INTERNATIONAL COMPETITIVENESS

Senate Finance Committee Staff Tax Reform Options for Discussion

May 9, 2013

This document is the fifth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT LAW

The United States income tax rules applying to cross-border income are based on two core concepts: the *residence* of the taxpayer and the *source* of the taxpayer's income. For nearly a century, the U.S. and other countries have tried to ensure that income earned by a resident of one country from a source in another country is not taxed twice. Some countries, including the U.S., have mitigated double taxation by giving a credit to their residents for income taxes paid to the source country. Other countries, like the Netherlands, have mitigated double taxation by exempting their residents from tax on foreign dividends paid from active business income that was taxed in the source country.

Under the U.S. credit-method system, residents generally must pay tax annually on their global income and can claim a credit for foreign income taxes paid (the "foreign tax credit") to prevent double-taxation. The rules are more complicated if the taxpayer is a U.S. multinational earning foreign income through a foreign subsidiary. In this case, the U.S. parent company generally does not owe any U.S. tax on its subsidiary's foreign earnings until the earnings are repatriated, typically by way of a dividend. The ability of a U.S. multinational to delay paying U.S. tax on their foreign subsidiaries' earnings is called "deferral" (a term that is also used in other non-international areas of the tax code). However, under the "subpart F" rules, a U.S. multinational still must pay tax immediately on the foreign earnings of controlled foreign corporations (CFCs) to the extent that the income is passive, mobile, or invested in certain U.S. property.

The impact of the subpart F rules is often reduced through tax planning that utilizes the "check-the-box" rules and the CFC look-through rule. The check-the-box rules, issued by the Treasury Department in 1996, are entity classification rules that provide a streamlined process to designate certain business entities as corporations or alternatively as pass-through or disregarded entities. This streamlined process enables U.S. multinationals to disregard, for U.S. tax purposes, certain controlled business entities and transactions between those entities and other affiliated companies within the corporate group. The CFC look-through rule, enacted in 2006, treats dividends, interest, rents, and royalties received by a CFC from a related CFC as active income not subject to current U.S. tax under subpart F if the payor CFC derives its income from active business activities.

The U.S. tax system also includes special rules for U.S. investors who own stock in a foreign corporation holding mainly investment assets, which is referred to as a "passive foreign investment company" (PFIC). The PFIC rules limit a U.S. person's ability to defer U.S. tax liability on their share of the PFIC's income.

Other developed countries have various anti-abuse rules similar to our subpart F and PFIC rules. These rules are intended to prevent their residents from shifting passive income and other types of mobile income to foreign subsidiaries in order to avoid or defer paying tax in their home country. In addition, most countries have rules to prevent related parties (such as two companies owned by the same parent) from making contracts that shift income to a lower-tax country. These "transfer pricing" rules require related parties transacting with each other to use, for tax purposes, the prices that unrelated parties would use, also known as "arm's length" prices.

Like other countries using the credit-method system, the U.S. limits the amount of foreign tax credits that a taxpayer can claim to the amount of U.S. tax the taxpayer would owe on their net foreign income if it were earned in the U.S. This limit on foreign tax credits is applied separately to two "baskets" of a taxpayer's foreign income: passive and non-passive income. These baskets mean that a taxpayer cannot use foreign tax credits derived from foreign active income to reduce the U.S. tax they owe on foreign passive income, and vice versa.

Nevertheless, within these two baskets, foreign tax credits derived from items of highly-taxed income can be used to offset U.S. tax on items of lower-taxed income. This ability to reduce the U.S. tax due on foreign income earned in a low-tax country through foreign tax credits received on foreign income earned in a high-tax country is known as "cross-crediting."

Under current law, there are also limits on the extent to which "dual capacity" taxpayers can claim foreign tax credits. A dual capacity taxpayer is one that receives a specific economic benefit from another country, such as the right to extract natural resources or operate a casino. When a dual capacity taxpayer is subject to a higher tax rate than other taxpayers that are not receiving a specific economic benefit, the taxpayer may not be able to claim a foreign tax credit for this extra tax if it represents a fee or royalty.

