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Comment on Peroni, Fleming and Shay, Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income

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Comment on Peroni, Fleming and Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income"

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PERONI, Fleming and Shay have performed an outstanding service in presenting a full-fledged proposal to end the deferral privilege enjoyed by U.S. taxpayers investing abroad through foreign corporations. Their contribution is particularly welcome because it comes at a time when U.S. multinationals are mounting a concerted effort to roll back Subpart F, arguing that it is incompatible with changed economic conditions.[1] If Subpart F is to be reconsidered, Congress should be able to weigh all the options, ranging from complete repeal of the anti-deferral regimes to a thorough-going effort to eliminate the deferral privilege. Peroni, Fleming and Shay have made it possible to seriously consider the practical implications (including transition issues) of the latter alternative. This effort is important even for those who believe that deferral should be retained or expanded, because as Peroni, Fleming and Shay state, "without articulating with some clarity the design of a system for ending deferral, it is not possible to accurately evaluate the costs and benefits of ending deferral."[2] The proposal to end deferral advanced by Peroni, Fleming and Shay is the most thoughtful and best articulated one available, and, as such, is a major contribution even if its chances of becoming law at present appear slim.

This comment will focus on three issues related to the deferral debate. The first two are only briefly discussed by Peroni, Fleming and Shay: (1) what can be said about the merits of ending deferral from an efficiency, equity, or administrability perspective; and (2) what are the implications of recent developments at the Organization for Economic Cooperation and Development (OECD) for the deferral argument. My conclusions on those issues are that the theoretical case for maintaining deferral is weak, and that the OECD anti-tax competition initiative renders the competitiveness argument for deferral largely irrelevant. The third issue involves

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1. *See* NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part I: A Reconsideration of Subpart F (1999) [hereinafter NFTC Report].

2. Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455, 497 (1999) [hereinafter Peroni].

Peroni, Fleming and Shay's proposed expansion of the PFIC regime to all foreign corporations.[3] While this may be the best solution available, it raises serious administrability issues that need to be considered.

I. THE MERITS OF ENDING DEFERRAL

Peroni, Fleming and Shay do not extensively address the merits of the debate on ending deferral, stating that "the policy controversy concerning the desirability of deferral probably cannot be resolved."[4] However, they also present a thorough analysis of the subsidy involved in granting deferral and explain the inability of current U.S. anti-deferral regimes to effectively limit that subsidy.[5] They then state that "making the case for the deferral privilege is not an easy task and it is not surprising that some regard the effort as unsuccessful."[6]

It may be useful, for those readers unfamiliar with the debate, to briefly examine the theoretical arguments for and against deferral. The question addressed here is whether there is a case to be made for deferral in terms of the traditional criteria for judging tax policy (i.e., efficiency, equity and administrability). These issues are separate from what many consider the strongest argument for deferral (i.e., the argument that deferral is necessary to maintain the competitiveness of U.S.-based multinationals vis-á-vis their foreign competitors).[7]

A. Efficiency

The traditional argument in favor of imposing the same tax rate on income from capital whether it is invested at home or abroad has been made in the name of capital export neutrality (CEN). CEN refers to the choice that an investor resident in a home country has between investing her savings domestically or in a foreign host country. CEN occurs when home and host country investments that earn the same pretax rates of return also yield the investor the same return after taxes.[8] CEN is violated, for example, if both the home and host countries fail to tax the income from an investment in the host country, while an investment in the home country is taxed. This could happen, *inter alia*, when the home country grants deferral and that host country does not impose a tax on foreign investors. In that case, investors would prefer to invest in the host country rather than in the home country even if the pre-tax yield on the

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3. *See id.*
4. *Id.*
5. *See id.* at 458-70.
6. *Id.* at 470. Professor Peroni has elsewhere stated his opposition to deferral more decisively, and has in fact proposed to revamp the U.S. international tax regime by eliminating deferral. *See* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. Miami L. Rev. 975 (1997).
7. *See* NFTC Report, *supra* note 1 (representing the position of U.S.-based multinationals and focusing almost entirely on the competitiveness issue). This issue will be addressed below.
8. *See* Richard E. Caves, Multinational Enterprise and Economic Analysis 227 (1982).

