Senate Finance Committee staff presents options for international tax reform

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In brief

The chairs of the respective Congressional tax writing committees, Rep. Dave Camp (R-MI) and Sen. Max Baucus (D-MT), intend to consider corporate tax reform options, including international tax issues, in 2013. Chairman Camp issued an international tax reform discussion draft in October 2011. The Senate Finance Committee (SFC) staff has now moved the process along by publishing a report outlining the main options for international tax reform, the fifth report in a series on tax reform options.

The SFC staff international tax report opens with a brief introduction, followed by a summary of current law and a discussion of current goals and challenges for tax reform. The last half of the report provides an outline of the options that the SFC may consider. In contrast with Chairman Camp's discussion draft, the Finance staff report notes that the options listed "are not necessarily endorsed" by either Chairman Baucus or Ranking Member Orrin Hatch (R-UT).

The SFC staff report emphasizes issues of global competitiveness and base erosion, both outbound and inbound. Most of the tax reform options in the report are prior legislative proposals, including provisions advanced by either the Obama Administration or members of Congress. A few of the options mentioned come from public testimony and commentary by international tax professionals outside the government. The report does not make recommendations among the various options, but it is likely that any reform proposals that the SFC may introduce as legislation in the current Congress will reflect options summarized in this report.

The SFC staff report also differs from a May 6, 2013 Joint Tax Committee staff report submitted to the House Ways and Means Committee. In addition to summarizing current law, the JCT staff report collates and categorizes comments submitted by outside observers to Ways and Means tax reform working groups, including the international tax reform working group that received comments on various international tax reform proposals, such as the discussion draft that Ways and Means Committee Chairman Camp offered in the last Congress.

In detail

As the report's introduction notes, the report does not deal with political issues such as the amount of revenue to raise or how to apply the revenue to lower tax rates or reduce deficits. Rather, the report focuses more narrowly on international tax policy issues.

The substantive part of the report begins by discussing the key elements of current law, including differences between source and residence taxation, differences between territorial exemption and foreign tax credit (FTC) regimes, the principle of deferral for foreign subsidiary income, entity classification and check-the-box rules, controlled foreign corporation (CFC) look-through, the passive foreign investment company (PFIC) concept, other anti-abuse regimes, and the idea of transfer pricing.

Current challenges and potential goals for tax reform

Much of the SFC staff report addresses current challenges and goals for international tax reform. This section emphasizes issues of global competitiveness but also discusses base erosion and profit-shifting. Finally, the report considers the "lockout effect" that discourages foreign subsidiaries from repatriating earnings to their US parent companies. As a general tax reform goal, the report mentions the desire to reduce complexity, uncertainty and compliance burdens arising from the US federal income tax system.

Regarding competitiveness, the SFC staff report focuses on the high US statutory tax rate relative to other countries where multinational companies (MNCs) reside. The report highlights the perception that the high rate reduces the after-tax return, and increases the cost of capital, for US MNCs relative to those foreign-headed MNCs. As the SFC staff notes, the consequences of those lower returns and higher costs for US MNCs could create for them a disadvantage in developing, acquiring and maintaining global business operations. However, the report does acknowledge that some observers believe the global effective tax rate for US MNCs is comparable to that of foreign MNCs.

One aspect of global competitiveness that the SFC staff highlights is the impact on jobs in the United States. The report notes that some observers believe the decline in the share of global income earned by US MNCs has a negative effect on US growth and jobs, although certain data reflect a preference by US companies to hire US workers and purchase US-produced inputs.

Regarding profit-shifting, the SFC staff report explains that MNCs try to arrange their global business to put the maximum amount of profit in low-tax jurisdictions through ownership of intellectual property (IP), provision of financing, and assumption of business risks. In addition, the report mentions the impact of base erosion through royalties and interest paid by affiliates in higher-tax jurisdictions. The report notes that estimates of the financial impact of base erosion and profit-shifting range from $58 billion to $111 billion per year. Finally, the report acknowledges that various European countries have concerns about these issues and that the G-20 countries are trying to combat profit-shifting to tax haven countries without substance.

The SFC staff's explanation of the lockout effect goes beyond the benefit of maintaining deferred income in lower-tax subsidiaries. The report recognizes that US MNCs are often more concerned about the financial accounting impact of income taxes than about the cash tax impact. Foreign subsidiaries can designate certain foreign earnings that they do not intend to repatriate as "permanently reinvested" outside the United States. Because financial accounting rules do not treat such earnings as subject to the higher US statutory income tax rate, this treatment can result in a lower global effective tax rate for financial accounting purposes. Thus, US MNCs have powerful incentives to keep lower-tax foreign earnings offshore. The report cites a study that estimates the total of permanently reinvested foreign earnings at $1.3 trillion.

International tax reform options

The report addresses possible approaches for (i) a territorial system, (ii) base erosion concerns, (iii) changes to subpart F and (iv) other issues, including changes to the FTC regime (assuming a territorial system does not replace it), changes to the income sourcing rules, and other miscellaneous changes.

