Corporate Inversions: An Economic Perspective

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Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify at this hearing. Corporate inversions have increased in recent years and raise a number of difficult and sometimes confusing issues. My testimony aims to provide background on both the institutional and economic aspects of inversions.

- Inversions Corporate inversions occur when firms move their legal headquarters out of the U.S. solely for tax purposes. Although they are not illegal and often make sense from the firm's perspective, inversions are particularly troubling from a policy viewpoint. Specifically, inversions allow firms not only to reduce or eliminate taxes on their foreign source income, but also to reduce or eliminate taxes on their domestic income. And they create these incentives without requiring any sort of change in "real" economic activity. The economic incentive for inversions is not due to the overall taxation of corporate income, it is due only to the statutory tax rate.

- Policy response: New laws should strive to eliminate the tax savings from inversions. Several legal options are available, but the most often-discussed options--reducing the effective tax rate on capital, moving to a territorial tax system or implementing fundamental tax reform--would not resolve the basic incentives for, or problems with, inversions.

- Territorial tax system: It is natural to consider more broad-based reforms to the tax system as a response, but moving to a territorial system is not a helpful way to deal with corporate inversions. Territorial systems generally make it more difficult to defend the domestic tax base from attack, since moving offshore results in a bigger tax savings under a territorial system than a world-wide system. That is, territorial systems enhance and legitimize methods of tax avoidance and evasion that should be curtailed under any sensible policy rule toward inversions. Going to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes. Thus, although there are reasons to consider territorial tax systems, stopping inversions are not among them.

- Fundamental tax reform: Replacing the corporate income tax with a value-added tax raises many important issues, including the impact on economic growth, the distribution of tax burdens, tax complexity and so on. A VAT, however, would not relieve the demand for corporate inversions by very much, if at all. Some businesses would see their statutory tax rate on income fall, which would reduce demand for inversions, but others would see their tax liabilities skyrocket under a VAT and thus would have increased incentives to shift profits out of the U.S.

Analysis[1]

I. International features of the U.S. tax system

[1] Due to time constraints in the development of this testimony, I do not provide references to particular publications used throughout the text. Rather, the sources listed at the end of the text include the publications that I referenced in developing these comments.

The United States taxes the world-wide income of its individual and corporate residents. Although this may sound simple in theory, in practice it raises a number of difficult issues.

To avoid having the foreign source income of its residents taxed twice, the U.S. provides a foreign tax credit for income taxes paid to foreign governments. To ensure that the credit does not reduce tax on domestic income, the credit cannot exceed the tax liability that would have been due had the income been generated domestically. Firms with credits above that amount in a given year have "excess" foreign tax credits, which can be applied against their foreign source income for the previous two years or the subsequent five years. To limit the ability of firms to use foreign tax credits for one type of foreign source income to reduce taxes on a different type of foreign income, the foreign tax credit limitation is calculated separately for nine different "baskets" of income.

Foreign branches of U.S. corporations are considered U.S. residents and therefore are subject to immediate taxation on foreign source income and eligible for the foreign tax credit. In contrast, controlled foreign corporations (CFCs, which are American-owned, separately incorporated foreign subsidiaries of U.S. corporations) are not considered U.S. residents. Their profits, therefore, are not taxable as long as the earnings are retained and reinvested locally in active lines of business. That is, U.S. income tax (and foreign tax credits) on such income is deferred until the income is repatriated to the U.S. parent.

Deferral of taxes and credits on retained earnings is intended to allow foreign subsidiaries to compete on a more even basis with local firms. To ensure that the benefits of deferral are used only to achieve that goal, the law provides complex and extensive limits on the ability to defer income. These rules (subpart F) make deferral available only on active business income that is reinvested locally. Certain forms of income are "deemed distributed" and thus denied deferral. These include passive income broadly defined, and including portfolio interest and dividends.

Because the tax treatment of domestic and foreign income differ under the U.S. system, firms have incentives to shift income to low-tax jurisdictions and deductions to high-tax jurisdictions. Income can be shifted via the transfer prices at which internal firm transactions are recorded. As a result, the U.S. imposes an extensive set of rules, that essentially require that transfer prices correspond to the prices that would have occurred in an arms-length transaction. These rules, however, are notoriously difficult to enforce and, in some cases, to interpret. The U.S. also imposes rules regarding the allocation of deductible expenses—such as research and development costs and interest payments—across jurisdictions. U.S. corporations may allocate only a portion of their expenses to domestic operations, with the rest being allocated against foreign income.