domestic investment is higher. The result is a deadweight loss from a global efficiency perspective, because investments will not be allocated to their most productive (highest yielding) pretax uses. This argument has led most economists to support current residence-based taxation of worldwide income as the optimal international tax rule (i.e., to oppose deferral).[9]

The economic case in favor of deferral is traditionally made in the name of capital import neutrality (CIN). CIN requires that equal before-tax returns at the margin to competing (domestic and foreign) suppliers of capital to a host country producer translate into equal after-tax earnings.[10] CIN is violated, for example, if foreign investors in a host country are currently taxed on their investment income at the home country rate (as required by CEN), while the host country does not levy an income tax on investment income. In that case, domestic (host country) investors will have a different net return on their investment in the host country than foreign (home country) investors. The result is that intertemporal marginal rates of substitution (that is, the choice between present and future consumption) will not be the same between countries, and the international allocation of world savings will be distorted.[11]

A simple example can be used to clarify the distinction between CEN and CIN. Assume that an investor faces a choice between a home country investment yielding 100 and a host country investment yielding 70. In a tax-free world, he would choose the home country investment. Now assume that the home country investment is taxed at 40% while the host country investment is currently untaxed (because there is no host country tax and the home country grants deferral). In that case the investor faces a choice between a home country investment yielding 60 (100-40 tax) and a host country investment yielding 70 (70-0 tax, assuming that home country taxation can be avoided indefinitely). The investor would then choose the host country investment even though it yields the lower pretax return, violating CEN.

Now assume, however, that the home country abolishes deferral and taxes its resident investor currently on foreign source income. In that case, the home country investor would prefer the domestic investment (yielding 100 before tax) over the host country investment (yielding 70). Both will subject him to a tax of 40%, so that the after tax yield of the domestic investment is 60 and of the foreign investment is 1.00-0.4x70=42. In that case, the home country investor will have a lower after-tax yield (60) than a host country investor in the host country who faces a 0% tax, and will have a yield of 70. This violates CIN, and leads (under assump-

9. *See, e.g.*, Assaf Razin and Efraim Sadka, *International Tax Competition and Gains from Tax Harmonization*, 37 ECON. LETTERS 69-70 (1991); Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies*, 47 J. FIN. 1159 (1992); Michael P. Devereux and Mark Pearson, *European Tax Harmonization and Production Efficiency*, 39 EUR. ECON. REV. 1657, 1660 (1995).

10. *See* Caves, *supra* note 8, at 227.

11. *See* Razin and Sadka, *supra* note 9, at 70.

tions discussed below) to lower savings in the home country.[12]

In a classic paper, Thomas Horst showed that if tax rates vary among countries, it is impossible for CEN and CIN to obtain simultaneously.[13] How, then, is one to choose between a policy that assures efficient allocation of world investment (CEN or no deferral) or world savings (CIN or deferral)? Horst showed that the choice depends on the assumption made regarding the relative elasticity (i.e., responsiveness to taxation) of the supply and demand of capital. If the supply of capital is fixed (i.e., savings rates are not responsive to taxation), and the demand for capital is elastic, then CEN (no deferral) is preferred because it assures an efficient allocation of the home country's supply of capital. If the demand for capital is fixed while the supply is elastic, then CIN (deferral) is preferred because it assures the efficient provision of the host country's demand for capital.[14]

Horst argued that the most plausible assumption in the absence of empirical evidence is that the elasticity of supply and demand for capital is the same and is somewhere between 0 (fixed) and 1 (perfect elasticity). Thus, a policy that falls between CEN and CIN (like current U.S. policy) is called for.[15] However, as stated above, most economists prefer CEN to CIN, because the available empirical evidence suggests that the elasticity of demand for capital is considerably greater than the elasticity of supply (i.e., that savings vs. consumption decisions are less responsive to taxes than the choice of alternative investment vehicles).[16] An OECD study in 1994 concluded that "there is no clear evidence that the level of taxation . . . does generally affect the level of household saving."[17]

Thus, as a pure issue of global efficiency, the current state of the evidence favors CEN over CIN, which would require abolishing deferral. It is therefore not surprising that most of the current arguments in favor of deferral rest on other grounds, such as competitiveness.[18]

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12. In a setting where the home country grants deferral and the host country taxes its own domestic investors but not foreign investors (not an unrealistic scenario), deferral leads to violations of *both* CEN *and* CIN. CEN is violated because of deferral, while CIN is violated because foreign and domestic investors in the host country have different after-tax yields.

