POLICY · PAPER

National Taxpayers Union Foundation Issue #179 • September 14, 2017

What's the Deal with Base Erosion?

NTUF Policy Paper #179

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Overhauling the nation's tax system involves many difficult-to-grasp but important details with a language all their own. Recaptures, subpart F, MACRS … the list of terms goes on and on. National Taxpayers Union Foundation's (NTUF's) "What's the Deal with Tax Reform?" series is designed to provide non-technical explanations of highly technical tax policy issues – and options for addressing them.

Introduction: Base Erosion Explained

The United States' corporate tax base has been slowly shrinking. Partly because of congressional tinkering with the corporate tax code, and partly because of businesses' responses to what they see as increasingly onerous burdens with the U.S. system, "base erosion" has become a significant concern for policymakers. This is especially the case in light of the consensus among tax experts that the tax base should be as broad as possible, with rates that are as low as possible. In the United States in particular, the fact that this has become an issue is hardly surprising; our corporate tax rate is the third highest in the world, at around 39 percent.[1]

The complexity of the tax code incentivizes corporations to retain armies of tax lawyers and consultants to reduce their tax liabilities below the excessively high statutory rate. NTUF has previously estimated total tax compliance costs to be at least $262.6 billion, roughly three-quarters of which is not related to 1040 personal tax returns.[2] One of the methods that these tax lawyers and consultants use to reduce their parent corporation's tax liability is to engage in profit-shifting maneuvers that erode the tax base by putting dollars outside the reach of American tax officials.

Any credible tax reform plan must address these issues. Dramatically reducing complexity and lowering punitively high tax rates would effectively diminish the understandable incentive for businesses to engage in complex tactics to minimize their tax burden. Furthermore, reform should encourage multinational corporations to repatriate some of the roughly $2-3 trillion in profits held overseas.[3]

Recent Responses to Base Erosion

In the absence of congressional action in 2016, the Internal Revenue Service (IRS) issued economically harmful regulations aimed at addressing the occurrence of corporate inversions, which involves a U.S.-based business relocating its headquarters overseas so as to subject more of its income to lower foreign tax rates. These overly broad regulations entailed extensive compliance costs and would have further harmed the international competitiveness of American corporations.[4] In response to taxpayer concerns over these burdens, the new administration put a hold on the implementation of these regulations until January of 2019,[5] but they are a reminder of the potential effect of continued congressional neglect of tax base erosion matters.

Nor is the IRS the only organization outside of Congress seeking to address base erosion. Several years ago, the Organization for Economic Co-operation and Development (OECD) began a Base Erosion and Profit Shifting (BEPS) project. This project eventually culminated in a multinational treaty which aimed to create a certain set of shared standards for enforcement against base erosion across all OECD countries. Though the United States is not currently a signatory, it faces substantial pressure by the OECD to sign on to the treaty. The BEPS multilateral treaty would subject the United States to onerous regulations that would harm American corporations,[6] and would even represent a threat to the private information of American individuals and corporations.[7]

Future Policy Options

All tax systems contain measures to prevent base erosion. While low tax rates ease the problem of leakage of income to other jurisdictions, recent analysis from the Tax Foundation shows that even nations with highly competitive corporate tax policies are concerned with base erosion.[8] The goal of this NTUF report, which is intended to be informational rather than prescriptive, is to examine the most prominent policy options for addressing base erosion and the impact they would have on the economy and the deficit.

The first such plan, the “border adjustment tax” contained in the June 2016 House GOP tax reform blueprint,[9] was the subject of controversy and intense lobbying before ultimately being shelved by congressional leaders. In its absence, several existing proposals reviewed here, including former Congressman Dave Camp’s “Option C” plan, will likely get additional scrutiny as legislators proceed with efforts to reform the Tax Code.

