Can Corporate Integration Jump From Understudy to Center Stage?

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By Andrew Velarde

With tax reform negotiators aiming to reduce the corporate rate significantly while still maintaining revenue neutrality, it’s possible that corporate integration — a vehicle that has been backstage for several years — is ready to play a central role in reform talks, although stakeholders are in some disagreement over how far additional base erosion protection measures should go under such a system.

“Now that we’re in a situation where the border adjustment [tax] has been declared dead, we’re back to the original problem of how do you craft rules that address base erosion but don’t disadvantage U.S. companies,” Peter Merrill of PwC said. “While we were debating this a couple of years ago, a number of us had the idea that maybe corporate integration would be a twofer: Corporate integration would address both the disparity between corporate and noncorporate business, and at the same time it would address base erosion.”

In July a senior White House official told Tax Analysts that a 15 percent rate by itself would prevent base erosion, because companies could not justify tax planning around smaller rate differences available globally. The White House official acknowledged that the Trump administration was working with Congress to structure stand-alone anti-erosion measures, however. On August 31, Treasury Secretary Steven Mnuchin noted that a detailed tax reform blueprint would be released in the coming weeks.

Bret Wells of the University of Houston Law Center, however, sees base erosion measures as necessary, even if the corporate tax rate were to be substantially cut. “As long as there is a meaningful corporate tax — and 15 percent is still a meaningful corporate tax — there is still going to be a need to be concerned about base erosion strategies that shift profits from the U.S. to an offshore location,” Wells said. “Any tax savings that can be done through affiliated companies that someone controls, there’s just not a friction cost.”

The cost of a full rate drop from 35 percent to 15 percent, which the administration advanced in its one-page tax reform outline in April, could be enormous — an estimate from the Tax Foundation puts it at $2.1 trillion over 10 years. If instead the rate were lowered to 25 percent and then a corporate integration partial dividends paid deduction (DPD) operated as the vehicle to lower the effective corporate tax rate the last 10 points, from 25 percent to 15 percent, it could be substantially cheaper, a congressional aide has argued, without quantifying the difference.

Simply lowering the U.S. tax rate to protect the U.S. base is misguided, according to Steven M. Rosenthal of the Urban-Brookings Tax Policy Center. Reducing tax rates may reduce some of the savings from tax planning, but much will still remain. And even with a dramatic rate drop, the
United States may still find itself behind other jurisdictions. Ireland, for example, offers a 6.25 percent rate for some intangible income and 12.5 percent in other instances. But if not Ireland, plenty of other countries could undercut the United States, Rosenthal argued.

A move to territoriality, which National Economic Council Director Gary Cohn confirmed would be proposed in an August 24 interview with the Financial Times, only worsens the possibility of base erosion if proper anti-base-erosion measures aren’t implemented, a Senate staffer acknowledged in July. The staffer noted the delicate balancing act required in strengthening subpart F provisions while avoiding a system that resembles worldwide taxation.

As far as it being a cure-all, Rosenthal also said, “The suggestion [of] shifting from a worldwide tax system to a territorial tax system for multinationals has always struck me as bizarre.” Exempting foreign profits from U.S. taxation would just invite more profit shifting abroad. And implementing proper base erosion protections is easier said than done, Rosenthal added, pointing to the OECD’s years-long base erosion and profit-shifting project. Drafting the rules is difficult, and administering them “virtually impossible,” he argued.

Moving the Goal Posts

The House tax reform blueprint’s destination-based cash flow tax proposal dominated the reform conversation since shortly after its release in June 2016 until it was declared dead in July. Now lawmakers may be looking to alternatives, and Senate Finance Committee Chair Orrin G. Hatch, R-Utah, and his staff have continued to quietly work on an integration proposal, which Hatch has been championing since a December 2014 tax reform report. But because lawmakers have not put forward any written proposals on corporate integration, stakeholders are left reading tea leaves from comments given by staffers to glean favored paths forward for the reform vehicle. That all may change soon, though, with at least one lobbyist speculating that an integration proposal could come in September.

It is looking increasingly likely that the Senate is contemplating a 40 percent dividends paid deduction without withholding, which would represent a significant shift from an earlier idea to offer full DPD with withholding on both dividends and interest at a nonpreferential 35 percent rate that could have served as a significant pay-for for the DPD. That earlier idea was met with stiff political resistance from some who viewed it as a tax increase on tax-exempt shareholders, including pensions and retirement plans. The rumored plan now could resemble much more closely a 1984 integration plan that called for a 50 percent DPD.

