# INTERNATIONAL ROUNDTABLE

*Presented by*

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*For*

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International Tax Reform

**I. Goals of Reform Efforts:**

a. Discourage flight of U.S. operations and jobs abroad;

b. Allow U.S. companies to remain competitive with their foreign counterparts.

c. Ensuring U.S. corporations with foreign operations contribute their "fair share" to the U.S. fisc.

**II. The Administration's Fiscal Year 2012 Budget Proposal**

a. International Tax Reform Aspects of Significance:

i. Defer Deduction of Interest Expense Related to Deferred Income

1. *Current Law:*

a. The U.S. taxes its resident individuals and domestic corporations on their worldwide income, but allows income taxes to be deferred on certain active foreign income derived by a U.S. person indirectly through a foreign corporation until such time as the income is repatriated to the U.S. Under current law, despite the deferral of income taxes attributable to this foreign-source income, ordinary and necessary expenses properly allocable and apportioned to the foreign-source income, including interest paid or accrued within the taxable year with respect to indebtedness,[1] may be currently deducted by the U.S. taxpayer.

2. *Purported Reasons for Change:*

a. "The ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming our domestic economy."[2]

b. U.S. corporations that solely earn domestic income are placed at a disadvantage compared to U.S. corporations

[1] IRC § 163(a).
[2] U.S Treasury Dep't, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, 40 (2011).

with foreign-source income as foreign-source income is taxed a lower effective rate taking into account both the ability to defer tax on the foreign-source income as well as the ability to currently deduct expenses allocable and apportioned to same.

3. *Proposal:*[3]

   a. The interest expense of U.S. corporations that is properly allocated and apportioned to foreign-source income would be currently deductible only to the extent allocable to currently taxed foreign-source income; the deferred interest expense would be deductible in the subsequent year in which deferred foreign-source income is subject to U.S. taxation.

   b. The proposal will not apply to interest expense allocated and apportioned to foreign-source income earned directly by the U.S. corporation (i.e. royalty income) or through a foreign branch.

   c. The proposal anticipates using current Treasury regulations to determine the amount of interest allocable to deferred foreign-source income, but recognizes that the Secretary would have authority to issue additional regulations necessary to effectuate the purpose of the proposal.

ii. Determine the Foreign Tax Credit on a Pooling Basis

1. *Current Law:*

   a. In order to provide relief from double taxation, generally, a U.S. taxpayer is afforded a credit against U.S. income tax

[3] This proposal was included in the Administration's fiscal year 2011 budget proposal. A similar proposal was included in the Administration's fiscal year 2010 budget proposal that would have deferred deductions for expenses (other than research and development expenses), which were properly allocated and apportioned to deferred foreign-source income; thus, the current proposal is not as broad as the 2010 proposal in that it only applies to interest expenses.

liability for the foreign income taxes paid or accrued against foreign-source income.[4] In the case of a U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation, a foreign tax credit is allowed for "*deemed-paid*" taxes paid or accrued by the foreign corporation when the foreign corporation distributes a dividend to the U.S. shareholder, or the U.S. shareholder is otherwise required to include income under Subpart F.[5]

b. The foreign tax credit, however, is limited to a taxpayer's U.S. tax liability on foreign-source taxable income.[6] The limit is calculated by multiplying the taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign source taxable income for the year to the taxpayer's total taxable income for the year. If the amount of foreign taxes paid or accrued by the taxpayer is greater than the foreign tax credit limit, the excess is disallowed, but may be carried back to the previous taxable year or carried forward to one of the succeeding 10 taxable years.[7]

c. In applying the foreign tax credit limitation, the foreign source income of the taxpayer is generally divided into two baskets: the general category income basket and the passive category income basket. The limitation is then applied separately against each basket; credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

d. Under current law, U.S. taxpayers with multiple foreign corporations in its qualified group can engage in selective

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[4] IRC § 901.
[5] IRC §§ 901, 902, 960.
[6] IRC §§ 901, 904.
[7] IRC § 904(c).

"*cross-crediting*," whereby it can manipulate when repatriation of deferred foreign-source income to the U.S. occurs such that highly-taxed foreign earnings, and the high deemed foreign tax credits generated thereby, can be used to offset low taxed foreign income of the same basket.

2. *Purported Reasons for Change:*
   a. "The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction to two foreign tax credit limitation categories, for passive category income and general category income under the American Jobs Creation Act of 2004, enhanced U.S. taxpayers' ability to reduce the residual U.S. tax on foreign-source income through 'cross-crediting.'"[8]
3. *Proposal:*
   a. The proposal would require mandatory "*cross-crediting*" of all of the U.S. taxpayer's foreign subsidiary taxes within the same foreign tax credit basket. In other words, rather than allowing the U.S. taxpayer to manipulate which deemed foreign tax credits will be taken into account upon repatriating foreign-source income to the U.S. (or upon inclusion under Subpart F), when repatriation occurs, the deemed foreign tax credit will be determined on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit.