The U.S. generally treats exports as taxable income and imports as deductible expenses. But, relative to the rules above, the U.S. subsidizes exports in two ways. First, the sales source rule allows taxpayers that manufacture in the U.S. and sell outside the US to report 50 percent of the income from the sale as foreign income. For firms with sufficient excess foreign tax credits, this provision eliminates U.S. income tax on half of export sales. The U.S. also provides a subsidy for extra-territorial income. Taxpayers are allowed to exclude a portion of their income that is attributable to "foreign trading gross receipts" (FTGR) or net income from FTGR.

A firm cannot generally benefit from both the ETI regime and the sales sourcing rules. Firms with excess foreign tax credits will generally save more through the sales sourcing rules. The ETI rules thus mainly benefit taxpayers that do not have excess foreign tax credits—that is, those who either operate in low-tax foreign countries or do not have foreign operations.

The US taxes foreigners on income from their active business operations in the U.S. The U.S. imposes 30 percent withholding taxes on interest (but not portfolio interest, which is untaxed), royalties, and dividends that flow to foreigners, but frequently reduces or eliminates the withholding tax rate through bilateral tax treaties.

II. Background on inversions

"Inversions" refer to a complicated set of procedures that allow firms not only to reduce their taxes on foreign source income, but to reduce taxes on domestic income as well. Here is how a typical inversion works. First, a domestic corporation creates a foreign parent in a country like Bermuda—which has no income tax and no tax treaty with the United States. This allows it to eliminate U.S. taxes on foreign source income. Second, the domestic corporation sets up a foreign subsidiary of the foreign parent in a third country—often Barbados or Luxembourg—that has a treaty with the United States and has lax residency requirements. To qualify as a resident of Barbados, for example, the company just has to meet there once a year. The reason the third country and its U.S. tax treaty are important for this scheme is that the tax treaty eliminates withholding taxes on flows of royalties or interest payments from the U.S. to the third country. Thus, once the funds are transferred to Bermuda, which does not have a treaty, there is no access to the funds by U.S. government.

With the new foreign parent in place and the existing foreign subsidiaries turned over to the foreign parent, the inversion works in two steps. First, the American company "sends profits" to the foreign subsidiary in the third country. Sending profits means the American company makes payments to the subsidiary that are deductible under U.S. tax law. Note that this reduces the American company's American taxes on domestic operations. These payments could include interest payments, royalties for use of the company logo, and so on. No taxes are withheld on these transactions because of tax treaties with the U.S. and the third country. Second, the foreign subsidiary then sends the funds to the foreign parent in Bermuda, which has no income tax. As a result, taxable American profits have been shifted to Bermuda and escape U.S. taxation.

III. Inversions: Notes on economic analysis

This section discusses several economic aspects of inversions. First, inversions have nothing to do with a lack of competitiveness of our tax system. Competitiveness, if it means anything, should refer to the <u>effective</u> rate of taxation on businesses. The effective rate of taxation depends on the statutory tax rate, depreciation rules, whether the corporate and personal taxes are integrated. The ETR does not affect the incentive for inversions. Rather, inversions depend on the <u>statutory</u> tax rate. That is, U.S. firms have incentives to shift profits out of the U.S. because of the 35 percent statutory corporate tax rate. *This would be true even if* *investments were expensed, which would reduce the effective tax rate on capital income to below zero, since some investment is debt-financed.*

Second, there is a natural break on the tendency of firms to invert. Firms that invert create forced stock sales by their shareholders, who have to pay capital gains taxes on those sales. Thus, the presence of substantial capital gains and/or a high rate of tax on capital gains would inhibit inversions. Given the large declines in the stock market recently, the number of companies whose shareholders have large capital gains would have diminished over the last few years. Thus, the decline in the asset prices could encourage inversions by reducing or eliminating the capital gains taxes that shareholders would have to pay. Equally important, a low capital gains tax rate makes it easier for firms to invert, since it creates a smaller tax liability upon forced realization. Other things equal, a higher capital gains tax rate would reduce the incentive for firms to invert.

