What the Baucus Plan Reveals About Tax Competition

by Allison Christians

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Conventional wisdom explains tax competition as an external constraint on lawmaking: All countries compete for investment in a global capital market, and therefore each is forced, as by an incontrovertible law of nature, to lure investment into their jurisdiction with attractive tax policies. Conventional wisdom then also surmises that the only way governments can curb tax competition is by working together cooperatively to eliminate beggar-thy-neighbor tax policies. The international tax reform plan recently introduced by Sen. Max Baucus, D-Mont., squarely confronts both parts of this conventional wisdom and reveals some very disturbing observations about tax competition: that it is as much a supply-side as a demand-side problem (luring strategies require a supply of otherwise tax-favored capital), that governments have always had the power to counter this problem, and that accordingly, political will is the reason why tax competition has become the overwhelming force that it is today.

The Plan

In broad strokes, the Baucus plan for international tax reform proposes two big ideas that reveal much about how the U.S. has long been contributing to tax competition and how it could move unilaterally to undo this effect (and could have done so at any time before). The first of these proposals is in effect a forced — and not very generous — repatriation tax holiday, which disgorges the profits that have been built up offshore by U.S.-based multinationals, at a tax rate of perhaps 20 percent. The second is one of two alternatives for taxing foreign income (labeled option Y), under which the plan would prevent future buildup and tax deferral of offshore profits by expanding subpart F to cover specific kinds of active income. To understand what these measures reveal about tax competition, and how the U.S. helped create the base erosion that Baucus identified as the catalyst for reform, requires looking at the plan from a global perspective.

Perhaps the best way to approach the issue is with a simplified example — namely, a consumer goods manufacturer that operates along a global supply chain with a U.S. company headquarters (U.S. Parent, or USP) at the top. The manufacturing and sale of goods occurs through a series of related companies, each of which provides various parts of the manufactured whole, and each of which is located in jurisdictions other than the U.S. Of course, this example is grossly oversimplified, but it provides a way to unpack the global impact of a reform such as the one Baucus is proposing.

Following the Taxpayer Offshore

Let us assume that USP situates its operations in places other than the United States to take advantage of local labor and resource markets, and not for tax reasons. Let us further assume that USP cannot simply set up shop in another jurisdiction but must, for various regulatory reasons not having to do with taxation, establish foreign subsidiaries (FSubs) to own the assets, hire the workers, and run the operations in each jurisdiction. With these assumptions in place, we need not invoke any alarm about tax avoidance: The U.S. company is expanding offshore for nontax reasons, and in order to do so, it must set up multiple FSubs, thus forming a multinational group.

Of course, as any student of U.S. international taxation knows, FSubs are not U.S. taxpayers — they are
foreign taxpayers governed by foreign governments. As a result, an FSub is not generally subject to U.S. taxation on its foreign income (generally speaking, it would be subject to U.S. tax on U.S.-source income, but in the capacity of a non-U.S. taxpayer). This simple premise has enormous implications for any tax system, because by virtue of little more than incorporating offshore, a taxpayer can divert income streams out of the tax net indefinitely.

### People Respond to Incentives

Two interrelated outcomes occur if the premise goes unchallenged that a government cannot assert a jurisdictional claim over the foreign-generated incomes of foreign companies, even if these companies are ultimately owned by resident taxpayers. First, looking at the example of USP, it is clear that if nothing is done to prevent it, the income tax base will be gutted as U.S. taxpayers rush to earn non-U.S. income through non-U.S. entities where taxation can be deferred according to the whims of the owner.

Unchecked, the potential for gutting would turn the U.S. income tax base from one based on ability-to-pay to one effectively limited to domestic-source cash flows. This is unsustainable from the perspective of revenue as well as the basic tax policy constraints of equity and efficiency — equity because it treats taxpayers differently depending on the geographic source of their income rather than their relative ability to pay, and efficiency because it favors multinational over domestic taxpayers, thus distorting locational decisions. Therefore, we can expect governments to seek ways to protect their revenue bases against this universal problem. Most have done so in various ways, most of which are flawed at best.

### Governments Respond to Incentives

The second outcome is perhaps less immediately obvious, but it is equally significant. If USP is not taxed on FSub’s income and can defer indefinitely, this creates a baseline tax rate in the U.S. of effectively 0 percent on non-U.S. income earned in entities organized in non-U.S. jurisdictions. Accordingly, to the extent that gutting is left unchecked, the outflowing U.S. capital available for investment abroad necessarily seeks as close to 0 percent as it can get wherever it lands. In other words, U.S. companies are constantly seeking tax savings offshore because the U.S. intentionally provides this route to earning virtually tax-free income from the U.S. perspective. This means that any country looking to attract U.S. investment (for example, in the form of a factory) is immediately encouraged — indeed pressured — to be the most tax-attractive location for that capital to land.

