Economic Consequences of Limiting Base Erosion with Outbound Investment

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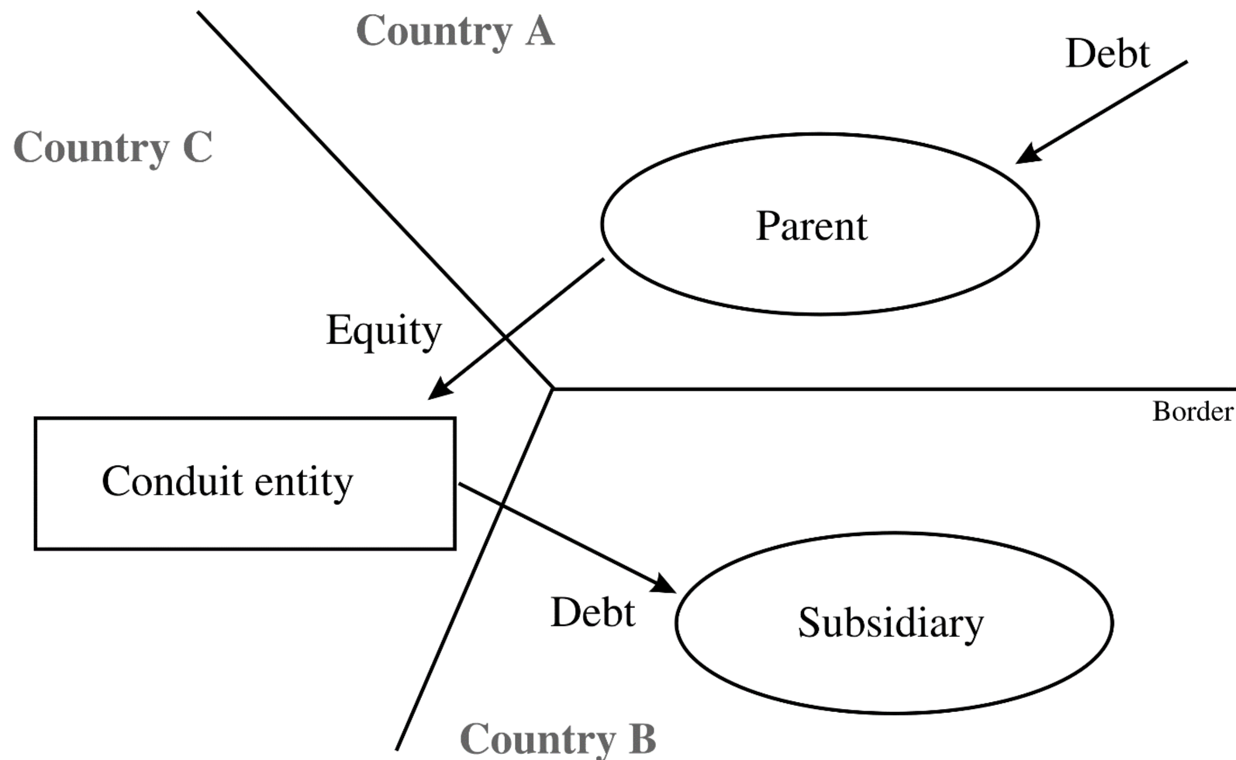
Thoughts on the Tax Cuts and Job Act

Issues

- The Positive Externality of Outbound Provisions
- GILTI and the Cost of Real Capital Abroad
- GILTI and the Benefit of Foreign Tax Changes
- Remaining Problems

The Positive Externality of Outbound Provisions

- Often, anti-avoidance measures benefit the tax revenues of host **and** parent's home country.



The Positive Externality of Outbound Provisions

- CFC rules may levy additional taxes for the legislating country.

- At the same time, tightening CFC rules may affect the cost of capital of affiliates owned by the legislating country (Haufler, Mardan, Schindler, 2016).

  →Reduced competitiveness

- GILTI as an alternative?