13. *See* Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q. J. ECON. 793 (1980).

14. *See id.* at 796.

15. *See id.* at 797. Horst notes, however, that the compromise embodied in Subpart F would only by coincidence be correct according to this criterion. *See id.* n.5.

16. *See, e.g.*, Austan Goolsbee, *Investment Tax Incentives, Prices, and the Supply of Capital Goods*, 113 Q. J. ECON. 121 (1997) (reporting high demand elasticity of investment); R. Boadway and D, Wildasin, *Taxation and Savings: A Survey*, 15 FISCAL STUD. 19 (1994) (higher elasticity of demand for investment than for supply); Michael P. Devereux, *Investment, Savings and Taxation in an Open Economy*, 12 OXFORD REV. OF ECON. POL'Y 90, 101 (1996).

17. OECD, Taxation and Household Saving 1 (1994).

18. An influential paper by Daniel Frisch has argued that the CEN/CIN debate is obsolete because it ignores changes in the world economy that took place since the 1960s. Specifically, portfolio investments are now more important determinants of efficient capital allocation than foreign direct investment (FDI). *See* Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 90 TNI 18-49 (May 2, 1990).

B. EQUITY

Equity arguments regarding deferral need to distinguish between deferral as applied to individual (mostly portfolio) investors and corporate (mostly direct) investors. In the case of the former, the equity argument against deferral is straightforward. Granting deferral to foreign source income violates both vertical and horizontal equity if one assumes that individuals are not free to freely shift their income from domestic sources (that are taxed currently) to foreign sources (that enjoy deferral).[19] Thus, if individual A has 100 of domestic labor income, and individual B has 100 of domestic labor income and 100 of foreign investment income earned through a foreign corporation, vertical equity is violated if: (i) B's foreign source income is not taxed currently; and (ii) A is unable to shift her domestic source income abroad. In the case of labor income, it seems plausible to assume that A will indeed be unable to shift the income to foreign sources as easily as B is able to do in the case of investment income.[20]

Most of the deferral debate, however, has centered on corporate income taxes, and in that case the equity issue is more complicated. Equity does not apply to corporations, only to individuals, and so to determine the equity dimensions of corporate taxation one needs to know the incidence of the corporate income tax, which is notoriously hard to determine. Let us assume, however, that the incidence does not depend on whether a corporation earns domestic or foreign source income. Even in that case, it is harder to establish that deferral violates an equity norm because a corporation earning domestic source income is theoretically free to switch to foreign source income, thereby transmuting any equity violation into an efficiency violation (as described above). If corporation A earns 100 of domestic source income and corporation B earns 100 of domestic source income and 100 of foreign source income (through a subsidiary which enjoys deferral), vertical equity is not violated if corporation A is free to shift its source of income to foreign sources as well.

Nevertheless, even in this case it may be possible to argue that an equity violation may exist because of the higher transaction costs imposed on corporation A. Most small corporations, even when they sell abroad, tend initially to do so through unrelated foreign distributors who are fa-

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However, the fact that portfolio investment now exceeds FDI does not mean that the latter is unimportant in allocating investment, and applying CEN to portfolio investment should not rule out applying it to FDI as well.

19. If shifting is possible, the equity violation transmutes into an efficiency violation. *See* Boris I. Bittker, *Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities?* 16 SAN DIEGO L. REV. 735 (1979).

