NEWS ANALYSIS

Shaviro's *Fixing U.S. International Taxation*

by Martin A. Sullivan

When it comes to international taxation, House Ways and Means Committee Chair Dave Camp, R-Mich., and professor Daniel N. Shaviro of New York University Law School have a lot in common. In the age-old debate between the two poles of worldwide and territorial taxation, they want compromise. They want to achieve a balance between promoting competitiveness and preventing excessive profit shifting to tax havens.

A pro-business conservative, Camp would have preferred his plan to lean more in the direction of multinational competitiveness. But in his three-year quest for tax reform, the chair has learned by doing, and what he has learned from the revenue estimators at the Joint Committee on Taxation is that moving to an exemption system is too expensive without tough measures to discourage profit shifting. Shaviro's path to compromise is based on his own reasoning after extensive review of the legal and economic scholarship on international tax.

The main way Camp and Shaviro seek to achieve a balanced approach is by setting the average effective rate on foreign-source income of U.S. multinationals somewhere below the statutory corporate rate and somewhere above zero. Although this conclusion would hardly be startling to a newcomer to the study of international tax — and is the practical result under current law for many taxpayers because of deferral — the traditional debate on international tax does not easily lend itself to compromise.

No Thanks to Alphabet Soup

Most of all, the traditional debate is hampered by what Shaviro calls the ''single-bullet approach'' to international tax reform, in which factions argue for a guiding principle that achieves neutrality on one margin and then in effect ignores or trivializes the economic inefficiency their policies would create at other margins. Shaviro devotes two of the six chapters in his book to reviewing the ''alphabet soup'' of possibilities that have framed the debate (Shaviro, *Fixing U.S. International Taxation*, Oxford University Press, 2014).

Shaviro first reviews policies that purport to maximize global economic welfare. But he questions and rejects on practical grounds the basic premise that U.S. international tax policy can or should seek to promote worldwide welfare when it clearly plays little role in politicians' development of economic policy.

Even absent this concern, the worldwide welfare maximization goals are lacking as useful guides. Capital export neutrality (CEN) may equalize tax incentives for domestic resident firms' choice between domestic and foreign investment, but it ignores the possibilities that shareholders in U.S. corporations can circumvent the rule by investing in existing foreign corporations or that existing U.S. corporations can expatriate. Capital ownership neutrality (CON) exempts foreign profits, and this allows the most competitive multinationals to invest anywhere in the world without a competitive tax disadvantage, but it encourages foreign over domestic investment and profit shifting to tax havens.

In Shaviro's analysis, alternative approaches that promote domestic welfare to the detriment of foreigners also are not particularly useful policy guides. National neutrality (NN) would tax foreign and domestic income at the same rate and would replace the credit for foreign taxes with a deduction. This approach takes into account the fact that taxes paid to the U.S. treasury are not the same as taxes paid to a foreign government. By allowing a deduction instead of a credit, a U.S. multinational is encouraged to allocate cross-border investment so the after-foreign tax return equals the U.S. before-tax return. This results in taxation of foreign profits in excess of either the foreign or domestic rate and clearly discriminates against foreign investment.

But as with capital export neutrality, concerns about corporate residence electivity, shareholders' shifting of their portfolios to foreign companies, and the extra burden on cross-border investment by efficient multinationals all rule out national neutrality as a practical guide to U.S. tax policy.

National ownership neutrality (NON) is not a useful guiding principle either. The unilateral exemption of foreign profits that this approach espouses in order to avoid tax disincentives for foreign investment by efficient multinationals does not take into account the seemingly intractable problems of income shifting, nor does it allow for the efficiency gains of shifting at least some of the tax burden from domestic to foreign investment by, for example, lowering the domestic corporate tax rate.

A Question of Balance

Shaviro wants a framework that explicitly acknowledges there are trade-offs and provides criteria for balancing them. Fundamental tax economics is his guide. First, he notes that economic inefficiency from taxation increases with the square of the difference between the actual and optimal tax rate. So let's say the most efficient tax rate for various investments uniformly varied from 0 to 30 percent (or that you only know the one efficient rate was somewhere between 0 and 30 percent), but you could only choose one rate. In this case, economic inefficiency is minimized with a tax rate of 15 percent. Compromise is efficient because being a little bit wrong a lot of times is better than being a lot wrong some of the time.

