

## Fair Approaches for Taxing Previously Untaxed Foreign Income

*By Jeffery M. Kadet*

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Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle.

In this article, Kadet suggests two approaches to identifying controlled foreign corporation earnings that should be subject to the full 35 percent corporate tax rate when transitioning to a new tax system, with the remainder subject to whatever favorable transition rate Congress might choose.

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The 2016 Obama administration green book released on February 2, 2015, proposes a new per-country minimum tax approach to taxing the foreign earnings of C corporations and their controlled foreign corporation subsidiaries. In conjunction with the transition to this new approach, the green book includes a one-time 14 percent tax on earnings accumulated in CFCs not previously subjected to U.S. corporate tax. A partial foreign tax credit would apply. This proposal is similar to provisions in several prior international tax reform proposals from Congress. (See, for example, former House Ways and Means Committee Chair Dave Camp's international discussion draft, the Tax Reform Act of 2014, and former Senate Finance Committee Chair Max Baucus's discussion draft on foreign-source income tax reform.)

Thinking about these proposals, I have mixed feelings, which others may share. In connection with any transition to a new international tax system, we need an approach that effectively deals with the trillions of dollars of previously untaxed foreign income held by CFCs. I can see the logic and fairness of applying a rate on those earnings that is

less than the 35 percent home country rate because the rules of the game are being changed significantly, and many U.S. multinationals may have legitimate commercial reasons for retaining their earnings overseas. So I can accept whatever rate Congress chooses, whether it is at the lower 3.5 percent level of TRA 2014, the 14 percent level in the green book, or the 20 percent level in the Baucus discussion draft.

I may be oversimplifying a little, but I see two categories of CFC earnings. First, there are plenty of CFCs that have accumulated earnings from conducting legitimate business operations in their countries of incorporation and that were structured without any significant profit-shifting intentions. Those CFC earnings should benefit from whatever lower-than-35-percent rate Congress chooses.

A second category of CFC earnings, which grew significantly following the 2004 repatriation tax holiday, is the zero- or low-taxed earnings that resulted from conscious, and often aggressive, tax structuring meant to achieve the goals of:

- avoidance of any current U.S. taxation through planning around the CFC rules in subpart F; and
- avoidance of taxation in the foreign countries in which operations are conducted or sales are made.

Professor Edward D. Kleinbard has given us the appropriate label of "stateless income."<sup>1</sup> Whether through congressional hearings (think Apple,<sup>2</sup> Microsoft, and Hewlett-Packard<sup>3</sup>), the tireless work of journalists (think Jesse Drucker of Bloomberg regarding Google<sup>4</sup>), or the efforts of whistleblowers (think the International Consortium of Investigative Journalists' effort on the "Lux leaks"<sup>5</sup>), the success and unbelievable extent of aggressive, and often

<sup>1</sup>Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes*, Sept. 5, 2011, p. 1021; Kleinbard, "Stateless Income's Challenge to Tax Policy, Part 2," *Tax Notes*, Sept. 17, 2012, p. 1431.

<sup>2</sup>Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, "Offshore Profit Shifting and the U.S. Tax Code" (May 21, 2013).

<sup>3</sup>Permanent Subcommittee on Investigations, "Offshore Profit Shifting and the U.S. Tax Code — Part 1 (Microsoft and Hewlett-Packard)" (Sept. 20, 2012).

<sup>4</sup>Drucker, "Google 2.4 Percent Rate Shows How \$60 Billion Is Lost to Tax Loopholes," Bloomberg, Oct. 21, 2010.

<sup>5</sup>Available at <http://www.icij.org/project/luxembourg-leaks>.

convoluted, tax structuring has been well publicized. Bloomberg's Richard Rubin recently reported on Gilead Sciences, Inc., which reported in its 2014 Form 10-K more than \$8.2 billion of foreign pre-tax earnings on less than \$7 billion of foreign sales.

