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Obama's International Tax Plan A Major Step Forward

By Reuven S. Avi-Yonah

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President Barack Obama last week personally introduced a set of proposals to reform U.S. international taxation that are the most significant advance toward preserving the income tax on cross-border transactions since the enactment of the subpart F rules by the Kennedy administration in 1962. (For prior coverage, see *Doc 2009-10047* or *2009 TNT 84-1*.)

In essence, the Obama proposals introduce a 21st-century version of the vision begun by Thomas Adams in 1918 and continued by Stanley Surrey in 1961: a world in which source and residence taxation are coordinated so as to achieve the underlying goals of the international tax regime. As I have explained at length elsewhere, those goals are known as the single tax principle (all income from cross-border transactions should be subject to tax once, not more and not less) and the benefits principle (active income should be taxed primarily at source, and passive income primarily at residence).

The Obama plan does this by addressing the central problem of implementing corporate and individual income taxation in a world of open economies: Effective source taxation requires residence taxation, and effective residence taxation requires source taxation.

I will comment below on the major proposals in the Obama plan and explain how they form a coherent step toward achieving the single tax and benefit principles. I will first address the proposals related to the taxation of active income earned by corporations, and then the proposals related to the taxation of passive income earned by individuals.

Source Taxation Requires Residence Taxation

The taxation of active income earned by multinational enterprises is assigned by the consensus underlying the international tax regime primarily to the source country. This makes sense both because the source country provides the benefits that enable the income to be earned (such as infrastructure and education) and because active income is earned primarily by corporations, and source-based corporate taxation is more sensible than residence-based taxation because corporate residence is not very meaningful.

However, as has been recognized by numerous scholars as well as the OECD since the 1990s, source-based taxation of active income is increasingly difficult because of tax competition among countries to attract foreign direct investment. Also, various techniques have been developed by MNEs to shift their income from high-tax to low-tax jurisdictions, either by transfer pricing or by various earnings stripping techniques (such as thin capitalization and the judicious placing of intangible assets in tax havens). The result, as the Obama plan notes, is that in 2003 nearly one-third of the profits of U.S.-based MNEs were located in Bermuda, the Netherlands, and Ireland, and that of the top 10 locations of those profits, 7 had effective tax rates of less than 10 percent.

In this environment, effective source-based taxation of MNEs requires a backup in the form of effective residence-based taxation. Because more than 90 percent of the parent corporations of MNEs are resident in OECD member countries, if all the OECD countries abolished deferral or exemption of the income of controlled foreign corporations belonging to their MNEs, then tax competition would cease to be a significant problem and source-based taxation of active income would once again be possible, just as it was before globalization took off in the 1980s.

The Obama proposal takes several significant steps in that direction. First, it curtails the benefit of deferral by limiting deductions (other than research and experimentation deductions) taken by U.S.-based MNEs on their tax return that are associated with the earning of income that is eligible for deferral until the underlying earnings have been repatriated. It is estimated that this proposal, which is based on legislation introduced in 2007 by House Ways and Means Chair Charles B. Rangel, D-N.Y., would raise $60.1 billion between 2011 and 2019.

Because R&E is excluded because of the positive externalities it generates, the main deductions affected are interest and various forms of headquarters expenses allocated to foreign-source income. In that context, it is interesting that the Obama proposal is silent as to whether the worldwide interest allocation enacted in 2004 and scheduled to take effect in 2011 will in fact be implemented (it was eliminated in Rangel's legislation).

The Obama proposal on deferral is much more conservative than some commentators envisaged when the idea was broached in the president's budget. For example, the Treasury subpart F report from 2000 (written when Larry Summers was secretary and therefore of continued relevance today) suggested a total repeal of deferral with a lower tax rate for foreign-source income, or making deferral conditional on the effective foreign tax rate (a so-called low-tax inclusion, the mirror image of the current high-tax exclusion from subpart F). The Obama administration presumably concluded that those types of proposals would run into too much opposition from the MNEs in the name of competitiveness.

Second, the Obama proposal reins in various forms of foreign tax credit abuse such as FTC generators (like the ones used by insurance giant AIG) and transactions that purport to generate current FTCs while the underlying income is subject to deferral. While the details are still unclear, the first proposal would focus on granting FTCs only for taxes that the taxpayer ''actually pays,'' which presumably refers to various techniques that use the technical taxpayer rule to obtain credits for taxes economically borne by another party to the transaction. The second proposal relates to schemes built on the *Guardian* case (*Guardian Industries Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007), *Doc 2007-4863*, *2007 TNT 38-14*), in which the taxpayer used a Luxembourg form of consolidation to obtain direct credits for taxes paid by a Luxembourg holding company (which was treated as a branch for U.S. tax purposes) while maintaining deferral for the underlying earnings in the operating Luxembourg subsidiary.