All of the rules described above require U.S. taxpayers to determine what portion of the income they earn is U.S. versus foreign income. A complicated set of rules determine the source of different items of income. For example, income from services is "sourced" to the U.S. if the service is performed in the U.S. and "sourced" to a foreign country if the service is performed abroad. Another complicated set of rules determine how expenses, such as interest payments, are allocated to U.S. versus foreign income.

The rules described above also assume that the taxpayer is subject to U.S. tax. All U.S. persons, whether an individual or corporation, are subject to U.S. tax. However, foreign individuals and foreign corporations are generally only subject to U.S. tax if they earn U.S. source income. The rates they pay depend on whether their U.S. source income is effectively connected to a U.S. trade or business in which they are engaged. If it is, they pay tax on their net income at our graduated income tax rates. If it is not, they must pay a 30% flat tax on their gross income, which is withheld by the payor.

The U.S. has 67 bilateral income tax treaties, which often substantially change the U.S. tax treatment of non-resident foreign individuals and foreign corporations. In general, our income tax treaties lower the 30% withholding tax on U.S. source dividends, interest, and royalties paid to a treaty-country resident, sometimes to zero. Our income tax treaties also typically bar the U.S. from taxing the business profits of a non-resident foreign individual or foreign corporation unless they have a permanent establishment in the U.S.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

In an increasingly global economy, our international tax rules have become more important for the competitive position of the U.S. economy and U.S. businesses. We are competing with other nations for investment, both from U.S. businesses and foreign businesses. At the same time, U.S. companies are competing with foreign companies for business in foreign markets. Yet our international tax rules have not been substantially reformed since 1962, when exports as a share of GDP were 5%. Today, exports are 14% of GDP.

Tax reform is an opportunity to strengthen the competitiveness of the U.S. in the global economy. It is also an opportunity to improve the tax system by making it more fair, efficient, clear, and simple. Following are some potential broad principles for reform in this area:

- Increase U.S. competitiveness and job creation by reducing tax barriers to U.S. and foreign multinationals investing in the U.S.
  - Reduce tax incentives for multinationals to be foreign-based (either by incorporating abroad or being acquired by foreign multinationals)
  - Reduce tax incentives for U.S. multinationals to keep foreign earnings abroad rather than bringing them back for U.S. investment
- Prevent base erosion and profit shifting to low-taxed foreign entities lacking relevant business substance
- Reduce complexity, uncertainty, and compliance burdens

Specific concerns about our international tax system today include the following:

- **Competitiveness:** U.S. corporations generally pay tax at a federal statutory rate of 35% on their foreign earnings (reduced by foreign tax credits), either immediately or when such earnings are repatriated. Their competitors in foreign countries typically pay tax on their foreign earnings at a lower statutory rate (and, some believe, a lower effective rate). Their competitors also are not taxed significantly, if at all, on repatriated foreign earnings. Some are concerned that these features of our tax system put U.S. multinationals at a competitive disadvantage by reducing the after-tax return they can offer investors, which in turn increases their cost of capital compared to a typical foreign competitor. Others believe that our tax system does not put U.S. multinationals at a competitive disadvantage because U.S. multinationals' average effective tax rates are in line with those of our competitors and the U.S. offers other competitive advantages, such as strong intellectual property protections.

  If U.S. multinationals do face a higher cost of capital (whether actual or perceived) because of our tax system, this may result in foreign companies being able to outbid U.S. companies for profitable business opportunities. It may also result in a decline in U.S.-resident multinationals as new businesses incorporate abroad and existing U.S. businesses are acquired by foreign companies.

  Some believe that a decline in the share of global income earned by U.S. multinationals, as opposed to foreign multinationals, would adversely affect U.S. growth and jobs. While the evidence is mixed, some research suggests that U.S. multinationals have a "home country bias," meaning that they are more likely to hire U.S. workers and purchase inputs from U.S. companies than their foreign competitors.