Now back to my mixed feelings. While I'm happy to subject the first category of CFC earnings to a beneficial congressionally determined lower-than-35-percent rate, I find it abhorrent to reward multinationals that have aggressively pushed the envelope to maximize their stateless income. Whether one is a Republican or a Democrat, we simply cannot reward that behavior with any beneficial lower-than-35-percent rate upon transition to a new system of taxing international income.

Convoluted tax avoidance structuring may be technically legal, but to quote Margaret Hodge, chair of the U.K. Parliament's Public Accounts Committee, it's "morally reprehensible."<sup>6</sup> It's not just Hodge who speaks in these terms. Sen. John McCain, R-Ariz., in his opening statement<sup>7</sup> at the 2013 Senate subcommittee hearings on Apple said:

As the shadow of sequestration encroaches on hard-working American families, it is unacceptable that corporations like Apple are able to exploit tax loopholes to avoid paying billions in taxes. . . . It is completely outrageous that Apple has not only dodged full payment of U.S. taxes, but it has managed to evade paying taxes around the world through its convoluted and pernicious strategies. . . . It is past time for American corporations like Apple to reorganize their tax strategies, to pay what they should, and invest again in the American economy.

Considering those words from a Republican and former presidential candidate, what we really need is an administratively easy approach to distinguishing between the two categories of CFC earnings so that earnings resulting from "convoluted and pernicious strategies" are taxed at the 35 percent rate that would have been paid in the absence of those strategies (with an offset for any foreign taxes paid).

For simplicity, this article mentions only the corporate 35 percent rate. For individual U.S. shareholders of any CFC, the normal section 1 individual rates should apply — without the benefit of the qualified dividend income rules. It should also be noted for fairness to Sen. McCain that he appears to have forgotten some of his 2013 rhetoric in light of

<sup>6</sup>Raymond Doherty, "Tax Is a Choice for the Rich, Says Hodge," *Economia*, Oct. 30, 2014.

<sup>7</sup>See *supra* note 2 (McCain's opening statement).

the recent announcement of an Apple \$2 billion global data command center in Arizona.

## A. Suggested Approaches

**1. Camp approach.** In his 2014 discussion draft, Camp broke CFC earnings into two portions by imposing a higher 8.75 percent rate on earnings being held in cash and cash-equivalent forms. The remaining earnings would be subject to the lower 3.5 percent rate. This approach is administratively easy to apply, objective, and definitely a workable solution. Its shortcoming, however, is that it focuses on the form in which CFC earnings are held on the transition date (to a new tax system) and not on any "convoluted and pernicious strategies" that may have shifted profits into zero- or low-tax havens. But having said this, the existence of earnings that have been subjected to relatively little or no foreign tax and that are held in cash or cash-equivalent form is pretty good evidence of tax avoidance planning.

With this in mind, the first suggested approach is to use Camp's solution with all CFC previously untaxed foreign income — on transition to a new tax system — being subject to the maximum rate under section 11 (35 percent but with an FTC offset) to the extent of cash and cash equivalents. All remaining previously untaxed foreign income would be taxed on transition at whatever favorable less-than-35-percent rate Congress chooses.

Should Congress desire, this Camp solution approach could be modified by providing for the favorable less-than-35-percent rate to apply when it is clear that there has been no tax avoidance structuring:

- The favorable rate could apply to any previously untaxed foreign income that had, in fact, been subjected to an effective rate of tax of, say, 90 percent of the U.S. corporate rate, which would sensibly match this treatment to the section 954(b)(4) subpart F income exception for income subject to high foreign taxes.
- Congress could direct Treasury to identify countries of incorporation that U.S. multinationals would never use for tax avoidance planning. As a simple example, because of its worldwide taxation regime on resident companies and its significant 25 percent tax rate, it is unlikely that China would ever be used as a place of incorporation for a company that would earn income that had been shifted from some other country where operations were conducted. After appropriate review, Treasury could publish a list of those countries, with all previously untaxed foreign earnings of such companies being granted the favorable rate.