GILTI and the Cost of Real Capital Abroad

- Global Intangible Low-Taxed Income (GILTI)
- GILTI = CFC net income
  – 10% of aggregate tangible depreciable business property (QBAI).
- Inclusion of 50% of GILTI in US tax base
- New: GILTI may tie the possibility to earn low taxed income abroad to the amount of tangible capital invested abroad (Qual. Business Asset Investment).
- To what extent is this an implicit subsidy to foreign tangible investment?

GILTI and the Cost of Real Capital Abroad

- Some countries in the past have done similar things with CFC rules.
- Germany 1992-1994: CFC rule did not bite if a CFC had at least 50% in active income.
- Theoretical cost of capital reduction of German investment in Ireland by some 28%.

GILTI and the Cost of Real Capital Abroad

- GILTI implication; simple case
  - Abstract from depreciation
  - Effective zero foreign tax (possibly due to shifting and tax havens)
  - Therefore no FTC on GILTI income
  - All equity finance of CFCs abroad
  - Given after tax discount rate r

- Cost of capital in a simple exemption system
  - $F'(K^*) = r$
- Cost of capital with GILTI (if GILTI > 0, $t^*=0$)
  - $F'(K^*) - 0.5\, t^{US} [\, 10\% - F'(K^*) \,] = r$ or
  - $F'(K^*) = \frac{r - 0.5 t^{US} \cdot 10\%}{1 - 0.5t}$

GILTI and the Cost of Real Capital Abroad

- With F'(K*) = $\frac{r - 0.5t^{US} \cdot 10\%}{1 - 0.5t^{US}}$,
  - the cost of capital F'
  - and also the deviation from a simple exemption system depend on r.

r	F'(K), GILTI	Deviation
5.0%	4.4%	-12%
6.0%	5.5%	-8%
7.0%	6.6%	-5%
8.0%	7.8%	-3%
9.0%	8.9%	-1%
10.0%	10.0%	0%

  - Intuition: only low-return real income reduces GILTI. Low-return real income is only acceptable if r is low.

GILTI and the Cost of Real Capital Abroad

- GILTI implication with positive foreign tax rate t^*
- Economic profit /w given intangibles I^*
- Assume $F(K^*,I^*) > 10\%K^*$.

1) $\Pi = (1 - t^*)F(K^*, I^*)$ (Net income after foreign taxes)

$-0.5t^{US}\{[F(.) - 10\%K] + t^*[F(.) - 10\%K]\}$ (US tax on inc. + FTC)

$+0.8t^*[F(.) - 10\%K]$ (limited FTC)

$-rK$ (Opportunity cost of capital)

GILTI and the Cost of Real Capital Abroad

- Cost of capital with t* = 10%

r	simple exemption	GILTI	Deviation
5.0%	5.6%	5.4%	-3%
6.0%	6.7%	6.5%	-2%
7.0%	7.8%	7.7%	-1%
8.0%	8.9%	8.8%	-1%
9.0%	10.0%	10.0%	0%
10.0%	11.1%	11.2%	0%

GILTI and the Benefit of Foreign Tax Changes

- GILTI and the incentives to change LOW foreign tax rates to attract US CFCs.
- What is the value to a US-owned CFC when the host country rate is marginally increased?
- Taking the derivative of 1) w.r.t. t^* (using envelope theorem):
- $\frac{\partial \Pi}{\partial t^*} = -0.305 \cdot F(K^*, I^*) - 0.695 \cdot 10\% \cdot K$

$$= 1 \; if \; F(K^*, I^*) = 10\% \cdot K$$
$$< 1 \; if F(K^*, I^*) > 10\% \cdot K$$

The higher the profitability, the less negative a tax increase.

Remaining Problems

Remaining Problems as I suspect them

- 50% deduction leads to low revenue compared to traditional CFC rules.
- No carryforward of FTCs →Preference for low risk operations; penalty for operations with huge profitability in one year and losses in another.
- Dividends are excluded from tested income, but what about one-time sales of assets/shares by foreign CFCs? (Again, no carryforward of FTC may be a problem.)

Thank you for your attention!