens, details can have important implications for the direction of tax policy.

On July 1 the Government Accountability Office made a lot of headlines when it released a study reporting that the average effective corporate tax rate in 2010 was only 12.6 percent. The GAO reported a lot of different tax rates, but it was the 12.6 percent figure — the lowest of the bunch — that got the most attention. That effective tax rate was calculated as the amount of tax liability reported on U.S. federal returns of large profitable corporations divided by worldwide pretax book income of entities included in tax returns. The GAO got its figures from publicly available but yet unpublished IRS data compiled from Schedule M-3 of tax returns filed by corporations with more than $10 million in assets. (Prior analysis: Tax Notes, Aug. 15, 2011, p. 689.)

Although it is common knowledge that many U.S. multinationals have used tax planning to substantially reduce their tax bills, the GAO figure is surprisingly low. Although it is common knowledge that many U.S. multinationals have used tax planning to substantially reduce their tax bills, the GAO figure is surprisingly low. Other studies typically report average rates in the mid-20s. For example, 40 leading U.S. firms that recently formed a tax reform coalition had an average effective tax rate of 24 percent over the 2010-2012 period. (Prior coverage: Tax Notes, June 24, 2013, p. 1462.) The GAO itself (p. 28) cites eight prior studies using a variety of data, methods, and time periods, and the average rate of these studies was 28.4 percent, with a minimum of 22 percent and a maximum of 31.3 percent.

Missing Foreign Profits and Taxes

So what explains the difference between the GAO’s 12.6 percent rate and other studies’ rates?
Mainly two items. First, the GAO did not include foreign taxes in the widely reported 12.6 percent figure. It did in fact provide a much more conceptually defensible measure that includes foreign taxes in the numerator and arrives at a worldwide rate of 16.9 percent as a result. The table below details the GAO calculation.

| Calculation of Average Federal Tax Rate for Profitable Schedule M-3 Filers in 2010 |
|----------------------------------|-----------------|-----------------|
| Dollar Amount (billions) | Percentage of Book Income |
| U.S. tax minus credits from Form 1120 | $181.4 | 12.6% |
| State and local current expense | $30.4 | 2.1% |
| Foreign current tax expense | $26.2 | 1.8% |
| Foreign withholding tax | $5.5 | 0.4% |
| Sum of above | $243.4 | 16.9% |
| Pretax book income | $1,442.9 | 100% |

Source: Author’s calculations using IRS Schedule M-3 data for 2010.

To arrive at its 12.6 percent figure, the GAO divided total U.S. tax liability reported on Form 1120 ($181.4 billion) by pretax book income ($1.44 trillion). To arrive at its 16.9 percent figure, it added current state and local tax expense, current foreign tax expense, and foreign withholding taxes to the numerator. The $30.4 billion for state and local income taxes seems low but not entirely unreasonable, because we know from census data that state corporate tax receipts in calendar year 2010 were $45.7 billion. The $26.2 billion figure for foreign tax expense, however, seems entirely too low.


The low GAO figure for foreign tax liability is attributable to the fact that Schedule M-3 data do not include the taxes paid by foreign subsidiaries (which are not includable on federal tax returns). The GAO’s pretax income in the denominator — “pretax worldwide income reported in financial statements (for those entities included in their tax return)” — excludes deferred income of foreign subsidiaries. The absence of information about subsidiary taxes and profits means that effective tax rates computed with Schedule M-3 data are missing one of the most important aspects of their worldwide tax picture. Without the missing data, it is...
impossible to say if a truly worldwide effective tax rate would be above or below the 16.9 percent reported by the GAO.

**Recession Effects**

The second and more important reason for the GAO’s low effective tax rate for 2010 compared with those found in other studies is that the effects of a recession are more dominant in 2010 than they are in other studies, which include both recession and non-recession years or no recession years at all. In 2010 the U.S. economy was still severely hobbled by the Great Recession. Figure 1 shows liability for all corporations from 1997 through 2010, as well as net and gross corporate tax receipts from 1997 through 2012. It shows that in 2010, corporate tax liabilities reported on tax returns used in the numerator of the GAO’s effective tax rates were extraordinarily low in that year.

