

President Obama's Proposals for International Tax Reform

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The U.S. Income Tax System

Gross income includes all income from whatever source derived, including:

- (i) Interest
- (ii) Dividends
- (iii) Royalties
- (iv) Capital Gains

Internal Revenue Code (Code) Section 61.

The U.S. Income Tax System

The U.S. imposes its tax on the worldwide income of:

All individuals, trusts and estates; and

All corporations

Except that:

Nonresident aliens individuals (NRAs),

Foreign trusts and foreign estates, and

Foreign corporations,

are taxed only on:

U.S. Source FDAP (Fixed and Determinable Annual and Periodical
Income)

Income Effectively Connected with the Conduct of a Trade or
Business in the United States

The U.S. Income Tax System

The U.S. unilaterally reduces the possibility of international double taxation with its foreign tax credit system –

- Direct foreign tax credits for foreign branch income
- Indirect foreign tax credits for 10% subsidiaries
- Foreign tax credit limited to U.S. tax on foreign income
- Since American Jobs Creation Act of 2004,
only two “baskets” -- Active and Passive

The U.S. has an extensive network of double tax treaties with the developed world but a rather limited network of treaties with the less developed world

Unique Aspects of the U.S. Tax System

Taxpayers Subject to Taxation on Worldwide Income:

- U.S. citizens as well as U.S. residents
- Corporations formed in the United States

Breadth of Concept of “Gross Income”

Breadth of Concept of “Trade or Business in the United States”

Observation: U.S. has historically had the luxury of developing its tax system to reflect primarily its own domestic political and economic interests with little regard to foreign competition

Absence of Federal-level Value Added (or Sales) Taxes

Indefinite Deferral of Offshore Income of Corporate Subsidiaries

Foreign subsidiaries are, in principle, beyond the range of the U.S. tax system

Foreign profits are therefore taxed in the United States only when repatriated in the form of dividends

Result: almost all U.S. taxpayers (except for banks and insurance companies) operate abroad through foreign subsidiaries

Obama estimate of effective U.S. tax rate on foreign profits of U.S. taxpayers: 2%

Amounts of deferred profits held offshore:

\$ _____

Consider: AJCA Repatriations in 2005

The 1962 Kennedy Compromise

Kennedy Administration considered eliminating deferral

But eventually compromised on system that:

- leaves in place deferral of tax on profits of foreign subsidiaries
- imposes current tax on the “SUBPART F INCOME” of “CONTROLLED FOREIGN CORPORATIONS” (CFCs)
 - Foreign base company income
 - Foreign personal holding company income

FPHCs and PFICs

Foreign Personal Holding Company rules -- developed on the basis of preexisting domestic Personal Holding Company rules – imposed current U.S. tax where foreign corporation:

- controlled by U.S. shareholders
- earning mostly passive income

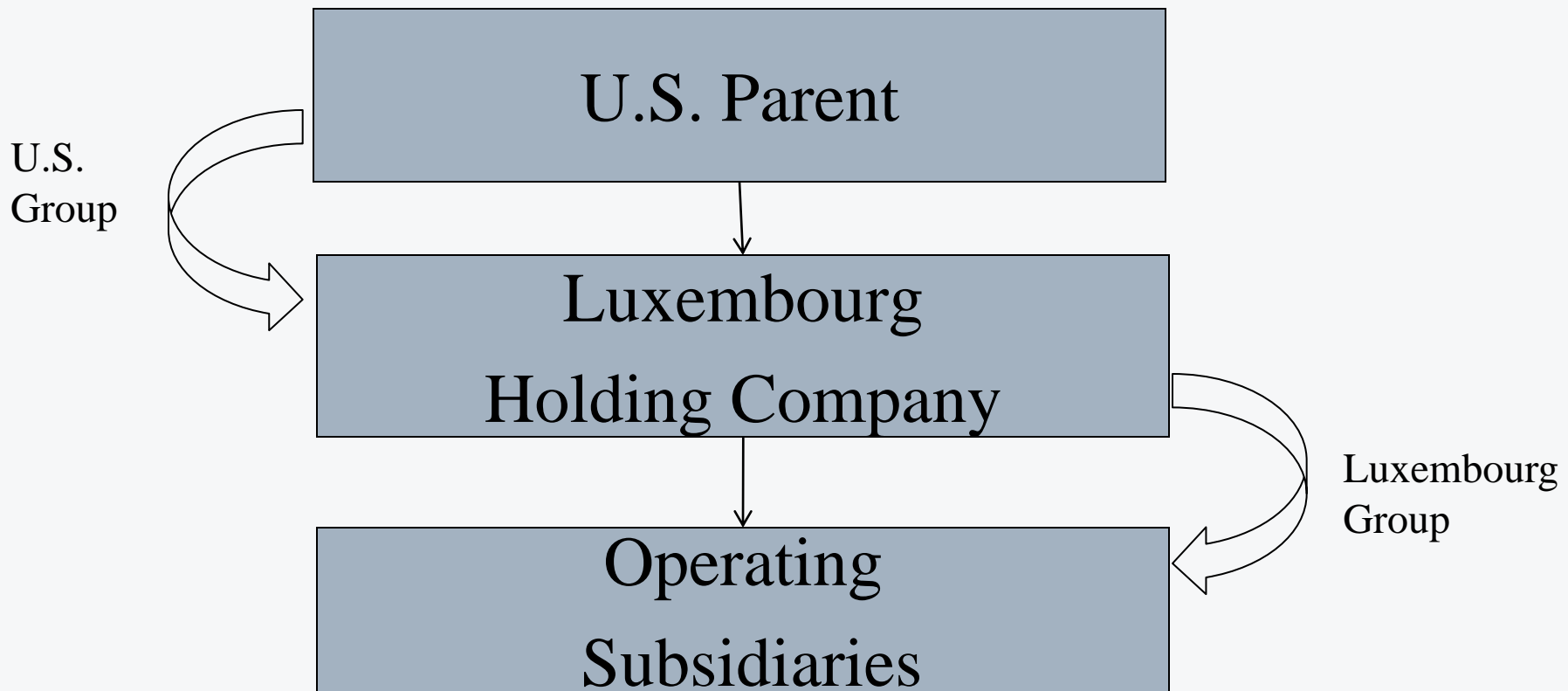
Replaced in [1986] by the Passive Foreign Investment Company rules that impose draconian U.S. tax whenever a U.S. shareholder earns income through a non-U.S. investment company

Allocation and Apportionment

Foreign tax credit rules require determination of net U.S. source income and net foreign source income

- Allocation of specific deductions to specific classes of income
- Apportionment of general deductions to general classes of income
 - Corporate headquarters and “stewardship” costs
 - Research and Development
 - Interest
- AJCA and worldwide apportionment of interest
 - Due in 2009, deferred until 2011