The IRS has attacked this type of structure in regulations, but the regulations depend on the use of foreign consolidation, and the same result can be achieved simply by using a hybrid (U.S. branch, foreign corporation) as the holding company and a reverse hybrid (U.S. corporation, foreign branch) as the operating subsidiary. The two FTC proposals together would raise $43 billion from 2011 to 2019. Those revenues and the revenues from curtailing deferral would be used to finally make the R&E credit permanent (at a cost of $74.5 billion over the same 10 years).

Third, the Obama proposal revives Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, *98 TNT 12-8*, by preventing MNEs from abusing the check-the-box option to make flows of passive income between CFCs disappear for subpart F purposes. As the proposal explains, if a U.S. parent has a CFC in the Caymans with two second-tier subsidiaries in Germany and in the Caymans, and the second-tier Caymans sub makes a loan to the German sub, it is possible to avoid subpart F inclusion of the interest paid from Germany to the Caymans by making both second-tier subs appear to be branches of the Caymans holding company. Because one cannot lend money to oneself, the result is no loan and no interest income, but the interest deduction is still effective to transfer profits from Germany to the Caymans. It is estimated that this provision would raise a whopping $86.5 billion from 2011 to 2019 (indicating that in the administration's view, MNEs cannot achieve the same result without relying on check the box, as they argued successfully in 1997 in support of the check-the-box rule).[1]

This is essentially the same as Example 2 of Notice 98-11, and the MNEs would no doubt object, as they did in 1998, that the only tax avoided is the German tax. But double nontaxation violates the single tax principle, which has been an underlying idea of the U.S. international tax regime since 1918. As Adams stated when explaining why the United States uses an FTC rather than an exemption to prevent double taxation, ''the state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax.''

The MNEs would no doubt argue that those steps to enhance residence-based taxation would adversely affect their competitiveness. But they have been making the same argument since 1961 with no regard to the actual competitive position of U.S.-based MNEs (in 1961, they dominated the world) and without any evidence that any of the changes to U.S. international tax rules in the past 48 years have in fact adversely affected them.

A more serious concern is that those parts of the Obama plan would induce U.S.-based MNEs to migrate their headquarters to other locations with laxer rules, and that new businesses that are run from the United States would be established with foreign parent companies. The anti-inversion rules enacted in 2004 establish some defense against the first threat but are ineffective against the second.[2] Because of this, I would suggest that Congress enact the ''managed and controlled'' provision of the Stop Tax Haven Abuse Act sponsored by Sen. Carl Levin, D-Mich., and Rep. Lloyd Doggett, D-Texas, which would treat as a U.S. resident any corporation that is publicly traded or has more than $50 million in assets and that is not a CFC if its actual management is in the United States. I doubt that too many CEOs of U.S.-based parents would actually be willing to move to tax havens in response (as the level of services in the havens is commensurate with the level of taxation).

In the longer term, I would urge the Obama administration to seek to curtail deferral in further cooperation with the OECD. If all OECD countries acted in unison to abolish deferral, tax competition could be eliminated without any threat to the competitiveness of U.S.-based MNEs. The Obama plan is a helpful first step in that direction and could be used as a way of persuading other OECD members to follow suit (as they did, for example, in prohibiting foreign bribes by their MNEs after the United States enacted the Foreign Corrupt Practices Act).

Corporations should be taxed primarily at source, and one can imagine an ideal world of purely source-based corporate taxation (if transfer pricing and other forms of shifting income are taken care of). But in a world of open economies, source-based corporate taxation must be backed up by residence-based corporate taxation because otherwise, tax competition and artificial income shifting lead to no corporate taxation at all (Intel notoriously pays not a penny in tax outside the United States, and the overall effective tax rate of U.S.-based MNEs on foreign-source profits is very low). The corporate provisions of the Obama plan are an important first step in protecting the U.S. corporate tax base from erosion, and in helping

[1]One concern that needs to be addressed is that if the proposal focuses only on disregarded entities, the same results can be achieved by constructing partnerships between CFCs. Another issue is section 954(c)(6), the CFC-to-CFC payment rule first enacted in 2006, which can lead to the same result and should be allowed to expire at the end of 2009 as scheduled.

[2]Section 7874.

to level the playing field between U.S.-based MNEs and purely domestic businesses subject to the full 35 percent U.S. corporate tax rate.

Residence Taxation Requires Source Taxation

The recent saga involving Swiss bank UBS has shown that effective residence-based taxation of U.S. individual citizens and residents is impossible in the absence of U.S.-source taxation of foreigners. Beginning with the enactment of the portfolio interest exemption in 1984, the United States has engaged in a race to the bottom designed to attract residents of other countries to invest their funds in the United States without having to report the income to their home jurisdiction. Thus, we permit those foreign residents to earn investment income from U.S. sources without meaningful withholding (capital gains, interest, and royalties are exempt, and dividends can be replaced with dividend substitutes) and without the U.S. payer having any information about the real identity of the payee (interest can be paid directly to tax haven corporations, while royalties and dividends can be paid to qualified intermediaries, and in both cases, the U.S. withholding agent will not know who the real payee is).