Figure 2 shows that in 2010, tax liability reported on tax returns as a percentage of total pretax corporate profits as reported by the Commerce Department in the National Income and Product Accounts was approximately 17 percent. Corporate tax liabilities are highly volatile, so there is no such thing as a typical year. But clearly 2010 was an outlier. A large part of the drop in tax liability as recorded on tax returns as a percentage of profits is likely due to bonus depreciation available in that year. The Business Roundtable has suggested that contributions to pension plans not deductible for tax purposes also contributed to the decline.

The average for the prior 10 years was approximately 25 percent, and in none of those years did the percentage go below 20 percent. Based on the reasonable assumption that total liability reported on tax returns is roughly proportional to liability of corporations with more than $10 million in assets, the GAO estimated that effective tax rates would have been approximately 8 percentage points higher if estimates were made for a year that was not affected by a large recession.

**Conclusion**

Putting all this together, it seems reasonable not to revise the consensus view that average worldwide effective corporate tax rates are somewhere in the mid- or upper 20s when we are not in the throes of a recession.

It is important to keep in mind that these broad averages hide a lot of interesting detail. Multinationals in the oil and mining businesses generally pay very high rates. Purely domestic firms generally have an effective rate close to 35 percent. And pharmaceutical, tech, and other companies with lots of intellectual property generally have effective rates much lower than average.

It is also important to keep on the lookout for misleading effective tax rate calculations from advocacy groups. In its critique of the GAO analysis, the Business Roundtable concludes by calculating a corporate effective tax rate for 2009 of 33 percent. And it notes that the figure would be closer to 35 percent if it had included business tax credits such as the research credit.
This, of course, implies that there are no significant tax breaks in the code and that no tax planning takes place. But the Business Roundtable’s method of calculating an effective tax rate would produce a number close to 35 percent, whether or not there was massive tax avoidance taking place. In the current environment, in which domestic tax credits are a relatively small part of the tax picture, it provides no useful information about the corporate tax burden. Its numerator is tax liability paid plus most tax credits. Its denominator is taxable income. The former as a percentage of the latter will almost always be approximately equal to the statutory rate.

### NEWS ANALYSIS

#### Tax Reform and Real Estate

By Lee A. Sheppard — lees@tax.org

Here’s a statistic: Within the next five years, $2 trillion of U.S. commercial real estate loans will need to be refinanced, and three-quarters of that sum is due in the next three years. Bank watchers have long argued that commercial real estate loans are the next shoe to drop, potentially taking down more community banks. The FDIC closed more than 25 banks in the first half of 2013.

Put a bunch of real estate professionals in a room, pass around a bottle of Jack Daniels, and they’ll confess that, yes, they want to keep their tax breaks, but that propping up prices is more important. Nonetheless, foreign money is sloshing into the U.S. commercial real estate market, with investors hungry for yield in a zero-interest-rate environment.

One professional noted that institutional investors are willing to accept a 4 percent capitalization rate for ordinary properties. One little uptick in interest rates would cause a loss on such a property, *ceteris paribus*.

The larger problem is that *ceteris* is not *paribus* in commercial real estate. The fundamentals are not improving — they’re eroding. Rents are not going up. Vacancies are not going down. And expenses are not going down.

Flight capital, a bubble, or both? Economists at the Federal Reserve Bank of San Francisco attributed the combination of weak fundamentals and historically low capitalization rates to the Fed’s zero-interest-rate policy (FRBSF Economic Letter 2013-12). Which is a fancy way of saying investors are desperate for yield.

### The Blank Slate

Max and Dave visited Minnesota to plump for tax reform. Yes, the chairs of the two congressional taxwriting committees have told the world that despite having put out several position papers, they have a “blank slate” for tax reform and that every tax expenditure has to be justified. (Prior coverage: *Tax Notes*, July 1, 2013, p. 24.)

But the real agenda behind their blank slate is to test political support for the various tax expenditures and some breaks that are not even classified as such. Real estate has a large stake in this project, because hitherto unquestioned tax provisions have been put in play.

Ryan McCormick of the Real Estate Roundtable addressed the PERE CFO Forum in New York on July 9 about real estate tax reform issues. McCormick, a former Senate aide, did not speculate about...