It’s possible not all businesses could benefit equally from a DPD. The 1984 plan noted that some industries, including communications and utilities, may fare better under its provisions than others, because historically they distribute a large fraction of their earnings as dividends, while other industries require earnings to be retained. Differentiating between winners and losers may have helped doom the border-adjustable tax, which while lauded by some industries with heavy emphasis on exports, was opposed by others such as retailers.

Rosenthal recommended a “drafting solution” for integration that would allow corporations to deduct retained dividends as long as shareholders pay tax on those deemed dividends, akin to a dividends reinvestment election. He added that the goal would be to move closer to a system that taxes corporate income once, whether for a business under the dot-com model of
reinvestment or a utility that pays out a high percentage of profits.

The Evidence

Citing a study by Dan Amiram of Columbia University, Andrew Bauer of the University of Illinois, and Mary Frank of the University of Virginia, Merrill argued that evidence points to decreased tax base erosion under implementation of a corporate integration system using shareholder imputation credits, similar to what is employed in Australia.

“The logic behind that is, shareholders only get a credit to the extent the corporation paid Australian tax. If the corporation shifts a lot of their income abroad . . . then the shareholder is going to get a smaller credit and owe more tax on the dividend,” Merrill said. The average gap between statutory rates and the worldwide effective tax rate increased by 9 percent when similar imputation credit systems were repealed within the European Union, he added.

But a 40 percent DPD follows a different integration model than what is used in Australia. And Merrill argued that, intuitively, a partial DPD wouldn't be as effective at preventing base erosion as would a full version of the proposal that was contemplated earlier.

The 40 percent DPD could still be somewhat effective and at a substantially lower cost than a 40 percent reduction in the corporate tax rate, Merrill continued, for two reasons. First, it would apply only to distributed income. Merrill noted that U.S. corporations distributed only about one-third of their positive domestic book income from 2010 to 2014 as dividends. Second, it would avoid a difficult political fight and potentially expensive proposition in which passthroughs would seek corresponding lower rates from any direct drop in the corporate statutory rate.

“What would companies do if we had a world where if they paid a dividend, they get a 40 percent deduction, and if they use the same income to do a buyback, they don’t get a deduction? My guess is, instead of buybacks we’ll see . . . more special dividends,” Merrill hypothesized. “It does seem to me quite plausible that a lot of companies will be saying the comparison I should be making is not 25 [percent] in the U.S. to whatever I pay abroad, but 15 [percent]. And that definitely reduces the incentive to shift income offshore.”

Wells argued that on a macro basis, the DPD’s attempts to collect corporate tax once — through a partial DPD that attempts to approximate the proportion of tax-exempt shareholders — could work. But he added that under either version of integration contemplated, anti-erosion methods would still be necessary because royalty and interest-stripping transactions paid to low-tax jurisdictions would otherwise remain a concern.

“We should expect that people would enjoy having the lower tax rate in the United States — that’s great — but then they would strip profits from that place down even further,” Wells said. “If I can make a tax-deductible payment not subject to any withholding going to someone that has zero tax, that is a problem under any iteration that has been discussed.”

Rosenthal said that by his estimates, tax-exempts, including foreign shareholders, hold about 75 percent of U.S. equities. A 40 percent DPD alone would not ensure one level of collection, and the United States still would need to bolster taxation at the shareholder level, he said. Rosenthal has argued that his estimates, which he has presented as testimony at a Senate
Finance Committee hearing, should be taken into account when designing a revenue-neutral corporate integration system.

“There’s lots of room for improvement to tax corporate earnings, but I’m not sure there’s the political will to improve it. My concern is we might end up going in the wrong direction — just relieving corporate earnings of tax partially or completely, which would just create new anomalies,” Rosenthal said. He added that a DPD, with a minimum tax on foreign profits, might lead corporations to leave fewer profits abroad, because the corporations might distribute their foreign profits to their shareholders to reduce the minimum tax.

Camp Revisited

One of the more detailed proposals on base erosion and international tax reform to come out in recent years and one that has drawn renewed interest since the death of the border-adjustable tax is the 2014 tax reform plan from Dave Camp, then-chair of the House Ways and Means Committee. The plan called for a move toward a territorial system with a 95 percent dividend exemption on foreign business income. Included were provisions to strengthen subpart F and limitations on interest expense deductions allowable under section 163. One provision designed to limit earnings stripping would have lowered the excess interest expense threshold for allowable interest deductions to foreign related parties from 50 percent of adjusted taxable income to 40 percent for taxpayers with a debt-to-equity ratio in excess of 1.5 to 1 while also limiting carryforwards.