But we can do better than this. We know that the inefficiency of a tax is greater for items with elastic demand than for those that are inelastic. So for an economist concerned only with efficiency, the perfect tax is a one-time expropriation that cannot be avoided. As economist Frank Ramsey pointed out in 1927, if we can know the elasticities of items we are taxing, we can improve on a uniform tax by taxing items with inelastic demand at higher rates than those with elastic demand. Applying this inverse elasticity rule to international tax suggests that in determining where in the range between zero and the full statutory rate we should tax foreign income, we should lean in the direction of exemption because foreign investment is more elastic than domestic investment. Shaviro tentatively suggests that in conjunction with his other suggested changes, the United States should tax foreign investment at a rate of at least 5 percent and possibly as high as 10 percent.

Jettison Deferral

The second fundamental point of agreement between Camp and Shaviro is the need to eliminate deferral. Although this would be a huge game changer for U.S. international tax rules, there is no question that deferral — which, as Shaviro writes, only arose by accident ''through the mindless application of legal conventions'' — should not be allowed to survive tax reform.

Although the new view of dividends taxation applied to international tax makes a convincing case that parent shareholders of foreign subsidiaries should be indifferent to the timing of dividend payments (because the present value of tax costs and benefits of distribution are the same in each case), nobody outside academia agrees. Shaviro attributes this to the fact that parent companies actually do intend to keep a large share of their earnings offshore indefinitely (in which case the new-view conclusions do not hold) or that corporate CEOs only care about short-term earnings, in which case taxes postponed for even a few years are invaluable. So profits generated by foreign subsidies are locked out and face a tax cost equal to the U.S. rate minus whatever foreign tax credits may apply.

This is a big deal for multinationals because they have accumulated more than $2 trillion in unrepatriated profits in foreign subsidiaries. With the advent of check-the-box regulations, multinationals have been able to rearrange their legal structures so an increasingly larger share of worldwide profits is booked in tax havens. There is considerable disagreement about how much damage this lockout effect causes and, consequently, about how much economic benefit could result from unlocking trapped profits, but even if these magnitudes are modest, taxing profits when distributed adds needless costs. Fortunately for everybody, Shaviro's views on ending taxation upon distribution are already baked into the leading proposals for international tax reform.

Most major international tax reform proposals in recent years would move the United States to a territorial system. A notable exception is the legislation proposed in 2011 by Senate Finance Committee Chair Ron Wyden, D-Ore., and Sen. Daniel Coats, R-Ind., that would move the United States to a worldwide system. Either approach, however, imposes no tax on distribution so the lockout effect is eliminated.

Who Gets the Money?

Shaviro stands out from the rest of the international tax reform crowd because of his strident opposition to the foreign tax credit. He would like the credit to be replaced with a deduction for foreign taxes. Traditionally this position would be interpreted as anti-business and an endorsement of national neutrality. But Shaviro has placed himself outside the traditional debate by pushing a separate and low tax rate on foreign profits. Adjustment of that rate is the main tool for calibrating the overall U.S. tax burden on foreign-source income.

Shaviro criticizes the large tax planning, compliance, and administrative costs of the foreign tax credit: ''I have been told by people associated with such companies that foreign tax credit issues consume more in-house and outside staff attention and time . . . than any other set of international tax issues.'' But his primary critique of the credit centers on the unseemly lack of ''cost consciousness'' the credit elicits from multinationals when it comes to paying foreign taxes.

Under current law, as long as taxpayers have foreign taxes that are below the foreign tax credit limit, they have zero incentive to minimize foreign taxes. This means that a profit-maximizing U.S. multinational will pay $99 in foreign tax rather than $100 to the U.S. treasury because it leaves that multinational more profitable by one dollar. So multinationals have no incentive to do what is in the national interest (i.e., reduce foreign taxes) and every incentive to enter into side deals with governments to pay a lot of creditable tax in exchange for some other favorable treatment.

The code does try to prevent this, for example with the specific economic benefit rule, but abuses are hard to police. It is not hard to imagine a U.S. multinational and its foreign host government finding it convenient in an audit to resolve all income tax issues in favor of the government and all excise tax issues in favor of the taxpayer.

The ability of a foreign government to take advantage of the U.S. crediting of foreign taxes was highlighted in *Tax Notes International* earlier this year (*Tax Notes Int'l*, Jan. 27, 2014, p. 267). For U.S. tax purposes, Puerto Rico is generally considered foreign (even though it is part of the United States). In 2010, in consultation with a former U.S. Treasury official, the financially troubled government of Puerto Rico imposed a new multibillion-dollar tax on multinational manufacturers doing business in Puerto Rico. In early 2011, the IRS issued a notice saying it would not challenge the creditability of the tax. This effectively meant that the federal government is subsidizing Puerto Rico.

