Arm's length principle vs worldwide taxation

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Residence-based tax consolidation of foreign controlled companies

- The US as a case study
- need to recalibrate the US system of taxation of multinational groups to limit aggressive tax strategies by global taxpayers
- assuming that a consensus could be reached on a change of the current situation,
  - broad policy choice
    - *worldwide tax consolidation system*
    - *territorial tax system.*

- *deferral principle*
  - undistributed profits as well as current losses of controlled foreign companies are not relevant for the controlling company
  - corporate profits or losses companies *cannot* be consolidated.

Residence-based tax consolidation of foreign controlled companies

- deferral privilege in the U.S
  - a U.S. person can conduct profitable business or investment activities through a company located in a country where corporate taxes are lower than in the U.S. **without paying U.S. residual tax until the foreign corporation distributes its profits**
  - U.S. shareholders can **defer** substantial amounts of U.S. residual tax and reinvest those amounts in foreign operations.

- the system morphs into a territorial system as the deferral becomes a final exemption that
  - incentivizes companies to refrain from distributing dividends back to the US

- “lock-out effect”,
  - U.S. multinational keep their profits abroad because of the tax benefits of deferral
    - restraints for management,
    - problems for shareholders not being able to optimize their portfolios
    - capital constraint for U.S. multinationals deriving from the lock-out effect,
    - cost of deferral is rapidly increasing because these firms are running out of feasible ways of reinvesting the sums accumulated abroad

- U.S. taxpayers encouraged to concentrate loss-generating activities in foreign PEs as the losses are passed through directly to the U.S. and, once foreign activities become profitable, to transfer them to controlled foreign corporations in order to defer U.S. tax on the foreign-source income.
  - U.S. tax system prevents this schemes
  - prior losses of the PE are attributed to the U.S. parent when the PE's assets are transferred to a controlled foreign company under the so-called "branch loss recapture rules."

- In some cases the US system however unilaterally allows a certain amount of consolidation of foreign corporate profits and losses by adopting a variation to a worldwide consolidation approach

- the system
  - allows the use of foreign corporate losses through purposeful tax planning

- deductions properly allocated to un-repatriated, foreign-source income
  - enhances the deferral benefit by producing a worse-than-exemption negative tax rate.

- *erosion of national tax base*
- U.S.
  - “earnings stripping” strategies
    - attribution to the U.S. tax jurisdiction of foreign losses.
  - tax rents bypass the purpose of source rules,
    - profits deducted from profits subject to higher rate and then extracted to lower rates in the country of the recipient.

- aggressive strategies
- interest expenses attributable to a foreign PE / transparent companies deducted both in the country of the PE and in the country of residence of the company of which the PE is a part.

- US companies deduct costs in the US which are not related to profits taxable in the countries where the deduction is claimed

- a multinational firm’s systematic use of domestic borrowing erodes the US corporate tax base
  - firm’s interest expense is deductible in the US,
  - resulting foreign corporate profits are not accounted for, because of deferral. In practice,
    - taxation on profits is deferred,
    - deduction of related costs is anticipated
      - arbitrage mechanism in which the costs that generate exempt profits are deducted

- A *worldwide tax consolidation system*
  - fully include foreign corporate profits and losses, on a current basis, in the taxable base of the US
    - net of related expenses,
  - relief from double taxation through a foreign tax credit.

- rollback of the existing deferral principle because foreign corporate profits and losses would be included in the US taxable base on a current basis, and subject to the same U.S. corporate tax rate.

- rules to prevent effective corporate inversions.

- major issue
- tax competitiveness of US firms

- Because US firms would face the same US tax rate everywhere,
  - they would not enjoy the same after-tax rate of return on investment reaped by their competitors in source-countries
    - when those competitors are ultimately exempt in their residence-countries that adopt the territorial system.

- advantages over deferral
- worldwide consolidation would
  - include both foreign corporate profits and losses,
    - cure the current asymmetry
      - foreign corporate profits are includible in the US tax base when repatriated, while foreign corporate losses are not directly recognized.[
  - address aggressive tax strategies
    - profits shifted to low-tax foreign jurisdictions would still be taxed in the US, i.e. the country of residence of the consolidating company.

- advantages over deferral
  - worldwide consolidation would
    - include both foreign corporate profits and losses,
    - dismantle the idiosyncratic US mechanism on repatriation as dividends + foreign losses.

- advantages over deferral
- worldwide consolidation would
  - mitigate the problem of expense allocations
    - deduction of domestic and foreign expenses attributable to taxable income.
  - solve transfer pricing problems,
    - no advantage in using aggressive transfer pricing strategies to move profits from the US to low-tax foreign affiliates.

- The worldwide tax consolidation faces major political hurdles
  - policy debate recently has shifted to the other basic overhaul option, the *territorial tax system*
    - fully disallow the consolidation of foreign corporate profits and losses and the expenses related to such exempted income
    - align the US with the strategies adopted by most EU countries which exempt repatriated dividends
    - “capital import neutrality” (“CIN”)

- US residents would be treated differently depending on the location of their income but would compete with foreign companies in the source-country at the same tax rates.

- A variant
  - formulary apportionment for taxing the corporate income of multinational firms.
    - US tax base for multinational corporations would be calculated based on a fraction of their worldwide income, determined by the share of their worldwide sales that occur in the US.
    - Only the portion of corporate profits commensurate with the apportionment formula would be consolidated

- U.S. could consider to adopt a form of mandatory worldwide consolidation
  - taken unilaterally by making the first move, without the need to pursue a multilateral agreement,
    - rational expectation that such an extra-territorial residence-based consolidation would predominate from a game theory perspective.

- why the U.S. could make this first move?
  - tax erosion of the U.S. corporate base is endogenously created. through the compounded effect of the deferral system and the erosion techniques pursued by U.S. global firms
    - and so the U.S. is in a position to reverse that situation unilaterally.