- **Base erosion and profit shifting:** Some multinationals minimize their tax burden by using planning strategies that shift income from a high-taxed affiliate to a low-taxed affiliate. They do so for income derived from both U.S. and foreign customers. This tax planning is possible through a combination of factors, including tax treaties, the ability to treat different subsidiaries as separate entities, and the ways in which multinationals set prices for transactions between their subsidiaries. Typically, multinationals seek to reduce their tax burden by arranging their affairs so that subsidiaries resident in low-tax countries receive as much income as possible through ownership of valuable intangibles, the provision of financing, and the assumption of business risks. They also seek to allocate payments of deductible interest and royalties to affiliates in higher-tax countries, which reduces their tax base in those countries.

Estimates of the amount of taxable income shifted by U.S. multinationals to low-tax countries from other countries (not necessarily only the U.S.) through base erosion and profit shifting range from $58 billion to $111 billion per year. Base erosion and profit shifting by global corporate groups has become a political issue in a number of countries including the UK, France, and Germany. The G-20 countries, which include the U.S., are discussing a range of alternatives to address profit shifting to tax haven entities that lack business substance.

- **Lockout effect:** The ability of U.S. multinationals to defer paying U.S. tax on some foreign earnings until they are repatriated creates a disincentive for U.S. multinationals to repatriate such earnings and invest them in the U.S. This is known as the "lockout effect." This disincentive does not exist if the foreign earnings are taxed abroad at a higher rate than the U.S. rate. But the U.S. has one of the highest statutory corporate tax rates compared to other countries. In addition, through tax planning, some U.S. multinationals shift income from high-tax foreign subsidiaries to low-tax foreign subsidiaries. This further reduces the foreign tax rate on their foreign income, exacerbating the lockout effect.

  The lockout effect may be heightened for U.S. multinationals that make business decisions with an eye towards the impact on their "book" income. Most U.S. multinationals that are publicly-traded focus primarily on book income meaning that avoiding financial accounting income tax expense is at least as important to them as avoiding cash taxes (if not more important). Under U.S. financial accounting rules, if a U.S. multinational has a foreign subsidiary that does not intend to pay dividends to the U.S. parent, the subsidiary's earnings are considered to be "permanently reinvested" abroad. This means that the U.S. parent does not have to account in its financial statements for the ultimate U.S. tax that will be due when the subsidiary's foreign earnings are repatriated. Therefore, keeping foreign earnings offshore can enhance a U.S. multinational's earnings for financial accounting purposes by reducing the company's overall effective tax rate.

  Many U.S. multinationals have accumulated large amounts of permanently reinvested earnings in foreign subsidiaries, including tax haven entities. According to research published by JP Morgan, the total amount is around $1.8 trillion.

- **Nonresident citizens:** U.S. citizens living abroad are generally taxable as residents of the foreign country where they live. They are also required to file U.S. federal income tax returns annually and pay tax to the U.S. on their worldwide income, subject to the foreign tax credit and an exclusion for a limited amount of foreign-earned income. Other countries generally tax their nonresident citizens only on income their citizens earn in their country of citizenship. Some believe certain employers overseas are reluctant to hire U.S. citizens because of the associated tax burden and compliance costs.

REFORM OPTIONS

I. BASE EROSION AND DEFERRAL

1. Tighten anti-base-erosion rules and reform the treatment of non-subpart F earnings

a. Redefine the earnings subject to immediate taxation under subpart F through one of the following:
   i. Immediately tax all income of relatively low-taxed CFCs, except income from substantial activities in foreign markets (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011; this is also the law in certain other countries, including Germany and Japan)
   ii. Immediately tax income of a relatively low-taxed CFC that exceeds the income proportionate to the CFC's share of the multinational group's business operations, based on factors such as the CFC's tangible assets and payroll (Avi-Yonah, Clausing, and Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," Florida Tax Review, 2009)

b. "Minimum Tax" on CFC earnings:
   i. For income taxed below a minimum foreign effective tax rate, immediately apply U.S. tax at a designated minimum tax rate or full U.S. rates (subject to foreign tax credits in both cases) (President's Framework for Business Tax Reform, 2012; Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011)