Shaviro's sounding the alarm about the foreign tax credit does not yet figure prominently in the flurry of international tax reform activity inside the Beltway. Camp's plan imposes a minimum tax of 15 percent on foreign base company intangible income (FBCII). Mechanically, the proposal achieves this by generally imposing a 25 percent corporate tax rate and including 60 percent of FBCII in taxable income. All foreign taxes of FBCII (which cannot exceed 15 percent of FBCII) are creditable against U.S. tax. Taxpayers with effective foreign tax rates on FBCII of less than 15 percent will have no incentive to minimize foreign taxes. Thus, the harmful foreign tax credit problems that Shaviro has highlighted will still be with us if Camp's plan becomes law.

FTC Versus Deduction

Professor Reuven S. Avi-Yonah of the University of Michigan Law School strongly disagrees with Shaviro's assessment of the foreign tax credit. He acknowledges that limits and antiabuse rules for the credit are important. But criticism of the credit as too generous is unwarranted and claims about administrative problems are overstated, according to Avi-Yonah. Moreover, he points out that replacing credits with deductions is impractical because U.S. treaties require that the United States either exempt foreign-source income or provide foreign tax credits to provide relief from double taxation (*Tax Notes Int'l*, Feb. 3, 2014, p. 449). Other prominent commentators share this view. ''In light of U.S. treaty commitments, allowing only a deduction for foreign taxes, even on a burden-neutral basis, is not a plausible policy option in the reasonably foreseeable future,'' write J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay (*Tax Notes Int'l*, Jan. 4, 2010, p. 75).

Avi-Yonah points out that even without treaties, ''arguably, preventing double taxation through a credit or exemption has become part of customary international law.'' (See ''International Tax as International Law,'' *Tax Law Review*, 2004, p. 483.) He argues that it is important to preserve the foreign tax credit because it serves as an important safeguard against harmful tax competition that ''threatens to undermine the individual and corporate income taxes, which traditionally have been the main source of revenue (in terms of percentage of total revenue collected) for modern welfare states.'' (See ''Globalization and Tax Competition: Implications for Developing Countries,'' *Law Quadrangle Notes*, 2001, p. 60.)

Shaviro's focus on national welfare could lead to a loss of revenue for foreign governments. Whether this is good or bad depends largely on your view about tax competition. Avi-Yonah says unrestrained tax competition results in tax avoidance, which leads to significant base erosion that ''threatens the social-insurance safety net in developed countries at a time when such countries are facing a severe fiscal crisis.'' On the other hand, the pro-business contingent in Congress sees no reason to restrain multinational tax planning at the expense of foreign governments. This view came across loud and clear when the Clinton Treasury tried to rein in check-the-box rules in 1998 and the Obama administration proposed legislation to the same effect in its early budgets.

Baucus Options Y and Z

While there clearly is a consensus developing that foreign income of U.S. multinationals should be taxed at some intermediate rate between zero and the U.S. statutory rate, lawmakers are trying to figure out the best mechanism for achieving that result. This is entirely new ground for them.

In November 2013 Senate Finance Committee Chair Max Baucus released a draft that included two alternative mechanisms. The first, Option Y, is a minimum tax similar to that proposed by Camp. Consistent with their views about the foreign tax credit, upon which Option Y heavily relies, Avi-Yonah strongly endorsed Baucus's proposal while Shaviro has said that Option Y is ''not a great idea from a U.S. standpoint because it results in zero cost-consciousness with respect to foreign taxes, as one's foreign tax liability increases.'' According to Shaviro, we should be more worried about foreign tax credit abuse under Option Y than under current law because repealing deferral makes the foreign tax credit's problematic incentive effects even worse.

Baucus's Option Z alternative provides an entirely different mechanism for applying U.S. tax to multinational foreign-source income. It does not use the deduction-in-lieu-of-credit approach that Shaviro advocates, but it does include an essential feature that Shaviro would like to be part of U.S. law. Under Option Z, U.S. multinationals do not get a 100 percent matching payment from the U.S. treasury for payment of foreign taxes. Passive income, income related to sales into the United States, and other nonactive business income is fully taxed. Active foreign market income would be 60 percent taxable and 40 percent exempt.