IV. Territorial versus world-wide taxation

As noted above, the U.S. operates its tax system on what is essentially a world-wide basis. No country, though, operates a pure territorial or world wide system. About half of OECD countries operate systems that are essentially territorial, while the other half operate systems that are basically world-wide in nature. In theory, the differences between a pure world-wide system and a pure territorial system are large. A world-wide system taxes all income of residents regardless of where it is earned, gives credits for foreign income taxes paid, and defers taxation of foreign subsidiaries until the funds are repatriated. As noted above, these rules lead to complex provisions regarding foreign tax credit limitations, anti-deferral rules, and income and expense allocation. In contrast, a territorial system only taxes income earned within the country's borders and only allows deductions for expenses incurred within the borders. While a territorial system sounds simpler in theory, in practice it often turns out not to be. First, territorial systems have to define the income that is exempt. In practice, territorial systems tend to apply only to active business income. Even within that category, the territorial system may only exempt active business income (a) if it faces taxes above a certain threshold level in the host country, (b) from a certain type of business (e.g., e-commerce), and/or (c) from certain countries. Second, the treatment of non-exempt income must be specified. Third, the allocation of income and expenses across jurisdictions takes on heightened importance in a territorial system. For all of these reasons, territorial systems end up with complex rules regarding foreign tax credits, anti-deferral mechanisms, and allocation of income and expenses.

Although the two systems are not as different in practice as in theory, they do have different tendencies that are worth noting. First, in a world of sophisticated and mobile transactions and firms, neither system is easy to operate. A territorial system is based on being able to define the geographic area where income is earned and expenses are incurred. A world-wide system is based on being able to define the geographic area where a corporation is resident. Both concepts are becoming increasingly difficult to assign and monitor and increasingly easy for firms to manipulate.

Changing to a territorial system would be a curious and flawed response to corporate inversions (and corporate shelters more generally). Territorial systems make it *harder* to protect the domestic tax base. In a world-wide system, if firms go abroad, their income is still taxable. In a territorial system, it is not.   Thus, going to a territorial system as a response to inversions would not make the underlying problem go away, it would simply ignore it by legitimizing and enhancing opportunities for behavior that should instead be prohibited or curtailed. It would be like legalizing a criminal activity as a way of reducing the reported crime rate.

Finally, it should also be noted that territorial systems are not generally much simpler than world-wide systems, for reasons noted above. In addition, moving to a territorial system may generate difficult transition issues with respect to deferred income, deferred losses and accumulated tax credits in the old system. It may also require the renegotiation of numerous tax treaties. For all of these reasons, although there may be many reasons to consider a territorial tax system , switching to one does not seem to be a useful way to address the problems raised by export subsidies or inversions.

V. Fundamental tax reform

In recent years, increased attention has been given to fundamental tax reform. Usually, this refers to the idea of eliminating the individual income tax, corporate income tax, and estate tax (and sometimes payroll and excise taxes, too) and replacing them with broad-based, low-rate taxes on consumption.

Four main alternatives have emerged in recent years. A national retail sales tax (NRST) would tax all sales between businesses and households. A value added tax (VAT) would tax each firm on the difference between the sales of goods and its purchases of goods from other businesses. (Alternatively, firms pay VAT on their sales of goods and receive tax credits for the VAT that they paid on their input purchases.)

The NRST and VAT are similar in economic substance. First, the retail price of a good represents the entire value added of that good. Thus, the NRST collects all tax on the value added at the final sale to the consumer. The VAT, in contrast, collects the same amount of tax (if VAT and NRST rates are the same), but collects it at each stage of production. Second, both are consumption taxes.

The similarity in structure between the VAT and the NRST indicate why it is appropriate for European countries to rebate VAT on exports. No one would expect a country to charge a retail sales tax on its exports. Thus, by rebating the VAT payments made up to the point of exports, European countries are giving firms the same treatment under a VAT as they would get under a retail sales tax.

A third approach to fundamental tax reform—the flat tax—is probably the most well known and the best conceived. Essentially, the flat tax is a VAT that is divided into two parts. The flat tax would tax non-wage valued added at the firm level and wages at the household level. There are some other differences (the VAT taxes pension contributions when made, the flat tax taxes pension contributions when they are consumed; the VAT is destination-based whereas the flat tax is origin-based), but essentially the flat tax is a two-part VAT. This means that the flat tax is also a consumption tax, though it may not appear that way to consumers or businesses.   A

A fourth approach is the so-called USA (unlimited saving allowance) tax, which combines a personal consumption tax and a VAT on businesses. Since both of these taxes are consumption taxes, the overall system would be a consumption.

In considering replacements for the corporate income tax, however, there are only two fundamental reform options: the NRST and the VAT. The flat tax and USA tax would not be implemented without repeal of the individual income tax, too. For purposes of this testimony, therefore, I focus on the NRST and VAT. Moreover, since all European countries that experimented with national retail sales taxes eventually switched to a VAT, I focus exclusively on switching the corporate tax to a VAT in this testimony.

Replacing the corporate tax with a VAT raises numerous issues. The main result, however, should be clear. The VAT would not be a panacea and although it offers the potential for improvement, it provides no guarantees of that, and indeed it creates several other identifiable problems.