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[8] U.S Treasury Dep't, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, 42 (2011).

b. The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year. Thus, foreign taxes deemed paid in a taxable year would be calculated by multiplying the U.S. taxpayer's proportionate share of foreign taxes by the ratio of the U.S. taxpayer's currently taxed income derived from its foreign subsidiaries and the sum of the domestic corporation's proportionate share of the total earnings and profits of each foreign subsidiary. This computation would be performed separately for each foreign tax credit limitation basket.

c. Once the amount of foreign taxes deemed paid is determined for each basket, the amount is added to the direct foreign taxes in the same basket. The foreign tax credit limitation is then applied to the total amount of such foreign taxes. [9]

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[9] In the Joint Committee on Taxation ("JCT"), *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal*, 189 (2011), the JCT provides the following example, which helps illustrate the practical effect of the proposal for determining the foreign tax credit on a pooling basis:

> A domestic corporation, Parent Co., that owns 100 percent of the shares of each of Alpha Co. and Bravo Co., CFCs organized in countries A and B, respectively. Alpha Co. has pre-tax earnings of $1,000 in the general basket, pays foreign taxes of $125 (a 12.5-percent tax rate), and has net E&P of $875. Bravo Co. also has pre-tax earnings of $1,000 in the general basket, but pays foreign taxes of $410 (a 41-percent tax rate) and has net E&P of $590. The aggregate amount of net E&P of Alpha Co. and Bravo Co. is $1,465 ($875 + $590), 459 and the aggregate amount of foreign taxes paid is $535 ($125 + $410).
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> Under present law, if Alpha Co. distributes $500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid would be $71 ($125 x ($500/$875)), but if the $500 distribution was made instead from Bravo Co., Parent Co. would be deemed to have paid $347 ($410 x $500/590). Under the proposal, Parent Co.'s decision regarding whether the $500 is remitted from Alpha Co. or Bravo Co. would not be influenced by the amount of foreign tax credits, as a $500 distribution from either Alpha Co. or Bravo Co. would result in a deemed-paid foreign tax amount to Parent Co. of $183 ($535 x ($500/$1,465)).
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> The blended effective tax rate on Parent Co.'s share of the aggregate earnings of Alpha Co. and Bravo Co. is 26.8 percent ($535/($1,000 + $1,000)). Parent Co.'s deemed-paid foreign taxes of $183 on distributed

iii. Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore

1. *Current Law:*

a. U.S. shareholders of CFC's are subject to the Subpart F anti-deferral regime. Subpart F requires current inclusion of the U.S. shareholder's pro rata share of certain types of income regardless of whether that income has been repatriated.

b. Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other proscribed activities. Foreign base company income, in turn, consists of foreign personal holding company income, foreign base company sales income, foreign base company services income and foreign based company oil-related income.

c. The Secretary is authorized to distribute, apportion, or allocate gross income, deductions, credits and other allowances between or among two or more organizations, trades or business under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or business," under the Code's transfer pricing provisions.[10] The regulations promulgated thereunder adopt the arm's-length standard as the method for determining whether allocations are appropriate.

d. The transfer pricing provisions provide a test in addition to the arm's-length standard for transactions involving

earnings of $500 reflects that blended rate after the section 78 gross-up amount ($183), i.e., $183/($500 + $183) = 26.8 percent.

[10] IRC § 482.

intangible property. In such cases, the transfer or license of certain intangible property to a related person must be commensurate with the income attributable to the intangible property.[11] Complementing this rule, Code Section 367(d) imputes a royalty stream within the compensation for an outbound transfer of intangible property in the context of an otherwise nontaxable reorganization transaction.

2. *Purported Reasons for Change:*
    a. "The potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, puts significant pressure on the enforcement and effective application of transfer pricing rules. There is evidence indicating that income shifting through transfers of intangibles to low-taxed affiliates has resulted in a significant erosion of the U.S. tax base. Expanding Subpart F to include excess income from intangibles transferred to low-taxed affiliates will reduce the incentive for taxpayers to engage in these transactions."[12]
3. *Proposal:*
    a. The proposal creates a new Subpart F income category – "*excess intangible income*." If a U.S. person transfers directly or indirectly an intangible from the U.S. to a related CFC, then the excess intangible income from *transactions* connected with or benefiting from said

[11] Id.
[12] U.S Treasury Dep't, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, 43 (2011).

intangible will be currently included in the U.S. person's U.S. taxable income through Subpart F.[13]

i. Only if the income is subject to a low foreign *effective* tax rate (yet to be defined).[14]
ii. The transfer can be by sale, lease, license, or through any shared risk or development agreement (including any cost sharing agreement).

b. "*Excess intangible income*" is defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up.

c. Excess intangible income will be assigned its own basket for foreign tax credit limitation purposes.