The failure of the U.S., in the role of capital exporter, to impose tax on the foreign income earned by foreign subsidiaries of USPs thus creates the supply side of the global tax competition market. When country A seeks to attract USP to set up an FSub in its jurisdiction to contribute to the supply chain, it produces a tax holiday, generous credits, and other favorable tax terms as a lure. The lure, if effective, can only be so to the extent that the return on that capital is not going to be taxed in the U.S. Incidentally, this is the impetus for “tax sparing” clauses in tax treaties: to provide this result when it otherwise would not occur. Of course, right beside country A is country B, which would also like to attract USP to set up an FSub there. So country B provides a longer holiday or a more generous regime, and country C follows suit, and so on.

It is the possibility of a residual baseline rate of 0 percent that creates footloose capital, the steady supply of which forms the necessary condition under which foreign tax policy can succeed as a lure. Governments around the world have deployed this lure with many and varied race-to-the bottom, beggar-thy-neighbor tax regimes. The increasing volume of studies that question the effectiveness and appropriateness of these regimes seems to have no impact: They continue to multiply across the globe. Together, the release of footloose capital and the lures enacted to attract it ultimately ensure that global conglomerates like Apple, Google, and GE will do things like achieve global tax rates in the low single digits and pile up vast stashes of cash offshore, thus attracting the increasing ire of the public and the attention of policymakers like Baucus.

### Opting Out

There is a simple way to opt out of this status quo: The U.S. could reduce the supply of footloose capital by asserting a jurisdictional claim over the foreign income of U.S.-controlled foreign subsidiaries. The precedent for this is, of course, the existing subpart F regime, which was adopted in 1962 under the Kennedy administration. Subpart F was limited to passive income, and not extended to most active income. One reason for this was a belief that passive income was highly mobile and easily transferred to offshore corporations by means of simple paperwork filing and therefore susceptible to tax-motivated offshoring, while active investment overseas required a more robust commitment of resources and activity, and was therefore less susceptible to artificial shifting via paperwork.

Clearly times have changed, or perhaps the belief was never accurate. Passive income is just as mobile, but the U.S. is catching more of it, thanks to greater tracing and third-party reporting. But now active income is increasingly shifted by means of paperwork filing, especially thanks to the rise of intangibles and electronic commerce. Reducing the supply of tax-free passive capital, as subpart F ostensibly attempts to do, is no longer sufficient as a strategy to protect the U.S. revenue base.

Baucus’s plan would thus finish what the Kennedy administration started, by adding active income to the pool of foreign subsidiary profits that are disgorge by means of imputing dividends to the U.S. Parent in a
controlled group in certain circumstances. In so doing, the Baucus plan cuts off or at least reduces one advantage of going offshore as compared to investing domestically, and it changes the scenario for those who would try to lure foreign capital.

**A New Present of Revenue?**

Now, instead of working against a baseline rate of 0 percent, capital-luring countries would be working against a residual baseline rate of something closer to 28 percent (or lower, assuming an overall reduced top U.S. corporate tax rate). Under Baucus’s option Y, the U.S. would, in taxing USP, collect the difference between what any FSub paid in foreign taxes and what it would pay in U.S. taxes (under a formula that would set the baseline lower than the top U.S. tax rate). Country A could continue to offer a panoply of tax holidays and generous tax incentives, but such a regime would lose its luster as a luring device for U.S. investment.

Since a taxpayer faced with a given tax is economically indifferent as to which government gets the revenue so long as only one level of tax is paid, one view is that eliminating deferral in the U.S. means that other countries could increase their tax rates up to the residual U.S. rate, and rely on the U.S. foreign tax credit (or exemption under option Y) to stabilize the new status quo. This would be a boon for countries whose bases are currently rapaciously eroded by U.S.-based multinationals, to the extent these companies continue to find value in staying abroad relative to returning operations to the U.S. From a foreign government’s perspective, then, the Baucus plan could be viewed as an enormous opportunity to end tax competition, even a “present of revenue,” as Edwin Seligman characterized the foreign tax credit when T.S. Adams suggested it for unilateral U.S. adoption a century ago.