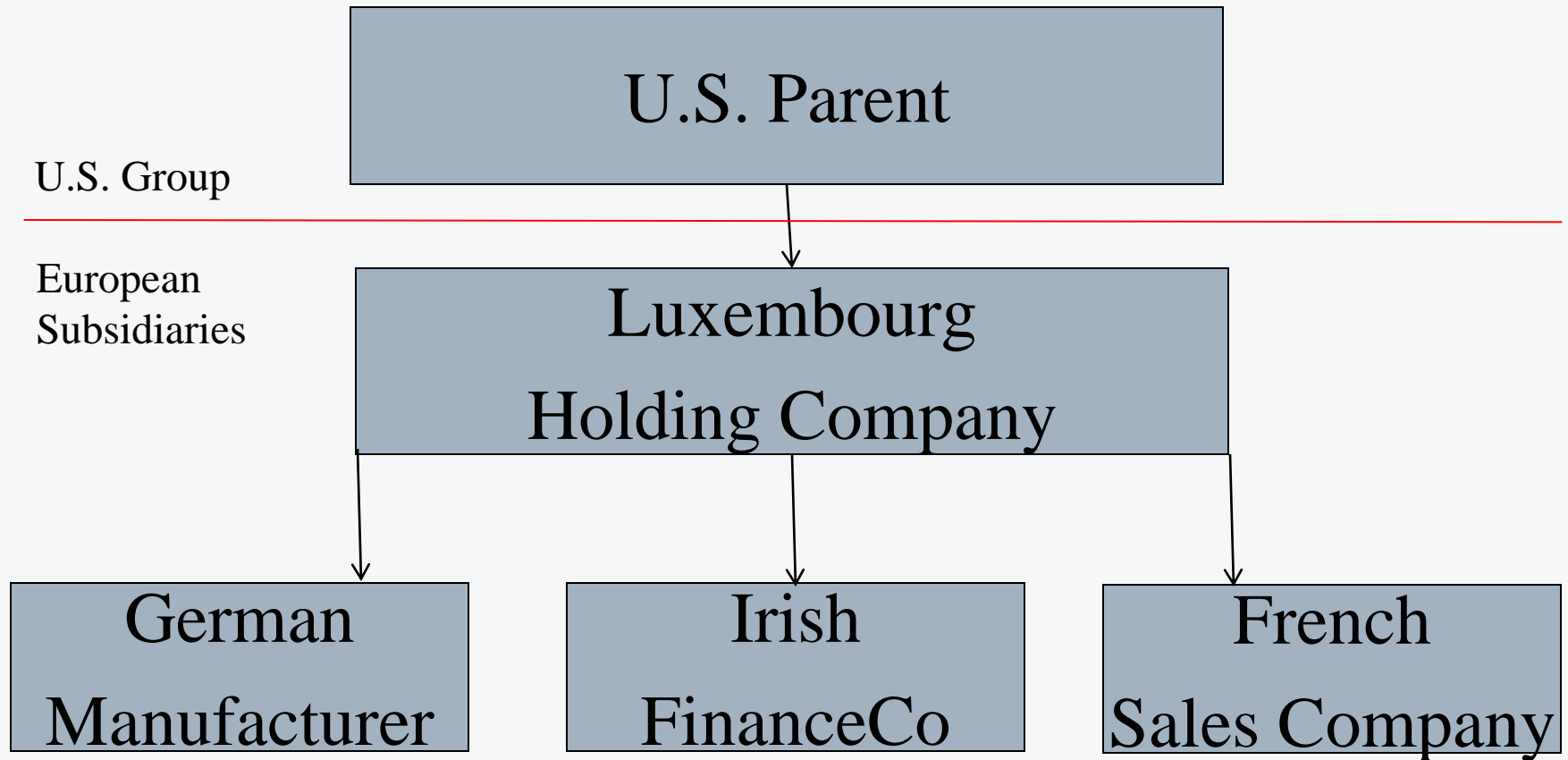
The Guardian Industries Case



Repatriation of Earnings

	Japanese Operating Company	Cayman FinanceCompany
Net Income	100	100
Local Tax	-35	0
Income after Local Tax	65	100
Dividend	65	100
U.S. Tax	-35	-35
Foreign Tax Credit	35	0
Net U.S. Tax	0	-35

Notice 98-11



Comment on State of U.S. Tax on Offshore Income of Corporations

Good tax design requires:

- Fairness
- Efficiency
- Potential to raise revenue

Current U.S. International Tax System:

- Affects different industries differently
- Induces massive tax planning
- Raises almost no revenue

Treasury Regulation Projects

1. Final: Partnership Special Allocations of FTC
2. Proposed: FTC Anti-Guardian Regulations
3. Proposed: Structured Transaction Regulations
4. Final: Section 482 Service Regulations
5. Final: Section 482 Cost Sharing Regulations
6. Final: Subpart F Branch Manufacturing (Notice 98-11) Rules
7. Abandoned? Global Dealing Regulations

Joint Committee Proposals – 2005

1. Amend rules for employment income earned abroad
 2. Amend rules for determining corporate residence
 - a) Inversion transactions
 - b) Offshore hedge funds
 3. Modify entity classification rules to reduce opportunities for tax avoidance
 - a) Notice 98-11 “hybrid branch” transactions
 4. Adopt a dividend exemption system for foreign business income
 - a) Move to territorial approach for offshore subsidiaries
 - b) Interest and other expense allocation rules provided
-

Revenue Estimates

1. Section 911 – \$2.2 billion over 10 years
2. Corporate Residency – \$0.9 billion over 10 years
3. Entity Classification -- \$1.2 billion over 10 years
4. **Dividend exemption system –
\$54.8 billion over 10 years**