The Joint Committee on Taxation scored that haircut as bringing in a relatively modest $2.9 billion over 10 years. By comparison, another change to section 163 that would have denied an interest expense deduction for U.S. shareholders that are members of worldwide affiliated groups with excess domestic indebtedness (defined as the lesser of 110 percent of the worldwide group or net interest expense in excess of 40 percent adjusted taxable income) would have increased revenue by $24 billion over 10 years.

Wells did not see the current limitations on interest deductions under the code nor Camp’s proposed modest revisions as adequate. “I can drop [the rate] to 15 percent and I can strip 40 percent or 50 percent of those profits under [section] 163(j) to a foreign affiliate that pays zero. Why pay a 15 percent overall rate on the profits when I can strip half of the profits and pay 7.5 percent on the total?” Wells asked. “We cannot chase the rate down to a tax haven rate and fund the government.”

Both interest deduction anti-base-erosion measures pale as revenue raisers in comparison with Camp’s contemplation of changes to the subpart F regime such that foreign personal holding company income, foreign base company sales income, and a new category of subpart F income — foreign base company intangible income (FBCII) — would be subject to U.S. tax if they are subject to low foreign tax rates of 25 percent, 12.5 percent, and 15 percent, respectively. FBCII is defined as the excess of a foreign subsidiary’s gross income over 10 percent of its adjusted basis in depreciable property. Those provisions were predicted to bring in $115.6 billion over 10 years.

That proposal has not been without criticism, however. In August 2016 the American Institute of CPAs questioned whether the “intentionally broad base of FBCII” might
be viewed as a “de facto minimum tax,” similar to the Obama administration’s proposal of a 19 percent tax on current earnings and profits of CFCs, and added that it might result in the inclusion of income that is subject to a foreign effective rate of less than 15 percent. They wondered whether the residual method as a proxy on return on tangible assets was the best estimate of intangible income, if 10 percent adjusted basis of fixed assets was equitable, and if fair market value of assets should be considered.

The Alliance for Competitive Taxation (ACT) also recently criticized the theoretical imposition of a foreign minimum tax on active business income of U.S. companies as resulting in “unintended and adverse consequences.” It foresees increased inversions and foreign takeovers and increased taxes paid to foreign governments that would set their rates at the minimum tax rate. ACT also argued that any limitations on interest expense should be in line with international thin capitalization norms and shouldn’t impose “across-the-board disallowance” of deductions since that might further disadvantage domestic companies in acquisitions and would discourage locating debt-financed manufacturing plants in the United States. ACT previously endorsed the House Republicans’ blueprint with its border-adjustable tax.

“Fourteen of the OECD member countries have CFC rules, and they all generally have active business exceptions. Taxing active business income that exceeds a 10 percent rate of return on the basis of tangible personal property . . . created great concerns, particularly from the U.S. companies that have foreign competitors that have high IP income as well. Pharmaceuticals is a poster-child for that,” Merrill said. A move to territoriality with a minimum tax still presents significant competitive disadvantages for U.S. companies, he added.

Wells argued that proposals on a minimum tax could serve as “a backstop behind the catcher” to other base erosion techniques. But they shouldn’t be the primary vehicle to prevent erosion, he said, because something like the Camp subpart F measures would come up short of the mark if enacted alone since they took a U.S.-centric approach to the problem.

“If the whole world were owned by the United States, a minimum tax is a great idea. . . . Problem is that is a minority of global companies today,” Wells said. “It will excuse from the room all the inverted companies, all the foreign-based multinationals, and give them an advantage versus all their U.S. counterparts,” he said. Wells added that a better measure would be to institute a base-protecting surtax on cross-border payments from a U.S. payor to a related foreign entity.

“It can’t be that we treat people in our own sandbox differently. We shouldn’t punish foreign-based multinationals, but we should not treat the foreign-based multinational better than we treat our own children . . . or we should expect our own kids to want to dress up to be expatriated inverted companies,” Wells said.

“Congress might pursue a territorial system, with a zero or minimum tax on foreign earnings, coupled with a package of anti-base-erosion rules — or a delegation to Treasury to write such rules — and declare victory,” Rosenthal said. “That’s a political path, which I would label wishful thinking, in light of the difficulties in creating effective anti-base-erosion rules.”

Rosenthal speculated that to the extent there is true reform and not simple rate cuts, it might come through corporate integration and base erosion efforts. But Rosenthal added that good policy may ultimately “take second chair” to good politics.
“The problem with the notion of tax reform is you have winners and losers. And the losers object loudly,” Rosenthal said. “Today we are in a political environment where giveaways are favored and sacrifice is avoided.”