

Stateless Income and Beyond: Ed Kleinbard's Contribution to International Tax Policy

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US International Taxation Before Kleinbard

- To understand Ed's contribution to international tax policy, it is necessary to understand the state of US international tax law before Ed came on the tax policy scene in the early 2010s.
- As Ed later characterized it, the US had an “ersatz” territorial system in which US persons were nominally subject to worldwide taxation but were actually subject to territorial taxation because controlled foreign corporations (CFCs) were generally not subject to current tax and dividends were rare.
- Still, until the mid 1990s Subpart F imposed some significant limits on the ability of US multinationals (MNEs) to shift income from the US to their CFCs.
- This was in turn justified by the general acceptance of Capital Export Neutrality (CEN) as the guiding norm of US international taxation, but by balancing it with competitiveness considerations.

US International Taxation Before Kleinbard

- In the mid 1990s, however, the balance began to change.
- After the Republicans took over Congress in 1994, they began undermining Subpart F by a series of measures, including the repeal of section 956A, the elimination of the CFC/PFIC overlap, and the enactment of the active software royalties and the banking and insurance exceptions to Subpart F.
- But ironically, the key blow to Subpart F was the “check the box” regulations issued by the Clinton administration in 1997.
- The Treasury had some misgivings over extending “check the box” to foreign entities but decided to do so anyway, and by the time they regretted it in 1998, the genie was out of the bottle and could not be put back in.

US International Taxation Before Kleinbard

- The result of “check the box” was dramatic.
- It meant that Subpart F became in effect a paper tiger.
- US multinationals could henceforth shift profits from high tax to low tax jurisdictions without running afoul of Subpart F.
- This was defended on the ground that it was only reducing foreign taxes.
- In addition, the consensus around CEN began to be eroded and Capital Ownership Neutrality (CON) was introduced as an alternative theory supporting territorial taxation.
- By 2004, when the multinationals were able to enact an international tax reform that was entirely geared to their interests, the reform did not touch Subpart F because it had become so weak that reforming it was unnecessary.
- The MNEs also got a one-year exemption from the tax on dividends from CFCs, which led to over 300 billion dollars being repatriated and used primarily for stock buybacks.

US International Taxation Before Kleinbard

- In 2006, just before Ed's arrival on the tax policy scene, the Republicans were able to codify "check the box" in section 954(c)(6).
- The triumph of de facto territoriality seemed complete, and the MNEs began the rapid accumulation of profits offshore at very low tax rates that ultimately culminated in over 3 trillion permanently reinvested earnings and in deferral becoming one of the biggest tax expenditures in the US budget.

Kleinbard's Analysis

- Ed began writing on international tax after he left the JCT in 2009, and in 2011 he published his two major articles on “stateless income” and on the “lessons of stateless income”, as well as several shorter articles on the same subject.
- These articles had a major effect of US international tax discourse and policy, as discussed below.

Kleinbard's Analysis

- Ed's main contributions in these articles can be summarized as follows.
- First, his most important point was that “check the box” allowed shifting profits not just from high tax to low tax foreign jurisdictions but also from the US to low tax foreign jurisdictions.
- His example was the Google Double Irish Dutch sandwich structure that he was familiar with from practice.

Kleinbard's Analysis

- Under this structure, Google set up two corporations incorporated in Ireland with a Netherlands corporation in between.
- The top Irish company held the intellectual property rights which they obtained from Google US via a cost sharing agreement.
- The top Irish company licensed the IP rights to the Dutch company, which in turn licensed it to the rest of the world.
- From a foreign perspective, the result was deductible royalties which shifted the profits to the Dutch company, which in turn shifted them to the top Irish company.
- Importantly, the top Irish company was for Irish purposes a resident of Barbados and therefore not subject to tax.
- The Dutch company had no income to be taxed because it paid out the royalties it received.
- Only the bottom Irish company was a resident of Ireland and subject to 12.5% tax, which was the Irish price for agreeing to the structure.
- From a US perspective, however, only the top company was a CFC; all the others were disregarded entities and therefore for Subpart F purposes the royalties did not exist and there was no deemed dividend to Google US.
- Ed's point was that this structure enabled the shifting of profits not just from the high tax foreign jurisdictions where the advertisers were located, but also from the US where the IP was developed.

Kleinbard's Analysis

- Second, Ed pointed out that because of these types of tax planning, the US already had a de facto territorial system, and the effective tax rate on the foreign source income of US MNEs was very low, so that complaints about competitiveness vis a vis EU countries with territorial systems were misplaced.
- In addition, Ed pointed out that CON was merely a substitute for competitiveness and was not valid as an economic concept.