1. Provide an exception for income from sales or services in the CFC's country of incorporation. (Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011)

ii. Immediately tax at, for example, a 15% rate (subject to foreign tax credits) all intangibles-related income of CFCs and of the U.S. parent from sales in foreign markets, with no further U.S. tax upon repatriation (Ways and Means Committee Discussion Draft on International Tax Reform: Option C, 2011)

iii. Immediately tax all income of CFCs, at, for example, a 15% rate (subject to foreign tax credits) except for the amount spent on tangible capital assets in the CFC's home country (Grubert and Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," 2013)

c. In addition to (a) or (b), move to an exemption system through one of the following:

i. Exempt, for example, 95% of dividends received by a U.S. corporation from a CFC, and 95% of gains on the sale of CFC stock, while allowing deductions for expenses related to exempt dividends and gains (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)

1. Could immediately tax remaining 5% of CFCs' earnings each year, reduced by any tax under (a) or (b) (Sullivan, "Designing Anti-Base Erosion Rules," Tax Notes, 2013)

ii. Exempt, for example, 100% of dividends received by a U.S. corporation from a CFC, and 100% of gains on the sale of CFC stock, but disallow deductions for expenses related to exempt dividends (Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 2005; President's Advisory Panel on Federal Tax Reform, 2005)

iii. Together with (i) or (ii) above, apply one of the following to foreign branch operations:

1. 95% or 100% exemption could cover foreign branch profits (The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth", 2010; similar to the law in Hong Kong)

2. Could deem foreign branches to be CFCs and therefore qualify for the exemption (Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 2005; Ways and Means Committee Discussion Draft on International Tax Reform, October 2011)

iv. Together with (i) or (ii) above, impose a transitional "toll charge" on accumulated, untaxed, pre-enactment earnings of CFCs (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)

1. Could be mandatory and payable over a period of years
2. Could be elective

2. Strengthen the subpart F rules through one or more of the following

a. Immediately tax all income of relatively low-taxed CFCs from sales of property or services used or consumed in the U.S. (S.260 (111th Congress), A bill to… provide for the taxation of income of controlled foreign corporations attributable to imported property, sponsored by Sen. Dorgan)
b. Immediately tax all income of relatively low-taxed CFCs on intangible property transferred from a related U.S. party to the extent that it is deemed to exceed a reasonable return (FY2014 Administration Budget Proposals; estimated in 2012 to raise $19 billion over 10 years; Ways and Means Committee Discussion Draft on International Tax Reform: Option A, October 2011)
c. Apply the subpart F rules separately to each foreign business unit within, or controlled by, a CFC (FY2010 Administration Budget Proposals; estimated in 2010 to raise $31 billion over 10 years; S.268 (113th Congress), CUT Loopholes Act of 2013, sponsored by Sen. Levin)
d. Treat interest and royalties received from a related CFC as subpart F income regardless of whether the payor derives its income from active business activities (S.268 (113th Congress), CUT Loopholes Act of 2013, sponsored by Sen. Levin)
e. Repeal rule treating CFCs' investments in U.S. property as taxable income of the controlling U.S. shareholder(s) (Dilworth, "U.S. Federal Income Tax Reform: International Recommendations," Tax Notes, November 8, 2010)

3. Repeal deferral for CFCs (S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats)

a. Include all earnings of CFCs in the U.S. parent company's income each year, with foreign tax credits

4. **Strengthen thin-capitalization rules to limit base erosion through excessive debt financing** (Ways and Means Committee Discussion Draft on International Tax Reform, October 2011; similar to the law in Germany and Italy)

    a. Disallow interest expense deductions by a U.S. corporation to the extent that net interest expense exceeds, for example, 25% of adjusted taxable income
    b. Create an exception for any U.S. taxpayer that is not more highly leveraged than the worldwide group of which it is a part
    c. Allow nondeductible interest to be carried forward and deducted in future years