Overview of Base Erosion Options

	2016 House Plan	Option C	Option D	Renacci's Plan	Stop Tax Haven Abuse Act
Deemed repatriation	◇	◇		◇	
Shift from global to territorial tax regime	◇	◇	◇	◇	
Cuts to top marginal corporate income tax rate	◇	◇		◇	
Reduction to tax rate for pass-through entities	◇	◇			
Addresses intangible income	◇	◇			
Replaces corporate income tax with VAT				◇	
Simplifies tax code	◇	◇		◇	
Focuses on enforcement over comprehensive reform					◇

Effects	2016 House Plan	Option C	Option D	Renacci's Plan	Stop Tax Haven Abuse Act
GDP growth (over first 10 years)	9.1%	1.3%		5.6%	
Jobs growth (over first 10 years)	1.7 million	685,000		1.9 million	
Average wage growth (over first 10 years)	7.7%	0.7%		4.4%	
Effect on deficit (over first 10 years)	$191 billion	$1.6 billion		-$695 billion	-$278 billion

Border Adjustment Option/Destination-Based Cash Flow Tax

The House GOP's "border adjustment tax" would have represented the most significant directional shift in the history of U.S. corporate taxation. Although Republican leaders announced they would "set this policy aside in order to advance tax reform," it is nonetheless valuable to examine its contents to help frame the discussion of other options.[10]

In June of 2016, House Republicans released a "blueprint" of their proposed tax plan under a unified Republican government. A notable inclusion in the blueprint was a proposal for a destination-based cash flow tax (DBCFT), a type of border adjustment tax. The House DBCFT would have replaced the current policy of excluding imported business inputs from taxable income with an exclusion for costs and sales involving exports. Where companies currently pay taxes on export revenue, they would have instead paid taxes on imports.

Thus, the tax system would have transitioned from taxing domestic production costs (origin-based tax) to taxing domestic consumption (destination-based tax).[11] Corporations would have been able to deduct 100 percent of their overseas income, as part of a transition from a worldwide tax system to a territorial tax system. The current worldwide system taxes income regardless of where it originates. This encourages companies with earnings abroad to stash that income overseas, as profits are only taxed when they are repatriated to the United States.[12]

All other things being equal, a DBCFT would have provided an instant boost to revenue. Since the U.S. is currently running a trade deficit, shifting to a tax that falls upon imports rather than exports broadens the base of taxable corporate income.[13] A DBCFT would also have rendered many profit-shifting techniques currently in use by corporations nonviable. For example, under the current origin-based system, a corporation can adjust the prices of goods and services it charges to subsidiaries, so as to cut tax liabilities. A subsidiary in a lower-tax jurisdiction may have its imports from the U.S. parent company underpriced in order to effectively shift their profits to the lower-tax jurisdiction. Under a DBCFT, tax liability is unaffected by such profit-shifting maneuvers, since tax is due on imports. Because of the effect border adjustment has on profit-shifting techniques, a DBCFT is the simplest and most direct way of addressing base erosion.

The House GOP blueprint would have enacted a retroactive “deemed repatriation” tax on overseas profits at a rate of 8.75 percent for cash and cash equivalents and 3.5 percent for other profits. This one-time tax would have required corporations to repatriate the estimated $2 trillion in foreign earnings that are held overseas due to current tax rules.[14] In addition, the corporate alternative minimum tax would have been eliminated, along with several other tax deductions.[15]

For any potential DBCFT to be successful, currency markets for the dollar would have to respond as predicted under standard economic theory. On its own (i.e., without other tax reductions) it would negatively affect importers and consumers. In theory, however, a DBCFT would cause the dollar to significantly and rapidly appreciate, which would make it less expensive for domestic companies to import goods (and more expensive for foreign companies to import goods from the United States).[16] Thus, a DBCFT would be, theoretically, trade-neutral because the currency adjustment would offset the negative impacts on consumers.

Not everyone is convinced that this accurately characterizes how an implemented DBCFT would play out.[17] Although a fair amount of previous evidence suggests there would be significant currency adjustment in reaction to a DBCFT,[18] if the dollar does not respond as quickly or fully as anticipated, importers would face heavy taxes on imported goods (under the House

Republican plan the tax would be set at 20 percent). Ultimately, consumers would bear these costs. There are also significant (and under-explored) concerns about whether or not a DBCFT would comply with World Trade Organization (WTO) rules. If WTO found the tax non-compliant, it could threaten a global trade war at a time when trade policy at home is in flux.[19]

For these and other reasons, the border adjustment plan failed to receive adequate congressional support to advance. There were many uncertainties as to how the proposal would function, but its supporters designed it to expand the tax base, disincentivize profit-shifting, and generate revenue that could be used to reduce overall rates.