**2. Tax-structured vehicle approach.** The shortcoming of the Camp approach is that it focuses on the form in which CFC earnings are held at the transition date and not on any “convoluted and pernicious strategies” that may have shifted profits to tax havens. The second simple approach defines “tax-structured vehicle.” For any such vehicle, its previously untaxed foreign income, upon transition to a new tax system, would be subject to the maximum rate under section 11 (35 percent with an FTC offset). The previously untaxed foreign income within all CFCs not so classified would be taxed on transition at whatever favorable less-than-35-percent rate Congress chooses.

As a first step to identifying tax-structured vehicles, Treasury would publish a listing of countries that can be used as the place of incorporation of CFCs that earn low- or zero-taxed foreign income through profit-shifting arrangements. Treasury would also provide examples of tax-motivated structures meant to achieve the goals of avoiding both (i) current U.S. taxation by planning around subpart F, and (ii) taxation in the foreign countries in which operations are conducted or sales are made.

A presumption of tax-structured vehicle status would be applied to all CFCs established in the listed countries. A U.S. multinational involved with the vehicle could attempt to rebut this presumption for its CFCs by establishing to the satisfaction of the Treasury secretary or his delegate, based on a facts and circumstances review, that there was no such tax-motivated structuring. If this presumption is not successfully rebutted, any previously untaxed foreign income within the CFC would be subject to the 35 percent tax, with an FTC offset.

If Congress chooses this tax-structured vehicle approach, it is strongly suggested that applicable committee reports include a clear statement of the principles behind the definition of tax-structured vehicle and numerous examples of common corporate structures that are seen to have tax avoidance motivations. Clear legislative instructions would not only provide necessary guidance to Treasury and the IRS, but also should importantly limit taxpayer presumption-rebuttal efforts to situations that truly deserve consideration. Further, the rules should be clear that the burden of proof is on the taxpayer to support any effort at rebuttal of the presumption.

Needless to say, this second approach does not have the true simplicity of avoiding all “facts and circumstances” analyses. However, if there is clear congressional guidance, it should be a simple and administrable approach — considering the billions of dollars at issue and the serious message that Congress should send that it will not reward the

aggressive tax avoidance behavior exhibited by many U.S. multinationals.

## B. Additional Considerations

**1. Interest.** The green book provides for the 14 percent tax on previously untaxed foreign income to be payable ratably over five years. The comparable provisions in the discussion drafts released over the past four years have all provided for installment payments but have been inconsistent regarding interest. Some, including the green book, have been silent concerning any interest charge.

For any previously untaxed foreign income that will qualify for a favorable less-than-35-percent rate, it makes sense to disregard any interest charge because any such additional interest amount is effectively only an adjustment of the favorable tax rate. (This, of course, ignores any effect if the interest were tax deductible; in this context, if interest is required, it should specifically be non-deductible.) It seems likely that most taxpayers would choose to pay in installments to defer those tax payments. Given that Congress would want to encourage earlier payment, perhaps discounts for early payment could be considered.

The previously untaxed foreign income that would be subjected to the 35 percent tax rate has resulted from tax avoidance behavior; the applicable taxpayer has already had the real economic benefit of deferral for years. There is no reason for extending the deferral period even more by allowing an interest-free installment payment scheme. Accordingly, interest should be charged to the extent of any installment payments.

**2. Ignoring claims of pain from U.S. multinationals.** It is fair to say that U.S. multinationals and their management (often with equity-based compensation arrangements) will be less than complimentary about my suggestions. While there will undoubtedly be other strongly expressed concerns, I will briefly comment on two.

**a. One-time charge.** Many U.S. multinationals have chosen not to accrue foreign taxes within their consolidated financial statements based on the assumption that their low- and zero-taxed earnings are being permanently reinvested overseas. The large buildup of cash overseas with no apparent investments in sight — plus, in some cases, instances of domestic borrowings — reflects the often artificial nature of these “permanently reinvested” assumptions.

