Moving to a Territorial System and Reforming the Corporate Tax

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As the Volcker task force evaluates base-broadening ideas, some important and meritorious reforms are unfortunately off the table. One example would be (after the housing market workout has eased) replacing the home mortgage interest deduction with a smaller, capped subsidy for homeownership that is unrelated to homeowner debt and takes the form of a refundable credit. Surely we've learned from the financial crisis that encouraging excessive homeownership (giving people undiversified asset portfolios), financed by excessive leverage, is undesirable.

On the business side, it's unfortunate that the Obama administration led off with international tax proposals whose long-term feasibility is undermined by the difficulty of sustaining residence-based taxation of corporate entities. Investors can all too easily avoid those taxes by investing through non-U.S. entities, suggesting that in the long run, the United States may need to follow the worldwide trend toward territorial taxation of active business income.

Tax reformers should keep in mind, however, that under the current international tax rules, U.S. multinationals have invested more than $10 trillion abroad, perhaps including as much as $1 trillion of what they designate for accounting purposes as permanently reinvested earnings. There is no reason those investments should reap a windfall transition gain from a shift to exemption. The most straightforward way to avoid the windfall would be to impose a one-time tax (the payment of which might be deferrable with interest) on the accumulated earnings and

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profits of U.S. companies' foreign subsidiaries.[1] If that is politically or administratively unfeasible, a more complicated fallback, based on William Andrews's similarly motivated effort to limit windfalls from the adoption of corporate integration, might involve limiting dividend exemption to a normal return on post-effective-date new equity.[2]

Shifting to a territorial system should also be accompanied by improving the source rules so that companies cannot as easily shift income outside the United States. Several important studies have recently explored how that might be done.[3] Key details should include relying on objective factors such as worldwide sales ratios[4] — whether or not the method used is called formulary apportionment[5] — and applying the system as uniformly as possible to multinational groups headed by U.S. companies on the one hand and foreign companies on the other.[6] That would make corporate residence as irrelevant for tax

[1]The tax on repatriation of those earnings under present law would have been partly offset by the allowance of foreign tax credits. One rough-justice simplification approach, in lieu of allowing the credits, would be to simply lower the tax rate to reflect average foreign tax credit levels. Thus, if the average foreign tax rate on foreign earnings is about 20 percent, the one-time transition tax on accumulated earnings and profits might deny credits but apply at a 15 percent rate.

[2]*See* American Law Institute, Federal Income Tax Project, ''Reporter's Study Draft — Subchapter C (Supplemental Study)'' (1989). Obviously, such a proposal would raise major design and feasibility issues that cannot be explored here.

[3]*See, e.g.*, Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* (Washington, D.C.: AEI Press, 2001) (proposing a shift to dividend exemption and raising revenue due to changes to source rules for interest and royalties); Reuven Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' *Fla. Tax Rev.* (2009).

[4]*See* Avi-Yonah, Clausing, and Durst, *supra* note 3, proposing that the United States unilaterally adopt formulary apportionment in determining the source of income, but that sales be the only weighting factor used (as distinct from the common practice of also using assets and payroll) on the grounds that it is less manipulable.

[5]*See* James M. Wetzler, ''Should the U.S. Adopt Formulary Apportionment?'' 48 *Nat'l Tax J.* 357, 361 (1995) (suggesting that ''the competing models of formula apportionment and arm's-length pricing are destined to converge'' because transfer pricing relies on quantitative data, while under apportionment, ''there would be pressure to develop specially tailored formulas for particular industries, to preserve existing tax incentives for exports and research, and to refrain from applying a formula across affiliates that were not highly integrated or had very different profit margins'').

[6]*See* Avi-Yonah, Clausing, and Durst, *supra* note 3, thus applying formulary apportionment, and noting that under present law and practices, corporate groups headed by foreign companies often must share worldwide group information with the IRS regarding the resolution of transfer pricing controversies.

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purposes as it is economically. However, because this proposal would amount to raising the tax burden on business investment in the United States, rather than simply preventing the use of tax planning to recharacterize income generated here as foreign source, it should be accompanied by lowering the U.S. corporate tax rate.

A further tax reform issue worth addressing, given the contribution that excessive debt levels made to the worldwide financial crisis, concerns the existing corporate income tax bias that generally favors debt over equity. Lowering the U.S. corporate tax rate would immediately reduce the tax bias in favor of debt, and indeed would create tax clienteles that would prefer investing via equity rather than debt, as long as they were confident that they could avoid the shareholder-level tax.[7] That in turn would raise concerns about the use of corporate entities as tax shelters to avoid application of the top individual marginal rates. One response might be to enact a corporate cost of capital allowance for equity as well as debt (further addressing debt bias), accompanied by an automatic inclusion for the holders of both types of financial instrument.[8] A second response might be to enforce reasonable compensation rules for owner-employees on the low end as well as the high end — so that, for example, the next Bill Gates could not cause the profits from his labor to be taxed only at the reduced corporate rate, rather than at the top individual rate, via self-payment of salary below arm's-length levels.[9] ■

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[7]This insight was first thoroughly developed in Merton H. Miller, ''Debt and Taxes,'' 32 *J. Finance* 261 (1977). I discuss it at length in Daniel N. Shaviro, *Decoding the U.S. Corporate Tax* (Urban Institute Press, 2009).

[8]*See* Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (Hamilton Project, 2007).

[9]Guidance on the possible design of those rules might be obtained from the study of Nordic dual income tax systems, which may treat corporate profits in excess of a normal return as indicating the presence of undercompensated labor income. *See, e.g.,* Peter Birch Sorensen, ''The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada,'' 55 *Canadian Tax J.* 557 (2007). I am grateful to Edward D. Kleinbard for bringing this literature to my attention.

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