Impact: The Tax Foundation analyzed the impact of the overall House Republican tax plan, which included a DBCFT.[20]

- Long-term increase of 9.1 percent to GDP, 7.7 percent to average wages, and 1.7 million additional jobs
- Federal deficit would increase by $191 billion over the first decade after taking into account GDP increases
- After-tax incomes of all taxpayers would increase by 8.4 percent

Pros

- Renders many profit-shifting techniques and methods of reducing tax liability uneconomic
- Simplifies the tax code by reducing the need for complex countermeasures to prevent base erosion
- Increases revenues by shifting tax to the larger base of imports, thus allowing for steeper rate reductions
- Reduces the short-term deficit impact of tax reform by enacting a deemed repatriation of corporate profits

Cons

- Under some economists' scenarios, imposes potentially significant burdens on import-reliant businesses and consumers
- Relies heavily upon full and immediate currency adjustment, as even slight delays in the response of the dollar's value to the implementation could cause significant disruption
- Risks external factors such as WTO sanctions or retaliatory tariffs

Option C

In February 2014, then-Chairman of the House Ways and Means Committee Dave Camp (R-MI) released H.R. 1, the Tax Reform Act of 2014.[21] At the time, political realities meant that the reform had to be presented as a "discussion draft" to shape and inform the policy debate. Many of the reforms in Option C are similar to those of the House GOP border adjustment plan,[22] and it is apparent that Option C had a significant influence on the House GOP plan.[23] However, Option C also included a form of foreign minimum tax, a feature that is not in the 2016 House GOP plan.

Like the House GOP plan from 2016, Option C shifts the country towards a territorial tax system, though not completely: there would be a 95 percent deduction on the tax rate corporations must pay on active overseas income. This would effectively translate to a 1.25 percent tax on foreign income. Option C would also enact the same deemed repatriation as the 2016 plan, retroactively taxing cash at 8.75 percent and other profits at 3.5 percent. In contrast to the House GOP plan, Option C would only lower the top marginal income tax rate to 25 percent, rather than 20 percent.[24]

Businesses whose income "passes through" to investors and shareholders where it is subject to taxation would face a lower tax liability under Option C. Under current law, this is often assessed as individual income, potentially incurring the maximum 39.6 percent rate. Option C would lower the top income tax rate on pass-through income from 39.6 to 35 percent. Additionally, domestic manufacturing income would be exempt from the 10 percent surcharge on income over $400,000, reducing the tax burden for this category of pass-through income to 25 percent.

Option C also includes provisions to address what is known as "subpart F" income. When Controlled Foreign Corporations (CFCs) – foreign corporations with more than 50 percent of stock owned by U.S. citizens – earn income overseas, it is classified as subpart F income.[25] Congress enacted subpart F to prevent U.S. corporations from locating profits in low-tax jurisdictions to avoid U.S. taxes.[26] Under Option C, intangible income, or income derived from intangible assets such as patents, royalties, or trademarks, would be taxed at a 15 percent rate.

Changes to subpart F income rules are also the reason that some are suggesting that Option C includes a foreign minimum tax. Option C would also create a category of subpart F income known as "foreign base company intangible income" (FBCII). FBCII would be subject to either a 15 percent or 25 percent rate, depending on whether it qualifies as foreign-derived adjusted gross income. PricewaterhouseCoopers explains the requirements for income to be considered foreign-derived adjusted gross income, in which case it would be taxed at 15 percent:

- Income earned from "goods sold for use, consumption or disposition located outside the United States," or
- Income earned from "services provided with respect to persons or property located outside the United States."[27]

FCBII that does not qualify as foreign-derived adjusted gross income would be taxed at the full 25 percent corporate rate. Note that any income taxed overseas would still be deducted under this proposal. FCBII that is already taxed at a foreign effective tax rate (ETR) of 15 percent or higher would be exempted from this tax, while income taxed at a foreign ETR of less than 15 percent would be deducted from U.S. tax liability.[28]

Option C would also make "look-through rules" permanent. Look-through rules were instituted on a temporary basis in order to ensure that CFCs were able to move income through foreign subsidiaries for legitimate business needs without incurring subpart F tax liability.[29]

Option C would also include significant alterations to other sections of the tax code. Much like the House GOP proposal, the tax code for individuals would be overhauled, and any energy-related tax credits and deductions would be eliminated.