Importantly, the 60 percent subject to U.S. tax can use only a prorated portion of foreign tax credits to relieve U.S. tax. Algebraically, if foreign tax credits relieve all foreign tax on the nonexempt portion of foreign income, the tax rate on that income is:

$$(t_{us} - t_f)*0.6 + t_f$$

or

$$0.6t_{us} + 0.4t_f$$

where t_{us} is the U.S. tax rate and t_f is the foreign tax rate. So while the U.S. multinational gets some relief from foreign taxes, it still has a net burden after U.S. credits of 40 cents for every dollar of foreign tax paid. The U.S. multinational will no longer be indifferent to paying foreign tax.

What is particularly intriguing about Option Z is that not only does it include all three of Shaviro's major criteria for improved taxation of multinational profits, it may also not violate tax treaties. Shaviro believes that Option Z may be treaty compatible because formally defined double taxation is avoided by dividing foreign income into two parts. The first is subject to classic worldwide taxation with tax credits and no deferral. The second is fully exempt from U.S. tax. So each component avoids violating treaties. Is the combination treaty compatible? If the answer is yes, Option Z would sidestep the major practical problem with Shaviro's deduction approach.

No Easy Answers

In addition to these core ideas, Shaviro provides other useful suggestions for Congress to consider. He proposes a transition tax rate between 5 and 20 percent on unrepatriated foreign earnings without allowing any use of unclaimed foreign tax credits. He would redefine the definition of a domestic corporation to include companies that are incorporated abroad but have U.S. headquarters (as proposed by Sen. Carl Levin, D-Mich.). He argues that inbound royalties should be domestic source because they ''presumably reflect U.S. economic activity in creating valuable intangibles.'' He suggests a well-designed formulary approach to allocating interest expense that would be less manipulable than current law.

In a mere 200 pages, Shaviro provides his readers with an invaluable guide through the economic and legal ideas that have framed the debate on international taxation for the last 50 years. But the literature review is ancillary. The true value comes from Shaviro's proposals and ideas. The subject matter is unavoidably complex, but he strives to boil down the material to the stuff that helps us achieve the task assigned in the title of the book. His explanations are clearly developed and rational so that readers with only a minimal background in international tax can follow even the most difficult issues. Unlike so much that is written on international tax, there is no ostensible pro- or anti-business slant and no political bias.

Stylistically, Shaviro writes in plain language that suggests all the highfalutin talk about international tax policy may just all boil down to common sense. On top of all its other virtues, Shaviro's book is timely: If lawmakers follow through on the ideas floated by Camp and Baucus, we may be experiencing the largest changes in U.S. international taxation since the inception of the income tax. If you are striving for a true understanding of the issues involved in this historic transformation, you are lucky Shaviro wrote this book when he did.

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EU Financial Transaction Tax to Take Effect in 2016

by Stephanie Soong Johnston

Finance ministers from the 10 EU member states that now support the controversial EU financial transaction tax (FTT) agreed on May 6 that the levy would take effect in 2016 despite strong opposition from countries such as the United Kingdom and Sweden and from the eurozone banking sectors.

According to a joint statement released during the May 6 Economic and Financial Affairs Council meeting, Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, and Spain reiterated their resolve to introduce an FTT enforceable in only their respective jurisdictions. The first stage of implementation should occur by January 1, 2016, at the latest, the statement says.

However, Slovenia, which was among the 11 member states that originally backed the proposal, did not sign the joint statement. According to Slovenian Finance Minister Uroš Čufer, the country is considering withdrawing from the initiative because the tax is no longer economically viable.

Recognizing that ''complex issues'' were raised while considering the ''technical, legal, and economic dimensions of the proposed tax,'' the group acknowledged that more technical work needs to be conducted. The ministers also expect to finalize the FTT proposal by the end of the year.

The group also agreed that the FTT should be implemented in a progressive manner, applying first to shares and some derivatives. Individual member states would also be allowed to tax other products not initially included under the FTT regime.

''Our commitment to the introduction of a financial transaction tax remains strong,'' the finance ministers said, adding that deliberations at the EU level and ''promising'' experiences with FTTs introduced in some member states, such as France and Italy, have confirmed their willingness to proceed with the initiative.

During a press conference, EU Tax Commissioner Algirdas Šemeta welcomed the participating member states' commitment to the FTT and their ''roadmap for its implementation,'' calling the move ''a welcome signal.''

''Of course, there is still quite a road to travel before the FTT is in place,'' Šemeta said in a statement. He said that the plan and pace are less ambitious than the European Commission had originally proposed but that ''every step forward on the Financial Transaction Tax is of significance.''