With a global minimum tax put in place by the U.S., country A could abandon its holidays and incentives so as to collect corporate tax revenues up to this rate, and it would face no competitive disadvantage vis-à-vis its neighbors — at least for U.S. capital investment. Since country A could do this, the same goes for country B, country C, and so on. The competition for U.S. capital investments thus could theoretically stabilize at a floor high above 0 percent. This could allow other countries to increase their corporate income tax take while leaving them free to compete for U.S. investment on other factors, including skilled workforces, infrastructure, natural resources, and so on. Of course, if this were to happen, the U.S. ultimately stands to gain little by way of increased revenue from the Baucus reforms. Taking the high road on tax competition could have positive knock-on effects, but U.S. policymakers might view these as a poor consolation prize.

**... Or an Exceptional Encumbrance?**

The immediate impact on tax competition is uncertain though, because the U.S. is not the only major multinational-producing country. A country that has already attracted a large amount of U.S. investment might start moving toward a 28 percent domestic corporate tax rate and try to capture the tax for itself. However, multinationals that did not face a global minimum tax would apply pressure to preserve a favorable tax regime to continue luring in their own 0 percent residual-rated capital.

This makes the Baucus plan look bleak from the perspective of U.S. multinationals, which would face a global minimum tax rate that no other country currently imposes on its resident multinationals. Representatives of U.S. multinationals can therefore be expected to be unhappy with the Baucus plan, especially when they face business competition from multinationals based in jurisdictions whose baseline rate is still set at 0 percent. If that remained the status quo for long, it seems reasonable to believe that these companies would gain market share relative to U.S. competitors as the latter would now have a much higher tax cost.

Assuming that tax discrimination is off the table, foreign governments would therefore seem to face a strategic choice: try to attract U.S. companies and their now-taxable investment dollars, or continue to try attracting the competition with tax incentives. The former strategy could allow countries to significantly increase the revenues they collect from multinationals operating in their jurisdictions to the extent they can compete for U.S. investment dollars on grounds other than tax policy. However, this is a risky strategy that relies on the success of U.S. multinationals to compete against non-U.S. multinationals under these conditions. The appropriateness of a government’s choice would presumably evidence itself quickly.

**Race to the Top**

One answer to the problem is that as the U.S. goes, so goes the rest of the world: If the U.S. raises the baseline rate on U.S.-based multinationals, other multinational-producing countries that are also facing revenue shortages and public pressure might well take the opportunity to follow suit. In other words, the U.S. could lead the world in a race to the top. The result could be in effect the creation of a cartel of multinational-producing countries that impose global minimum taxes on these companies. The U.S. would not necessarily view such a development favorably, as a reduction of supply-driven tax competition forecloses its own ability to act as country A or B, deploying tax incentives to attract foreign capital. On the other hand, a global minimum tax cartel would reduce the competitive harm that the U.S. regime would otherwise visit exclusively upon U.S. multinationals.

The larger that cartel became, and the more it filled with the world’s leading producers of multinational companies, the easier it would be for other countries to
follow suit. Clearly, being the first mover in this direction is tremendously risky. It banks on the attractiveness of the U.S. market to be strong enough to withstand the increased tax cost of being a U.S. multinational (and the strength of the anti-inversion rules to forestall a flood of expatriating companies). It further banks on the cartel attracting all of the main competitors before cartel-based multinationals are wiped out as a species.

**Tax Competition Is a Choice**

For all of these reasons, the Baucus plan faces steep barriers to actual enactment. Yet the proposal in and of itself is important. Simply having a plan like this articulated as a possibility demonstrates that tax competition is not and has never been a law of nature operating outside of the control of individual governments, but instead it has always been the product of policy decisions that can be reversed by other policy decisions. The Baucus plan goes even further and suggests that these policy decisions do not have to be coordinated at all; instead, a single government can act unilaterally to put a stop to global tax competition — at least, when that government is the United States. No doubt this last suggestion is optimistic, since a large percentage of the world’s largest multinationals are headquartered not in the U.S., but in China, Japan, Germany, and the U.K., each of whose domestic rules also contribute to the global picture.

Had Congress taken a Baucus-style route in the 1960s, when subpart F was first being considered, perhaps this forceful unilateral move by the United States could have been enough to prevent tax competition from becoming the overwhelming force it is today. Certainly it was a policy choice: The Kennedy administration recommended including all foreign profits in subpart F, but Congress decided against it. That created the impetus for tax competition, and that is exactly what the world’s nations produced. Now it might be too late for Baucus’s plan for unilateral U.S. action to change the course of history. Still, it is possible that the rising public anger at the low tax rates enjoyed by household-name multinationals could motivate other governments to follow the U.S. lead. The Baucus plan suggests that the U.S. should act as a leader now, and it should do so even if this reduces a current advantage in the short term, to prevent even greater harm later on.