House Ways and Means Committee – the Rangel Proposals – 2007

1. Repeal domestic production activities deduction
2. Limit treaty benefits for certain deductible payments
 - a) Treaty shopping by low- or no-tax parents through subsidiaries in higher tax treaty countries
3. Repeal worldwide allocation of interest
4. **Defer expense deductions attributable to deferred foreign income**
5. **Reduce corporate tax rate to 30.5% (later 28.0%)**

Revenue Estimates

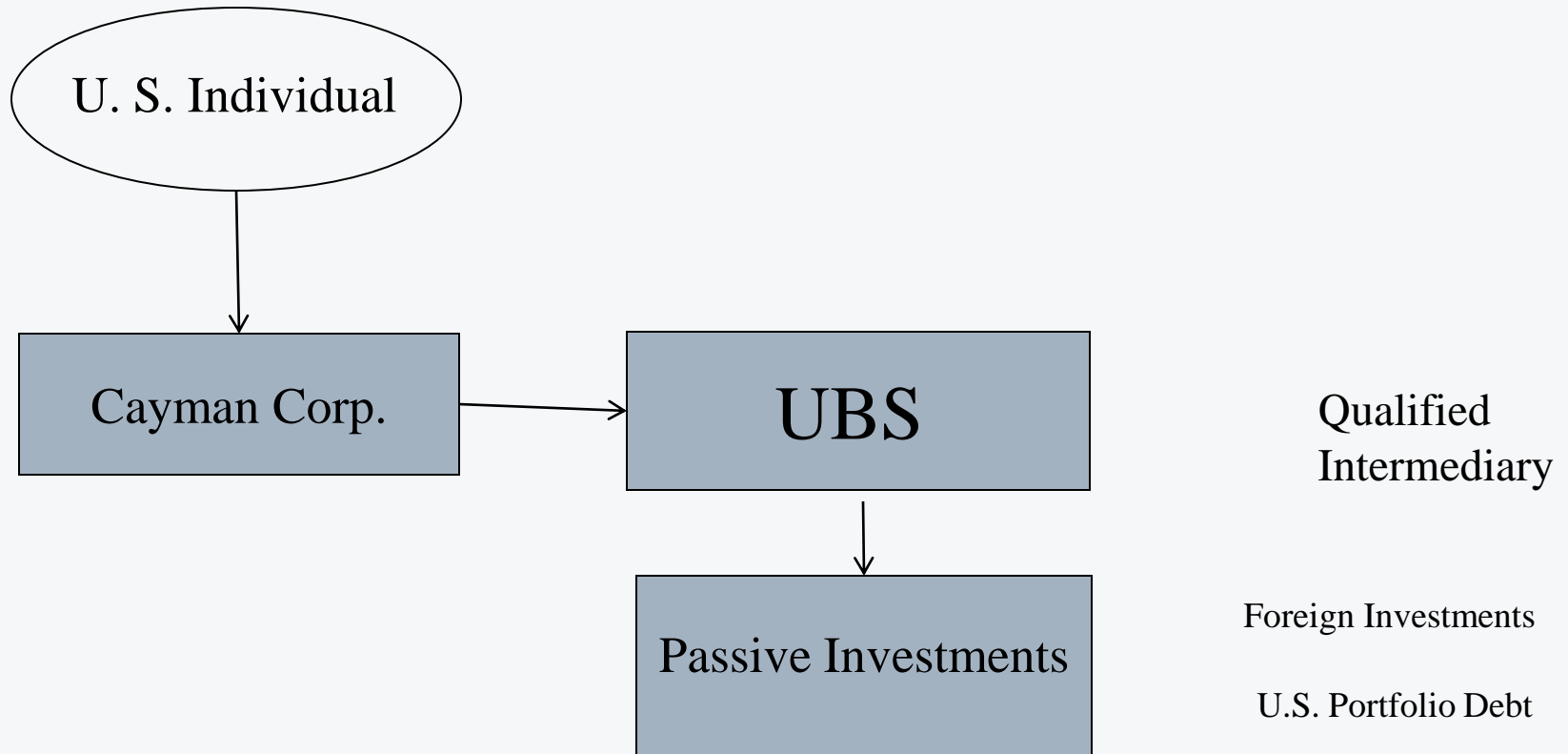
1. Repeal domestic production deduction -- **\$114.93 billion** over 10 years
2. Limit treaty shopping -- \$6.4 billion over 10 years
3. Repeal worldwide interest allocation -- \$26.2 billion over 10 years
4. Defer expenses related to deferred foreign income –
\$106.39 billion
5. Reduce corporate tax rate – **(\$363.84 billion)** over 10 years