Impact: The Tax Foundation has also analyzed the effect of Option C. Their analysis is heavily weighted by Option C's inclusion of rules that would change the current depreciation regime, which is unrelated to tax base erosion. Tax Foundation did include an estimate assuming the depreciation regime remains unchanged, which is what is used for the below statistics.[30]

- Long-term increase of 1.3 percent to GDP, 0.7 percent to average wages, and 685,000 additional jobs
- Federal deficit would decrease by $1.6 billion over the first decade after taking into account GDP increases

Pros

- Comes close to a shift to a territorial tax system, and addresses issues with subpart F and pass-through income rules
- Includes provisions to address base erosion such as the deemed repatriation, reduction in corporate taxes, as well as intangible income

Cons

- Does not reduce complexity as much as some other proposals
- Does not completely shift the United States to a territorial tax system
- Tax rate reduction for intangible income exports could potentially be seen as an export incentive and would therefore be in violation of international trade agreements; could incur sanctions or retaliatory tariffs[31]

Option D

Option D is not one of the alternatives presented by Chairman Camp in his 2011 discussion draft,[32] but rather a modified version of Option C developed by a group of companies. Many of the same elements of Option C are included in Option D, and both options move the current tax system in the general direction of a territorial tax system. Option D does this to a lesser extent than Option C by tiering the deduction received on foreign overseas income.[33]

Under Option D, the deduction that a controlled foreign corporation receives would depend on the ETR levied on it. If the CFC is subjected to:

- A 15 percent or higher foreign ETR, then they receive the 95 percent deduction and a tax on repatriation of foreign earnings of 1.25 percent;[34]
- Between a 14.9 percent and 7.5 percent foreign ETR, then they receive an 85 percent deduction, for an effective rate of 3.75 percent;
- A foreign ETR of less than 7.5 percent, then they receive a 75 percent deduction and a rate of 6.25 percent;
- A foreign ETR less than 7.5 percent and is domiciled in a country that does not have a tax relationship with the United States they will receive only a 60 percent deduction and a rate of 10 percent.

Repatriation taxes would also be tied to foreign ETRs. Corporations with a foreign ETR between 15 and 7.5 percent would have a 3.75 percent repatriation tax rate, while those below 7.5 percent would face a 6.25 repatriation tax rate.

Impact: Option D is not a comprehensive tax reform plan, but merely a modification to the repatriation rates enumerated in Option C. It can be assumed that the impact of Option D would be similar to that of Option C, albeit with marginally higher revenues and marginally lower levels of GDP and wage growth.

Pros:

- Decreases incentives to locate profits in low-tax jurisdictions by tying repatriation tax rates to foreign effective tax rates

Cons:

- Taxes are higher, economic growth is lower than in Option C

Rep. Renacci's Option

In early 2016, James Renacci (OH-16) released a discussion draft that presented an option to address tax base erosion.[35] Rep. Renacci's proposal overhauls the American tax regime, replacing the current corporate tax with a value-added tax (VAT).

Renacci's proposal is a comprehensive tax reform plan, and includes significant changes to income taxes. It also alters exemptions, eliminates the alternative minimum tax, and removes all deductions except for the mortgage interest deduction and charitable deduction.

In terms of addressing base erosion, Renacci's plan makes significant changes to U.S. taxation of businesses.[36] While all OECD nations with VAT also have a separate tax on corporate income, under Renacci's proposal, the corporate income tax would be eliminated completely. The plan also includes a deemed repatriation of corporate profits at a rate of 8.75 percent for cash, and 3.5 percent for other profits.

The corporate tax would be replaced by a 7 percent VAT, a form of territorial taxation that places a tax on each stage of production where value is added. A VAT is charged on all the supplies purchased within the country to make a final product as well as the sale of the final product. However, the cost of the supplies already taxed along the way is deducted from the tax on the sale of the final product.

Advocates of a VAT point to potential economic growth, as many models find them to be less damaging to the economy than other taxes that generate similar amounts of revenue. Opponents, meanwhile, claim that a VAT would disproportionately affect low-income earners since it operates in a manner similar to a sales tax. However, after taking into account changes to the individual tax code (the plan "reduces individual rates across the board and simplifies the individual tax system for all filers"[37]) and economic growth, the Tax Foundation estimates an after-tax increase to average income of 4.4 percent after accounting for GDP growth and changes to individual tax rates, with the more substantial income increases coming for lower-income earners.

Another concern is that implementation and enforcement of a VAT is complex and contains significant compliance and administrative costs.[38] Implementing a VAT could simply result in replacing one complex and costly form of taxation with another; one study even found that a VAT can be more difficult for corporations to comply with than a tax on profits.[39] Congress must weigh these concerns in attempting to modernize and simplify the tax code.