Although VATs can be described simply (see above), in practice VATs are extremely complex. Thus, one should compare existing corporate taxes to VATs as they would likely be created, not as they exist on paper.

Basically, the broader the tax base (i.e., the fewer the number of zero-rated or exempt goods), the lower the tax rate can be and (with a few exceptions) the simpler the tax system can be. But if the VAT is the only tax affecting corporations, one can expect to see pressure to allow corporations to deduct health insurance payments, payroll taxes and state and local taxes as they currently do. If these deductions were allowed, the required rate would jump significantly. This in turn would create pressure to exempt certain goods—e.g., food, health insurance, housing—which would raise rates further. In addition, items like energy subsidies and other forms of "corporate welfare" could be implemented through the VAT. Unless some mechanism were developed to keep such subsidies out, the VAT base would be eroded like the corporate base currently is and rates would be quite high.

Even if the VAT base is kept broad (and it is not in most European countries), there would be a fundamental conflict in the U.S. system with having an individual income tax but a VAT at the corporate level. Essentially, income could be sheltered indefinitely via retained earnings in corporations. This problem does not arise in Europe because European countries have a corporate income tax as well as a VAT.

Also, under a VAT, firms have incentives to report any cash inflow as an interest receipt and any cash outflow as a deductible expense. This would give firms incentives, in their transactions with government, non-profits, and foreigners, to relabel cash flows. Zodrow and McLure in a 1996 paper declared that this feature of the flat tax (it is also a feature of the VAT) offered unacceptable opportunities for abuse. Again, these issues do not arise with VATs in Europe because those countries have corporate income taxes (that tax interest income).

Switching from the corporate income tax to a VAT would likely be regressive. The ultimate incidence of the corporate income tax is unclear, but most estimates suggest it is borne by capital owners. The VAT, in turn, would be borne by consumers. In addition, the appearance of changes in distributional effects might prove very important: it would be hard to make the political case, for example, for a tax that raised the cost of food and health care for low-income families in order to reduce the costs for a multinational corporation to invest in a foreign country.

The impact on growth of a switch would likely be positive, if the VAT were implemented in a simple broad-based way. But if a U.S. VAT ends up looking like a European VAT, the net effects on growth may be substantially smaller. Many papers suggest that replacing the *entire* U.S. tax system with a *clean, broad-based, low-rate* consumption tax would raise the size of the economy by about 1-2 percent over the next 10-15 years. Certainly, replacing only one small portion of that system—the corporate tax—with a complex VAT would have significantly smaller effects.

Unlike the current corporate or individual business taxes, the VAT does not attempt to tax profits as commonly understood. Changing the entire logic and structure of business taxation will create several situations that will be perceived as problems by taxpayers and firms, even if they make perfect sense within the overall logic of the VAT. First, some businesses will see massive changes in their tax liabilities. For example, the developers of the flat tax, Hall and Rabushka, note that General Motors' tax liability would have risen from $110 million in 1993 under the current system to $2.7 billion under a 19 percent flat tax—and the flat tax offers deductions for wages, which a VAT would not.

Some businesses with large profits will pay no taxes. This will occur because calculations of profit (before federal taxes) include revenue from all sources and subtract expenses for a variety of items, including fringe benefits, interest payments, payroll taxes, and state and local income and property taxes. In the VAT, only revenues from sales of goods and services is included (financial income is omitted) and expenses on fringe benefits, interest payments and other taxes are not deductible. Thus, firms may be in the enviable position of reporting huge profits to shareholders, while paying no federal tax. This sort of situation makes perfect sense within the context of the VAT. However, in the past, precisely this situation led to the strengthening of the corporate and individual alternative minimum taxes, which are universally regarded as one of the most complex areas of the tax code. It is hard to see why those same pressures would not arise in the VAT.

Conversely, some firms with low or negative profits may be forced to make very large tax payments. Again, this makes sense within the context of the VAT, but will not be viewed as fair by firm owners who wonder why they have to pay taxes in years when they lose money and who will push for reforms.

Finally, converting the corporate income tax to a VAT would raise difficult transition with respect to unused depreciation allowances, interest payments on previously incurred debt, net operating loss carryovers, excess foreign tax credits and so on.

Turning to international issues, the generally lower tax rate on a VAT would cause firms to set transfer prices to shift some income into the U.S. But even with a lower-rate VAT, there would be big incentives for corporate inversions, especially for firms whose tax burdens rise under a VAT relative to the current system.

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