iv. Limit Shifting of Income Through Intangible Property Transfers

1. *Current Law:*

a. In the case of a transfer of an intangible, in addition to the arm's-length standard, the amount paid for such transfer (whether by purchase or license arrangement) must be commensurate with the income attributable to the intangible.[15] For these purposes, "*intangible property*" is defined as any:

[13] Note that by making the basis of taxation the *transaction* connected with or benefiting from the intangible, the date of transfer of the intangible may predate enactment of the proposal. Thus, intangibles previously transferred to a CFC will still be subject to the proposal at the time a transaction connected with or benefiting from the intangible occurs.
[14] As the JCT observes, "while basing the threshold on the effective foreign tax rate imposes a greater administrative burden on taxpayers and the IRS, statutory foreign tax rates can be unreliable indicators as a result of many factors including generous expensing rules, income tax credits, or negotiated tax grants or tax rulings. JCT, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal*, 189 (2011).
[15] IRC §§482, 367(d).

i. Patent, invention, formula, process, design , pattern, or know-how;
ii. Copyright, literary, musical or artistic composition;
iii. Trademark, trade name or brad name;
iv. Franchise, license or contract;
v. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or
vi. Any similar item which has substantial value independent of the services of any individual.[16]

2. *Purported Reasons for Change:*
   a. "Controversy often arises concerning the value of intangible property transferred between related persons and the scope of the intangible property subject to sections 482 and 367(d). This lack of clarity may result in the inappropriate avoidance of the U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons."[17]
3. *Proposal:*
   a. To remove argument, the proposal adds the following intangible property items to the definition of "intangible property" for purposes of sections 367(d) and 482:
      i. Workforce in place;
      ii. Goodwill; and
      iii. Going concern value.
   b. The proposal provides that where multiple intangible properties are transferred, the Commissioner may value the

[16] IRC § 936(h)(3)(B), incorporated by reference in sections 482 and 367(d).
[17] U.S Treasury Dep't, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, 45 (2011).

intangibles on an aggregate basis when it would achieve a more reliable result.

c. The proposal further provides that the Commissioner may value intangible property transferred to a related party based on profits the U.S. taxpayer could have realized by choosing a realistic alternative to the transaction actually undertaken.

**III. Senate Finance Committee Hearing on International Reform – September 8, 2011**

a. Worldwide v. Territorial System of International Taxation – Key Points

i. Testimony of Philip R. West, Steptoe & Johnson LLP – Partner

1. Moving toward a territorial tax system may provide a business-friendly environment and other incentives which could promote job creation.
2. Advocates lowering the corporate tax rate and exempting from taxation a large portion of, but not all, the dividends of active earnings from foreign corporations of U.S. shareholders. The portion of the dividends that would continue to be taxed, between 5-10%, would be a proxy for disallowed deductions of expenses incurred in connection with the earnings of the otherwise exempt foreign income.

ii. Testimony of James R. Hines Jr., University of Michigan – Professor

1. Foreign expansions stimulate demand for tangible and intangible domestic output. Thus, reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the U.S.
2. Finds that exempting foreign income (i.e. territorial tax system) gives taxpayers incentives to allocate their resources to maximize

after-local-tax profits. To accomplish this, must permit full deductibility of domestic expenses (i.e., no allocation of domestic expenses to foreign income even if expenses go toward increasing foreign income).

iii. Testimony of Scott M. Naatjes, Cargill, Incorporated – Vice President and General Tax Counsel

1. As a U.S. multinational corporation, Cargill is subject to a second layer of income tax on non-U.S. earnings when repatriated to the U.S. The U.S. expense allocation rules create U.S. tax costs attributable to non-U.S. investments even when earnings are not repatriated from the investments to the U.S. The Subpart F rules make deploying and managing risk on non-U.S. earnings expensive and complex. Thus, these differences constitute a significant disadvantage compared to a foreign multinational corporation.
2. The U.S. should adopt a territorial system, abandon current expense allocation rules and repair Subpart F.

iv. Testimony of Reuven S. Avi-Yonah, University of Michigan – Professor

1. Moving to a territorial system should not be made on the basis of a competitiveness argument. Territoriality is about whether U.S. multinational corporations pay tax on dividends distributed by their CFC's. Since U.S. based multinational corporations typically do not receive such dividends unless the U.S. tax is covered by foreign tax credits, this tax has no impact on their competitiveness because they do not pay it.
2. Rather, territoriality should be adopted to address the trapped income problem (i.e., allowing U.S. multinational corporations to repatriate currently trapped earnings).If this approach is taken, Subpart F, the source rules, and transfer pricing will need to be

seriously reformed to discourage income shifting to low-tax jurisdictions.

3. Alternatively, the trapped income problem may be addressed by ending deferral and taxing currently all foreign-source income. If the tax rate is reduced, competiveness should not be affected.