Territorial system

The report addresses possible movement to a territorial system of taxation. The options include some of the key provisions from Chairman Camp's discussion draft and the somewhat similar bill Sen. Mike Enzi (R-WY) introduced in the last Congress.

The SFC staff has divided this largest category into three main options. The first is to redefine the types of non-subpart F income subject to immediate US federal income taxation. The primary suggestion under this option is to include currently on the US parent's tax return the income of all relatively low-taxed CFCs except those with substantial activities in foreign markets. A second suggestion under this option would adopt a formulary approach to tax a certain share of low-taxed CFCs' income.

The second main option under this category in the SFC staff report is to impose some level of US tax on certain income of CFCs. The suggestions under this option include taxing CFC income (i) that incurs foreign income tax below a minimum effective rate (possibly with an exception for same-country activities), (ii) that is IP-related and derives from foreign sales or (iii) that the CFC does not spend on tangible assets in its own country.

The third main option under the first category would move to a territorial regime in addition to tightening anti-base erosion rules under the first or second main option.

Once in a territorial system, the taxation of income would fall under one of four options. The first suggestion under this territorial regime option would exempt some amount (e.g., 95%) of dividends received from CFCs and gains from sales of CFC stock (possibly with immediate US taxation of the non-exempt 5%), allowing deductions of expenses related to the exempt income. The second suggestion would exempt 100% of CFC dividends and stock gains but disallow deductions of such expenses. The third suggestion would treat foreign branches the same as CFCs or specifically exempt 95% or 100% of foreign branch profits. Finally, the fourth suggestion would combine a territorial regime with a transitional "toll tax" on accumulated, untaxed, pre-enactment CFC earnings.

Base erosion

Strengthen thin capitalization rules to limit base erosion through excessive debt financing

The three options under this category center on a proposal to disallow interest deductions by a US corporation exceeding a certain amount (e.g., 25% of adjusted income). The second element of the option would create an exception for corporations not more highly leveraged than the worldwide group. The third element of the option would allow a carryforward of non-deductible interest.

Strengthen rules against US base erosion by foreign companies

The suggestions under this option would restrict deductions for payments – specifically, reinsurance premiums or royalties -- from US companies to untaxed or low-taxed foreign affiliates.

Changes to subpart F

This option in the SFC staff report lists six suggestions for changing the subpart F rules:

1. tax currently all income of low-taxed CFCs for sales and services in the United States
2. tax currently all excess returns of low-taxed CFCs to which a related US person has transferred IP
3. apply subpart F rules separately to each business unit controlled by a CFC
4. treat all interest and royalties received by a CFC from related CFCs as subpart F income (i.e., narrow the scope of the CFC look-through rule)
5. repeal Section 956
6. assuming Congress does not pursue a territorial approach, one option in the report is the current inclusion of all CFC earnings on the US shareholder's return (with applicable FTCs). This proposal is not only at odds with a territorial approach, but it would be a dramatic expansion of the US taxing jurisdiction, in that it would seek to tax the earnings of non-US persons without a US earnings connection simply because US persons own them.

Other international tax reform options

Reform foreign tax credit rules

The FTC option addresses means of further limiting cross-crediting. That option includes four suggestions, two of them relating to FTC limitation categories (baskets). One of those suggestions would add new baskets to the current two (e.g., for subpart F income) or return to the previous system of per-country baskets. The other basket-related suggestion involves classifying royalties from related persons as passive basket income. The two remaining suggestions for FTC reform echo the Administration's legislative proposals for FTC pooling and changing the treatment of dual-capacity taxpayers.

Reform sourcing rules

The SFC staff's option for improving the sourcing rules includes three suggestions. The first suggests accelerating adoption of worldwide interest allocation and the possibility of repealing the fair market value method of interest expense apportionment. The second suggestion would replace the title-passage rule for inventory sales with a place-of-business rule. The third suggestion would further limit taxpayers' creation of foreign-source income.

Miscellaneous international reforms

Other tax options include the following miscellaneous proposals:

1. repeal the domestic international sales corporation (DISC) regime
2. reform the PFIC regime, with specific suggestions for both marketable and non-marketable stock
3. reform effectively connected income (ECI) rules, with specific suggestions for narrowing their scope
4. reform the taxation of non-resident US citizens, either by repealing the exclusion in Code Section 911 or allowing an election to be taxed as a non-resident alien under certain conditions.

The takeaway

The Senate Finance Committee has a history of bipartisan cooperation, and the international tax reform options listed in the staff report reflect both Democratic and Republican proposals. Any legislation that the Committee ultimately adopts likely will feature options from this list. Thus, the report indicates the potential shape that international tax reform may take during the current Congress. As always, companies that these proposals might affect should consider participating in the legislative process.

Additional resources

WNTS Insight: Numerous business tax reform proposals included in report to Ways and Means Committee

WNTS Insight: Ways and Means Chairman Camp releases Discussion Draft for corporate rate reduction, territorial tax system

US Outbound Newsalert: Senate Finance member Enzi introduces territorial tax bill with similarities and differences to Camp proposal

Let's talk

For a deeper discussion, please contact:

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