Whether from a low favorable rate or from a full 35 percent rate, many U.S. multinationals will have to make additional accruals of taxes on their financial statements to reflect the one-time tax imposed on transition to a new international taxation regime. These additional accruals will reduce their reported earnings and perhaps depress their share prices as

well. While U.S. multinationals will complain bitterly, this accrual of additional tax expense is a one-time charge that I believe the capital markets will understand and accept with minor disruption. Because these one-time charges reflect solely past earnings, they will have no effect on the future earning ability of these multinationals. In addition, many of these multinationals hold these past earnings in the form of cash, often sitting underused on the consolidated balance sheet. Considering these factors, any depression of share prices that does occur should be short-lived.

I must add that this is not a new issue about which there was no warning to U.S. multinationals. Over 10 years ago, the 2004 repatriation tax holiday and the more recent 2011 Camp discussion draft put U.S. multinationals squarely on notice that their foreign earnings could be subjected to some level of tax, either attributable to a new tax repatriation holiday (for which many U.S. multinationals continue to strongly lobby) or on a transition to a new international taxation system. Despite this clear notice, many U.S. multinationals chose to continue making the “permanently reinvested” assumption for their foreign earnings. This is a clear case of their having made the bed in which they’re now sleeping. Loud complaints regarding the need to accrue new taxes should be summarily ignored.

**b. Competition.** Perhaps the most common refrain heard from U.S. multinationals during discussions of tightening taxation of their foreign income is that terrible things will happen to their competitiveness. This is a red herring on several levels.

For previously untaxed foreign income, there would be a one-time tax calculation measured solely by reference to income earned in past years. This one-time imposition cannot affect the relative tax economics of any future foreign transaction vis-à-vis foreign-based competitors.

While on the subject of competitiveness, I want to add that even if the green book’s proposal for a per-country up-to-19-percent minimum tax on foreign income is established, it is simply wrong to say that this will cause a competitive disadvantage for U.S. multinationals. The 19 percent is, on the surface, higher than the taxes imposed on foreign profits by other countries that are home countries of multinationals. This is because these other foreign countries generally impose tax on a territorial basis, thus exempting active foreign income when it is

earned and repatriated. This is the argument strongly and loudly made by U.S. multinationals about being in a terrible competitive position.

That argument is fallacious today and will be even more so in the future. In brief, the existing CFC rules of other countries, as well as the expected strengthening of CFC regimes that will come out of the OECD base erosion and profit-shifting process, mean that competitor multinationals will sometimes be subject to their home country’s taxation on some or all of their foreign earnings. Whether a particular U.S. multinational for a particular transaction will depend on many factors, including for example the details of the transaction, the industry, the particular corporate and tax structure chosen by each multinational, which home country is involved, etc. With the proposed 19 percent rate (which is actually lower because of the proposed “allowance for corporate equity”) being lower than the general corporate tax rates of most of the home countries of these multinational competitors, there will be plenty of situations in which the foreign competitors will be worse off taxwise than U.S. multinationals.

### C. Concluding Comment

Many U.S. multinationals have succeeded beyond imagination at legally sidestepping our subpart F CFC rules and severely limiting taxable income within the foreign countries in which they operate or sell their products or services. For these multinationals, we cannot reward behavior that McCain has labeled convoluted and pernicious.

Despite that label from a well-known Republican, all proposals for revamping our international taxation system, including the recently released green book, would blithely reward in a major fashion the convoluted and pernicious strategies that have been aggressively pursued for many years, especially since the 2004 repatriation tax holiday.

This article has suggested two workable approaches to identifying CFC earnings that should be subject to the full 35 percent corporate tax rate on transition to a new taxation system, with the remainder subject to a favorable transition rate. Our legislators need to understand this distinction regarding past behavior and provide for appropriate differences in transition treatment.