20. From a lifetime perspective, A may be able to save and invest her savings abroad, thus enjoying the same benefits as B. But it seems plausible to assume that many individuals in the U.S. will never be able to save sufficiently to be able to enjoy the benefits of deferral available to top bracket individuals. The enactment of the FPHC rules in 1937 was motivated largely by accounts of very wealthy individuals who invested their savings through foreign corporations. This was perceived as undermining the progressive income tax.

miliar with the market. Only when a certain volume of sales has been reached does it make sense to set up a foreign subsidiary and bear the costs (in terms of learning the language and culture) of entering a foreign market directly. Thus, it seems plausible to argue that small corporation A is not completely free to enjoy the benefits of deferral available to large corporation B. If one assumes that the incidence of the corporate tax on A and B is the same, this results in an equity violation.

C. Administrability

It is not necessary here to repeat the case against deferral from an administrability perspective, because Peroni, Fleming and Shay have admirably done so.[21] As is clear from their list, ending deferral is the single reform of U.S. international tax rules that is most likely to produce meaningful simplification in this notoriously complex area of tax law.[22]

Some simplification may also admittedly be achieved if we went to the other extreme and allowed unlimited deferral. That would enable us to completely repeal the various anti-deferral regimes, which is more simplifying than the modifications proposed by Peroni, Fleming and Shay.[23] However, allowing full deferral would lead to further complications in other ways. For example, it would entail increased attention to outbound transfer pricing (and most of the litigation under section 482 already involves outbound transactions). In addition, as in any regime which permits deferral or exemption of foreign source income while fully taxing domestic source income, issues of sourcing (both income and deductions) would become even more sensitive and require more enforcement than under the current regime. Finally, issues of choice of foreign entity (branch vs. subsidiary) would be more prominent under a regime that allowed full deferral. It, thus, may be necessary to reconsider the check the box rules in this context.

II. THE COMPETITIVENESS ARGUMENT

Historically, by far the most effective argument in favor of deferral has been the argument based on competitiveness. The argument is generally as follows: If U.S. multinationals are subject to current tax on the foreign source earnings of their subsidiaries, they will not be able to compete in host countries (which, it is assumed, have little tax of their own) against foreign multinationals that are based in countries that grant deferral or exemption of foreign source income. Thus, for example, assume that both GM and Daimler have subsidiaries in Brazil for manufacturing and selling cars in the Brazilian market. Brazil does not tax either subsidiary. If

21. *See* Peroni, *supra* note 2.

22. *See* Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check the Box*, 74 Tax Notes 219 (1996).

23. Note, however, that Peroni et al. suggest repealing five of the six current regimes (PFIC, FPHC, FIC, PHC, AET), leaving only their expanded CFC regime. *See* Peroni, *supra* note 2.

the U.S. taxes GM currently on the Brazilian income of its subsidiary, while Germany does not tax Daimler (under its exemption regime for foreign source income) on the Brazilian income of its subsidiary, then (it is argued) GM will be at a competitive disadvantage vis-á-vis Daimler in Brazil and may eventually be forced to abandon the market.

This argument was the main reason Congress rejected the Kennedy Administration's proposal to end deferral altogether in 1961, and instead allowed deferral for active income (where presumably, competitiveness is an issue) regardless of whether it was subject to foreign tax. Moreover, the argument has, if anything, gained prominence since. The current National Foreign Trade Council report on "updating" Subpart F, which seeks to restrict its application to purely passive income, is entirely based on the competitiveness argument.[24] It is argued that U.S. based multinationals face much more competition now than in the 1960s, and therefore deferral should be expanded, not narrowed, to enable them to be more competitive.

There are three problems with this argument as it has traditionally stood. First, as Peroni, Fleming and Shay point out, there is little correlation between Subpart F (as currently enacted, or in the limited version proposed by the NFTC) and competitiveness. Deferral is fully available even if a U.S. multinational faces little competition or if its main competitor is another U.S. multinational.[25]

Second, the competitiveness argument implicitly assumes that "what is good for GM is good for America" (i.e., that U.S. tax policy should favor increasing the profitability of U.S.-based multinationals over foreign multinationals). Presumably, the reason is that the increased profits inure to the benefit of the multinationals' U.S. shareholders and/or employees. This argument may have had some logic in the 1960s, when most shares in U.S. multinationals were held (directly or indirectly) by U.S. individuals and most of their employees were U.S. residents. It is unclear whether it still applies in the 1990s when shares of all multinationals trade on many exchanges and are held by shareholders from many countries, and most employees of U.S.-based multinationals are not necessarily U.S. residents. U.S. tax policy should (if at all) enhance the welfare of individual residents of the U.S., not necessarily that of U.S.-based multinationals.

