News, Commentary, and Analysis

LETTERS TO THE EDITOR

20 TAX NOTES INT'L 1775 (Apr. 17, 2000), 87 TAX NOTES 445 (Apr. 17, 2000)

Thoughts on the IRS's APA Report and More Territorial Taxation

by
Michael J. McIntyre
Wayne State University

To the Editor:

1. *APA Report*. I agree with Lee Sheppard that the lack of cross tabs for the tables provided in the recent APA report makes the data in those tables nearly worthless to someone trying to understand what the APA program is doing. (See Tax Notes, Apr. 10, 2000, p. 184.) She may be overestimating what some of us outside Washington and New York know about the operation of the APA program, however, when she suggests that the report gives us no new information. For example, I was surprised -- maybe even astonished -- to learn that the IRS was cutting long-term deals of seven, even 10 years. By my calculation, the weighted average period for an APA agreement is 4.4 years.

The lack of cross tabs is pretty irritating. I do not understand why anyone thinks the basic statistical data on APAs should be trashed by breaking them into unusable parts. Is this just a stick in the eye to those of us who turned out to be right when we argued back in 1989 that the IRS was required by law to release redacted APAs? Back then, we were told that if we pressed the point, the Service would release Swiss-cheese APAs. So now we get the functional equivalent with these almost-useless tables.

My best guess for why the Service is treating the public so badly with its APA report is that some people within and without the Service were upset that everyone knew — or thought they knew — that Barclays Bank was the recipient of the global trading ruling addressed in Notice 94-40. Now I understand why Barclays would be upset. It was in litigation in the Supreme Court over California's formulary apportionment system, arguing that formulas were inconsistent with the international norm. The public identification of Barclays as the taxpayer in Notice 94-40 undermined its litigating position by creating the impression that it had no real objection to a formula, as long as the formula let it sock away a reasonable portion of its profits in its many tax-haven affiliates. Anyway, if the problem is the disclosure of the principal in Notice 94-40, I think we should just let the matter go. I really, really doubt that people figured out that Barclays was the object of Notice 94-40 from any of the information in the ruling. Almost certainly we are dealing with a leak, and I doubt the leak came from the Service.

Well, I liked Sheppard's APA story a lot. I think it is always useful for her to remind us that the transfer pricing rules under the 1994 regulations are not working and never will work. When the APA program was started in 1989, there was some expectation in some quarters that the section 482 regulations, when they eventually came out, would cure the major problems with the old regulations and put real pressure on multinational companies to negotiate realistic settlements on transfer pricing issues. That did not happen. The revised regulations provided at best a framework for negotiations -- negotiations in which the multinational company holds the upper hand. So now the choice for a taxpayer is to cut a deal at 30 cents on the dollar in Appeals or get an APA. My sense from the APA report is that taxpayers are simply using the APA process to deal with a few strategic problems and are leaving their serious business for Appeals.

2. *Territorial Taxation*. Various commentators claiming to represent the best interests of U.S.-based multinational companies have been arguing for some form of "territorial" tax system to replace the imperfect global income tax that the United States and many of its trading partners are attempting to enforce. (See Tax Notes, Apr. 3, 2000, p. 155.) In making their arguments, they typically do not identify the type of territorial tax they are proposing. The arguments for and against a territorial tax depend critically, however, on which type of tax is under consideration.

One type of territorial tax, favored by the Kemp Commission, is not an income tax at all. It is an origin-based value added tax. That tax is the business tax component of the flat tax — a tax the Republican establishment once endorsed but now seems to have abandoned. When commentators assert that a territorial tax is simple, they presumably are making reference to the flat-tax version of a territorial tax. A U.S. flat tax actually would present some very difficult international problems, because it would mesh badly with the corporate income tax systems used elsewhere in the world. But no one can plausibly deny that transactional taxes are simple relative to income taxes, just as no one can plausibly deny that transactional taxes fail to achieve the fairness and economic efficiency goals of an income tax.

A second type of territorial tax is a corporate income tax that is administered using formulary apportionment and worldwide combined reporting. California's income tax system, before the addition of the water's edge wart, is a real-life example of this type of territorial system. In that system, the worldwide income of a corporate group is allocated exclusively to a tax jurisdiction. Each tax jurisdiction taxes the income allocated to it by the formula and does not tax any other income. The tax is territorial in that each taxing jurisdiction gives up the right to tax income allocated to places outside its territorial boundaries. This form of territorial system has great appeal from the perspectives of fairness, efficiency, and administrative economy. The problem with it has been and remains largely political.

The third type of territorial system is a global income tax with an exemption for income earned through foreign corporations and, perhaps, for foreign-source income. As some commentators have noted, the current U.S. income tax is a hybrid. It has some features that are consistent with a global income tax, but it has some major loopholes -- if a loophole is understood to be a feature of the tax that is inconsistent with its basic organizing principles. The basic organizing principle of a global income tax is that a taxpayer's income from whatever source derived is the appropriate measure of its taxable capacity. Assuming the validity of that assumption, then a preference for foreign-source income or for income earned through foreign affiliates is properly identified as a loophole.

Opponents of a global income tax bristle at the term "loophole," and at its functional equivalent, "deferral privilege." Those terms are appropriate and useful, however, in framing a debate over deviations from an income tax, as that tax has been understood in the tax literature for the past 100 years. The terms may be quite inappropriate, however, in a discussion of some other tax — a tax that does not measure taxable capacity by increases in well-being over some specified period. The burden is on the proponents of this other tax to give a coherent account of its structure and policy goals.

A first step in specifying the features of a territorial income tax of the third type is to provide practical and theoretically sound rules for separating income assigned to a particular territory from income assigned to other territories. A global income tax has two rules of that type. The first are source rules and the second are transfer pricing rules. In an ideal global income tax system, these rules do not play a major role in determining the worldwide tax burdens on taxpayers. Their primary function is to determine, through the tax credit limitation and otherwise, how tax revenues obtained under the tax are to be shared among countries with overlapping claims to those revenues. I fully recognize that weaknesses in the source rules and the transfer pricing rules have important consequences in the current hybrid global income tax. The obvious weaknesses in these rules, nevertheless, do not discredit an ideal global income tax. Indeed, as many commentators have argued, much of the pressure would be taken off those rules if the hybrid system were moved closer to the ideal through the elimination of the deferral privilege.

In contrast to a global income tax, the coherence of a territorial income tax depends fundamentally on the coherence of its rules for attributing income to particular territories. No one can argue coherently for a territorial income tax, therefore, without offering workable solutions to the current practical and conceptual problems with source rules and transfer pricing rules. Those problems obviously are related, in that one of the weaknesses of the current source rules is that the source of income often changes when the taxpayer shifts income to a related entity through manipulation of the transfer pricing rules.

Lee Sheppard contends that the current transfer pricing rules, after a decade of intensive work by many well-intentioned and smart people, simply do not work. I agree, and I wonder how anyone familiar with international taxation would strongly disagree. Although U.S. source rules are not as incoherent as the transfer pricing rules, many source rules are deeply flawed and others, at best, are arbitrary. These are the rules that define the jurisdiction of a territorial tax system of the third type. If the rules defining territorial jurisdiction are, at best, arbitrary and capricious, then a territorial income tax built on those rules will be, at best, arbitrary and capricious. At worst, this third type of territorial system is not a tax system at all. Like the section 482 regulations, it is simply a framework for negotiations between the multinational companies and their outgunned counterparts in the public sector.

Sincerely yours,

Michael J. McIntyre

Professor of Law
Wayne State University