Treasury Office of Tax Policy – 2007

“Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century”

1. Introduction of business activities tax
2. Broad-based reform of income tax
 - a) Base broadening initiatives
 - b) Lowering rate toward 28%
 - c) Moving to territorial system
3. Addressing structural problems with income tax
 - a) Simplification for small business
 - b) Earnings of individuals working abroad
 - c) Reform of Subpart F

The UBS Scandal



Estimates of Tax Losses

Joseph Guttentag and Reuven Avi-Yonah:

\$40 to \$70 billion per year

Senate Subcommittee on Investigations: the Levin Proposals

1. Treat foreign corporations managed and controlled in the United States as domestic corporations
2. Treat earnings on derivatives the same as dividends
3. Establish evidentiary presumptions favoring the government in tax and securities proceedings relating to private entities located in “Offshore Secrecy Jurisdictions”
 - a) List of 34 OSJs based on IRS court filings
4. Strengthen restrictions on the use of foreign trusts
5. **Require banks and securities firms to file Forms 1099 for accounts beneficially owned by U.S. taxpayers**
 - a) Availability of information under money-laundering rules
 - b) Eliminate reliance on self-certification under current withholding rules

The Four Magic Words

Reform

Competition

Jobs

Deficit

President Obama's Remarks

One of the strengths of our economy is the global reach of our businesses. And I want to see our companies remain the most competitive in the world. But the way to make sure that happens is not to reward our companies for moving **jobs** off our shores or transferring profits to overseas tax havens.

[T]hese and other reforms will save American taxpayers \$210 billion over the next 10 years -- **savings that we can use** to reduce the deficit, cut taxes for American businesses that are playing by the rules, and provide meaningful relief for hardworking families.

The President's Proposals (1)

1. Defer expense deductions attributable to deferred foreign income
 - a) Applies to interest and head office expenses
 - b) Does not apply to research and development costs
2. Close foreign tax credit loopholes
 1. Fix Guardian Industries problem
 2. Grant credit for average foreign taxes paid on all foreign earnings
3. Deny check-the-box elections to second-tier foreign subsidiaries
4. Make the Research and Development Credit permanent

Revenue Estimates

1. Defer expense deductions attributable to deferred foreign income -- \$60.1 billion over 9 years
2. Close foreign tax credit loopholes -- \$43.0 billion over 9 years
3. Restrict check the box elections -- \$86.5 billion over 9 years
4. Make the Research and Development Credit permanent – **(\$74.5 billion)** over 10 years

The President's Proposals (2)

1. Expand rules on transfers of intangibles to foreign entities
2. Prevent earnings stripping by expatriated companies
3. Modify boot within gain rule for outbound transactions
4. Eliminate 80/20 rules
5. Prevent avoidance of dividend withholding taxes
6. Tighten FTC rules for dual capacity taxpayers

The President's Proposals (3-1)

1. Discourage taxpayers from using intermediaries that are not Qualified Intermediaries
 - a) Require withholding on FDAP, gross proceeds at 20-30%
 - b) Legal presumptions that favor the government
2. Tighten rules relating to FBAR reports
 1. Require FBAR reports to be attached to income tax returns
 2. Legal presumptions that favor the government
3. Extend information reporting on transfers abroad and formation of foreign entities and accounts
4. Increase penalties on understatements re: foreign accounts
5. Improve foreign trust reporting penalty

The President's Proposals (3-2)

1. Substantially increase resources to international functions at IRS
2. Extend statute of limitations to 6 years for offshore transactions
- 3. Require banks and securities firms to file Forms 1099 for accounts beneficially owned by U.S. taxpayers**

The President's Proposals (4)

The missing piece:

REDUCE THE CORPORATE TAX RATE