Third, the competitiveness argument in its simplest form suffers from the "UBIT fallacy." This refers to the argument made in favor of imposing tax on the "unrelated business income" of tax-exempt organization for fear that otherwise they will be able to compete "unfairly" against taxable entities in the same line of business. But as Bittker and Rahdert illustrated long ago, under normal competitive conditions, the tax-exempt organization has every incentive to charge the price that the market will

24. *See* NFTC Report, *supra* note 1.
25. *See* Peroni, *supra* note 2.

bear.[26] If the competing taxable entity charges $1.00 per box of Macaroni and is left with 65¢ after tax, the tax exempt will maximize its own profit by charging $1.00 as well, even though it is not subject to tax. Similarly, in the Brazilian example given above, Daimler will have no incentive to charge less than GM does, even though its costs are lower because it is effectively tax exempt. Instead, it will normally charge as much as GM in order to maximize its profit. Only if Daimler is predatory and seeks to drive GM out of the market will it deliberately undercut GM's prices, and even then it will succeed only if GM's after tax profit margin is sufficiently low so that it cannot afford to match any price reduction. The burden is on advocates of deferral to show that such predatory behavior is the norm under current market conditions.

Thus, even before recent OECD developments, the competitiveness argument for deferral rested on shaky ground. But the most convincing reason to reject it are the recent developments in the OECD, which are summarized by Peroni, Fleming and Shay.[27] As they point out, the first recommendation of the recent OECD report on curbing harmful tax competition is "that countries that do not have [CFC] roles consider adopting them and that countries that have such roles ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices."[28] The meaning of this recommendation is that OECD member countries apply their CFC rules in coordinated fashion to curb "harmful" tax competition, which the OECD report defines as including measures designed to attract foreign investors (such as targeted tax holidays), as well as more traditional tax havens.[29]

In the context of the competitiveness argument, these actions by the OECD mean that now would be precisely the wrong time to expand the deferral privilege. Historically, the U.S. was the first country to adopt a CFC regime, and as Peroni, Fleming and Shay show most other developed countries have followed suit.[30] If the U.S. were now to move to repeal deferral in the way suggested by Peroni and his colleagues, the OECD report makes it very likely that other OECD members would also tighten their anti-deferral rules, just as they did in the 1960s and 1970s. Since 85% of all multinationals are based in OECD member countries, such a coordinated move by the OECD would effectively solve the competitiveness issue. That is, GM would not have to fear that Daimler may push it out of the Brazilian car market because Daimler would be subject to similar anti-deferral rules as GM.[31]

26. *See* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299 (1976).

27. *See* Peroni, *supra* note 2, at 72-73.

28. OECD, Harmful Tax Competition: An Emerging Global Issue 40-41 (1998) <http://cweb.loc.gov./catdir/toc/98-180118.html>.

29. The OECD Report focuses only on financial activities and does not apply to "real" investments, thus drawing a similar line to that envisaged by Subpart F. However, the OECD is considering applying similar principles to real investments.

30. *See* Peroni, *supra* note 2.

31. Germany is a major advocate of the OECD tax competition initiative.

On the other hand, if the U.S. were to expand deferral now, as the NFTC is suggesting, this would in all likelihood lead other OECD members to expand deferral as well, despite the OECD report. We are thus in a classic prisoners' dilemma situation, but one that can be successfully resolved because of the availability of the OECD as a coordinating institution through which countries can credibly commit to limit their deferral or exemption regimes. The Peroni, Fleming and Shay proposal thus comes at an extremely opportune time, when action by the U.S. to repeal deferral is extremely likely to result in similar actions by other OECD members, rendering the competitiveness argument largely moot.