5. **Strengthen rules against U.S. base erosion by foreign companies**

    a. Restrict deductions for reinsurance premiums paid to untaxed offshore affiliates (FY2014 Administration Budget Proposals; estimated in 2012 to raise $13 billion over 10 years; S.1693 (112th Congress), A bill to… prevent the avoidance of tax by insurance companies through reinsurance with non-taxed affiliates, sponsored by Sen. Menendez)
    b. Restrict deductions for royalties paid to untaxed offshore affiliates (Multistate Tax Commission, Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, 2006)
        i. For example, disallow deductions unless the effective tax rate of the recipient is greater than, for example, 20% and the recipient does not pay out the amount to another related party that is taxable at a lower rate

II. FOREIGN TAX CREDIT AND SOURCING RULES

1. **Further limit cross-crediting**

    a. Supplement the two existing foreign tax credit limitation baskets (passive and general income) with additional baskets (for example, subpart F income and dividends from non-controlled foreign corporations)
        i. Alternatively, use per-country baskets (S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats)

b. Treat rents and royalties received from a related party as falling in passive income basket for foreign tax credits (Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion," 2013)
c. For purposes of determining the foreign tax credit from foreign subsidiaries of U.S. multinationals, treat all foreign subsidiaries as one corporation (FY2014 Administration Budget Proposals; estimated in 2012 to raise $57 billion over 10 years)
d. Strengthen the dual capacity rules (FY2014 Administration Budget Proposals; estimated in 2012 to raise $10 billion over 10 years; S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats; S.307 (113th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sen. Menendez)

2. Improve the sourcing of income rules

a. Accelerate adoption of worldwide allocation of interest expense (currently effective in 2021)
   i. Could also repeal fair-market-value method of interest expense apportionment (H.R.4238 (102nd Congress), A bill to amend the Internal Revenue Code to more fairly apportion interest expense between domestic and foreign sources, sponsored by Rep. Schulze and others)
b. Replace title-passage rule for source of income from sales of inventory with a place-of-business rule (Fleming, Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty," 2012)
c. Expand the scope of the rules limiting the creation of foreign-source income upon U.S. taxpayer elections (FY2014 Administration Budget Proposals; estimated in 2012 to raise $1 billion over 10 years)

III. OTHER INTERNATIONAL BUSINESS REFORMS

1. Repeal DISC provision (H.R.3970 (110th Congress), Tax Reduction and Reform Act of 2007, sponsored by Rep. Rangel)

2. **Reform passive foreign investment company (PFIC) rules** (NY State Bar Association, PFIC Reform Recommendations, Tax Notes Today, 1993)

    a. Annual recognition of gain or loss on marketable PFIC stock
    b. For non-marketable stock, impose a small tax on the amount invested in the stock (H.R.8000 (88th Congress), The Interest Equalization Tax Act of 1963, sponsored by Rep. Mills)

3. **Reform effectively connected income rules** (Lokken, "Income Effectively Connected with U.S. Trade or Business: A Survey and Appraisal," Taxes, 2008)

    a. Narrow circumstances under which a foreign individual or corporation is considered to be engaged in a U.S. trade or business through its agents
    b. Only treat income from sales of goods as effectively connected to a U.S. trade or business to the extent that the sales are attributable to a fixed place of business in the U.S.

IV. NON-RESIDENT U.S. CITIZENS

1. **Provide an election to citizens who are long-term nonresident citizens to be taxed as nonresident aliens if they meet certain conditions** (Schneider, "The End of Taxation Without End: A New Tax Regime for U.S. Expatriates," 2013; similar to the law in Canada)

    a. Require a minimum period of residence abroad
    b. Impose an exit tax on electing taxpayers where deemed to sell all assets at the time of election

2. **Repeal the foreign-earned income exclusion** (H.R.2 (108th Congress), Jobs and Growth Tax Relief and Reconciliation Act of 2003, sponsored by Rep. Thomas)