Kleinbard's Analysis

- Finally, Ed pointed out the major flaw in the system, which was that US multinationals could not repatriate the foreign source income without incurring a 35% tax on the dividends.
- Meanwhile, they could show the profits for financial accounting purposes but were able to avoid taking a reserve for the future tax on dividends only as long as they could persuade the accounting firms that the earnings were permanently reinvested offshore (but this became increasingly hard as the earnings offshore grew and grew).
- This lock out effect also meant that the earnings could not be deployed in the US where they may have been used in a more efficient fashion (e.g. by the shareholders who wished for further stock buybacks).

Kleinbard's Solution

- In “The Lessons from Stateless Income”, Ed proposed two alternative solutions to the lock out problem.
- The first was for the US to adopt a truly territorial system with no tax on dividends from CFCs (but retaining Subpart F for passive income).
- The problem, as Ed pointed out, was that this would encourage further shifting of profits from the US unless there were a much more robust definition of source, such as a formulary apportionment regime to replace the broken transfer pricing system that relied on the arm's length standard.
- Ed argued that such a reform (as advocated e.g. by Kim Clausing and myself) was highly unlikely to be adopted.

Kleinbard's Solution

- Ed's second alternative was a worldwide regime in which Subpart F was extended to all CFCs, which meant that all profits as well as losses would be included in a US consolidated return.
- This would mean that "check the box" and 954(c)(6) would be obsolete.
- Ed preferred this outcome but pointed out that in that case to alleviate competitiveness and inversion concerns the US corporate tax rate should be reduced from 35% to the mid 20s.

The TCJA as a Kleinbardian Law

- In 2014, Dave Camp, the Republican chair of the House Committee on ways and Means, proposed an international tax reform that was pretty close to what Ed had in mind.
- He suggested reducing the corporate tax rate to 25%, adopting a participation exemption for active dividends, but coupling it with current taxation of CFC profits above a certain level.
- This proposal was part of an overall tax reform that was designed to be revenue neutral, and it went nowhere; Camp could not even get it approved by his own committee.
- The US seemed stuck with the highest corporate tax rate in the OECD, and massive trapped profits offshore.

The TCJA as a Kleinbardian Law

- This situation changed with the 2016 election that saw the GOP take over both the White House and both branches of Congress.
- Tax reform suddenly became possible as long as it was not revenue neutral, and in December 2017 the TCJA was signed into law.

The TCJA as a Kleinbardian Law

- Ed hated the TCJA with a burning passion. As he wrote in The Hill:

“The Tax Cuts and Jobs Act, this year’s Christmas present to the donor class, is an abomination. Its top-heavy distribution of cuts, its wasteful mistargeting of incentives, and its funding of permanent corporate tax cuts via tax hikes on millions of ordinary taxpayers have been widely publicized. From the other direction, whatever virtues the bill might have are completely swamped by its trillion-dollar plus impact on government deficits. But before moving on, we should review some of the process through which this bill was fashioned.”

The TCJA as a Kleinbardian Law

- While Ed's ire may have been justified as to the TCJA as a whole, the international tax provisions of the TCJA were quite Kleinbardian.
- They grew out of the Camp draft of 2014, which was heavily inspired by Ed's stateless income articles.
- Moreover, unlike the rest of the TCJA, with the exception of the BEAT they were the result of a careful and deliberate legislative process spanning many years.

The TCJA as a Kleinbardian Law

- The main outbound international tax reforms in the TCJA were to cut the corporate tax rate from 35% to 21%, to adopt a limited participation exemption, and to subject all income of CFCs above the exempt amount to current taxation under GILTI with a limited foreign tax credit.
- Ed presumably approved of the corporate tax rate cut, even though he may have thought it was a bit too large, because he has advocated that result in “the lessons of stateless income”.
- He presumably disapproved of the participation exemption, but he must have realized that because most US MNEs (and certainly those with the most offshore profits) had little offshore tangible investments, the actual exempt amount was minimal because it was calculated as a deemed 10% return on tangible assets.

The TCJA as a Kleinbardian Law

- Moreover, he presumably approved of GILTI even if he disliked some of its features, like the fact that it allowed averaging between high and low tax foreign jurisdictions, which encourages shifting income out of the US.

The TCJA as a Kleinbardian Law

- Unfortunately, we do not have a full-fledged Kleinbardian assessment of the international tax provisions of the TCJA because of Ed's illness.
- But we do have a slide deck from January 2018 in which he summarized his critique of the law.
- While he had many objections to the law as a whole as well as of specific provisions like section 199A, his critique of the international provisions was limited to the worldwide application of GILTI and to the incentive that QBAI times 10% (the exempt amount) created for future shifting of real investment offshore.
- Both are valid critiques, but Ed must have realized that most of the international provisions of the TCJA were actually quite consistent with what he proposed in his "stateless income" articles.
- Specifically, TCJA did away with the lock out problem while imposing a relatively high retroactive tax on the accumulated past offshore earnings of US MNEs, and current tax at a reduced rate on their future earnings.
- His main objection was to the rates, not to the structural features, but as he knew well rates can be changed.

Current Developments

- TBD