There is, however, one additional twist to the competitiveness issue that is worth mentioning. In recent years, there have been several well-publicized transactions in which U.S. public companies reincorporated abroad to escape the application of Subpart F to their subsidiaries.[32] Even if all OECD members adopted strict anti-deferral rules such as the ones proposed by Peroni, Fleming and Shay, this would still leave the door open both to reincorporation in non-OECD members, and to formation of new companies in such non-OECD member countries. If such developments take place, this may require further action to prevent erosion of the tax base.[33]

III. AN EXPANDED PFIC REGIME

There is one final area in which I believe the proposal advanced by Peroni, Fleming and Shay may require further elaboration. This has to do with the elimination of deferral for individual U.S. shareholders.

In general, Peroni and his colleagues propose that only a single anti-deferral regime should apply to all U.S. shareholders (whether individual or corporate), without regard to the percentage of shares they hold in a foreign corporation.[34] They propose to treat any foreign corporation as a pass-through entity with respect to its U.S. shareholders, who would directly report the income earned by the foreign corporation and credit any foreign taxes attributable to that income under section 901.[35]

This approach seems relatively unproblematic in regard to U.S. corporate shareholders and their CFCs, and is certainly superior (for the reasons given by Peroni, Fleming and Shay) to merely expanding Subpart F to all income. However, in the case of portfolio investors (who are typically individuals, either directly or through mutual funds) there may be a problem similar to the one faced currently by investors in a PFIC: How

32. See the Helen of Troy and Tyco transactions, discussed in Peroni et al., *supra* note 2, at 461-73 nn. 28, 78, 100.

33. Two possibilities are a reconsideration of corporate residence rules (e.g., defining residence by where the shareholders reside) or an expansion of source-based taxation (e.g., modifying the permanent establishment requirement). *See generally* Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 53 TAX L. REV. (1997).

34. *See* Peroni, *supra* note 2.

35. *See* Peroni, *supra* note 2.

will the U.S. shareholder know about the income of a foreign corporation in which she owns a minuscule proportion of the shares?

Peroni, Fleming and Shay respond to this dilemma by adopting (with modifications) the approaches currently available in the PFIC context: mark to market for publicly traded corporation, using publicly available financial data, or an interest charge when a distribution is made.[36] A couple of observations are in order. First, the PFIC regimes are notoriously complicated, especially the interest charge alternative. Second, Peroni and his colleagues propose to apply the regime to all foreign corporations, not just the ones qualifying as "PFICs" (i.e., having *75%* passive income or *50%* passive assets). This means that it is more likely that these corporations will be subject to tax abroad (since active income is more often taxable at source than passive income), and thus many more individual taxpayers will have to contend with foreign tax credit calculations (baskets and all) than is currently the case. The resulting complexities for ordinary taxpayers without access to sophisticated international tax software are very significant, and are not addressed in detail by Peroni, Fleming and Shay.

I would therefore offer a modest alternative proposal: Deferral is largely problematic only when the deferred income is not subject to current tax abroad at rates similar to the U.S. rate. Therefore, I would suggest that at least individual U.S. taxpayers (or in general U.S. shareholders holding less than 10% of the shares) be given the option to defer or even exempt income from foreign countries where the U.S. Treasury determines the effective tax rate on domestic source income to be at least 90% of the applicable U.S. rate.[37] This proposal may also not be easy to administer in detail (as indicated by the difficulties of the current "high tax kickout" under Subpart F), but with a measure of rough justice may be simpler than the thorough abolition of deferral in all cases suggested by Peroni, Fleming and Shay.

That said, I would once again emphasize my admiration for the enormous task performed by the three authors in designing the best available anti-deferral proposal. Given the golden opportunity presented by the OECD tax competition initiative, one can only hope that Congress will respond by giving this proposal the serious consideration it deserves.

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36. *See* Peroni, *supra* note 2.
37. This would presumably entail giving up on the foreign tax credit for those taxes.