<u>Impact</u>: The Tax Foundation has modeled the economic impact of this plan.

- Long-term increase of 5.6 percent to GDP, 4.7 percent to average wages, and 1.9 million additional jobs
- Federal deficit would decrease by $695 billion over the first decade after taking into account GDP increases
- After-tax incomes of all taxpayers would increase by 4.4 percent

<u>Pros</u>

- Changes to the individual tax code would ensure that low-income Americans are not negatively affected by the regressivity of a VAT
- Tax code simplified through the elimination of most deductions, increasing fairness

<u>Cons</u>

- Without constitutional safeguards, the repealed corporate profit tax could be resurrected alongside a VAT
- Can present significant compliance and complexity burdens

Stop Tax Haven Abuse Act

Democrats have introduced the Stop Tax Haven Abuse Act (STHAA) in each Congress since the 110th Congress (2007-2008).[40] In general, the STHAA represents a different approach to addressing tax base erosion than the other options discussed in this report. Whereas other proposals plan to deal with base erosion by incentivizing corporations to return profits to the United States and fundamentally altering the tax system to discourage corporate profit-shifting, the STHAA focuses more on increasing enforcement through the existing tax system.

One major provision of the STHAA would shift the way civil courts handle overseas accounts. Instead of requiring the IRS to prove that Americans (and "U.S. persons," a legal term referring not only to citizens, but also to certain nonresident individuals, estates, trusts, corporations, and partnerships) with accounts in certain financial institutions[41] owe taxes, the account holder must instead prove that he or she does *not* owe tax. This would make it easier for the IRS to win such cases, and increase taxable revenue. Reporting requirements for these individuals would also be strengthened.[42]

The STHAA would make it easier for the IRS to issue "John Doe summons," or summons in which the IRS is unaware of the taxpayers' names and requires approval from the courts to serve the summons. It would also classify any firm that is either publicly traded or holds assets over $50 million as a U.S. corporation, and subject it to U.S. corporate tax. Subsidiaries of multinational corporations would not be included in this provision, but hedge funds will. Hedge funds, which often include U.S. tax-exempt investor entities such as charities and pension funds, would be heavily damaged by this proposal.[43]

The STHAA would also crack down on tax shelters by creating a procedure through which investigators could regulate them. These regulations would include improving the gathering and reporting of information to detect suspicious tax-related activity, preventing firms from charging fees based on tax deductions, and increasing communication between enforcement agencies. STHAA would also increase penalties for all forms of tax haven abuse.[44]

Impact: The Joint Committee on Taxation analyzed a previous version of the STHAA in 2015, and determined that it would raise $278 billion over ten years.[45] On the other hand, the economy may be damaged by policies which hurt investment vehicles such as hedge funds.

Pros

- Would likely reduce the incidence of tax evasion and force some corporations out of profit-shifting schemes

Cons

- Presumption of guilt in terms of non-FATCA-compliant accounts would make it hard for taxpayers to appeal their case before the courts
- Hedge funds would be damaged by provisions intended to target shell corporations
- Reform would not encourage U.S. multinationals which have shifted headquarters to move back to the United States; would more likely encourage many to leave

Conclusion

Though the DBCFT seems to no longer be politically feasible, several possible options remain before Congress to address tax base erosion. Lawmakers must decide for themselves on the merits of each of these proposals, but the need for reform is clear. Congress cannot wait for bureaucrats to try to step in and solve the problem through administrative fiat or regulation; policymakers must be proactive and enact reforms that are conducive to expanding businesses, growing the economy, and thereby, addressing the deficit. As former Treasury Secretary William E. Simon once said, "the nation ought to have a tax system that looks like someone designed it on purpose."

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[41] Such institutions would be those that are not certified with the Foreign Account Tax Compliance Act (FATCA), a controversial law enacted in 2010 but since delayed in its implementation owing to numerous concerns over its practical impact.

[42] Gravelle, Jane G., *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, January 15, 2015. https://fas.org/sgp/crs/misc/R40623.pdf

[43] Ibid.

[44] Ibid.

[45] Joint Committee on Taxation, *Summary of Tax Haven Abuse Act*, 2015. https://www.whitehouse.senate.gov/imo/media/doc/Stop%20Tax%20Haven%20Abuse%20Act%20Summary_2015.pdf