The problem, as the UBS case revealed, is that these rules enable U.S. residents to also earn U.S.-source investment income without paying any tax on it. The provisions that are designed to prevent this, such as legends on bearer certificates and audits of qualified intermediaries by foreign auditors, do not work.

The Obama plan contains several helpful provisions designed to prevent U.S. residents from evading U.S. taxation. The plan constructs a dichotomy between investors through QIs and other investors. In the case of QIs:

> The Administration's plan would increase the reporting requirement on international investors and financial institutions, especially QIs. QIs would be required to report information on their U.S. customers to the same extent that U.S. financial intermediaries must. And U.S. customers at QIs would no longer be allowed to hide behind foreign entities. U.S. investors would be required to report transfers of money or property made to or from non-QI foreign financial institutions on their income tax returns. Financial institutions would face enhanced information reporting requirements for transactions that establish a foreign business entity or transfer assets to and from foreign financial accounts on behalf of U.S. individuals.

In the case of investors through non-QIs, the Obama proposals would:

- impose a withholding tax of 20 percent to 30 percent on U.S.-source payments to individuals who use non-QIs, refundable on showing that the true recipient is a non-U.S. resident;
- create a rebuttable presumption that any foreign account held by the U.S. citizen at a non-QI is subject to foreign bank account reporting; and
- increase penalties and extend the statute of limitations.

Also, the line between QIs and non-QIs would be enforced by requiring all affiliates of a QI to be QIs. Those proposals together would raise only a modest $8.7 billion over 10 years, a far more conservative estimate than others have suggested for similar proposals (for example, the Stop Tax Haven Abuse Act).

This solution is similar to the EU savings directive in that it relies on information exchange (in the case of QIs) and refundable withholding (in the case of non-QIs). In principle it should work, but the devil is in the details. For example, how will the QI rules be effectively enforced in the face of foreign bank secrecy claims such as those advanced by UBS?

Another issue is that the non-QI rules apply only to U.S.-source income, but many types of investment income that economically are U.S.-source are treated as non-U.S.-source under current rules. For example, capital gains are sourced to the residence of the seller (who will purport to be a foreign investor), and dividend substitutes under equity swaps are sourced to the residence of the recipient.[3]

Still, the Obama plan is definitely a step in the right direction toward enforcing residence-based taxation on U.S. citizens and residents. Enacting the Stop Tax Haven Abuse Act, which has the support of the Obama administration, would be another advance toward the same goal. Further steps require cooperation by other countries, lest they induce investor flight from the United States.

The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the prosperous and stable economies of the world (which is why some laundered funds that need to remain in the tax havens earn a negative interest rate). If the OECD countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, imposing a refundable withholding tax (for example, at 35 percent) on all payments to noncooperating tax havens, or more broadly, to all nontreaty countries, and insisting on effective automatic exchange of information with treaty countries. The withholding tax would be refunded on a showing that the income was reported to the residence country. This idea is similar to, but much broader than, the refundable withholding tax proposal in the Obama plan.

The financial services industry would no doubt lobby hard against such a step on the grounds that it would induce investors to shift funds to other OECD member countries. However, the EU and Japan have both committed themselves to taxing their residents on foreign-source interest income. The EU savings directive, in particular, requires all EU members to cooperate in the exchange of information or impose a withholding tax on interest paid to EU residents. Both the EU and Japan would like to extend this treatment to income from the United States. Thus, this would seem an appropriate moment to cooperate with other OECD member countries by imposing a withholding tax on payments to tax

[3]This problem can be solved if dividend substitutes are treated as dividends, as envisioned by the Stop Tax Haven Abuse Act.

havens that cannot be induced to cooperate in exchanging information, without triggering a flow of capital out of the OECD.

Fundamentally, in a globalized world with open economies, residence taxation of individuals is impossible without source-based taxation because in the absence of source taxation, the information required to ensure residence taxation is not available. The Obama plan recognizes this reality and is a major step toward achieving taxation of U.S. citizens and residents based on their true ability to pay.

Conclusion

As the president stated in introducing his plan:

> Nobody likes paying taxes, particularly in times of economic stress. But most Americans meet their responsibilities because they understand that it's an obligation of citizenship, necessary to pay the costs of our common defense and our mutual well-being.
>
> And yet, even as most American citizens and businesses meet these responsibilities, there are others who are shirking theirs. And many are aided and abetted by a broken tax system, written by well-connected lobbyists on behalf of well-heeled interests and individuals. It's a tax code full of corporate loopholes that makes it perfectly legal for companies to avoid paying their fair share. It's a tax code that makes it all too easy for a small number of individuals and companies to abuse overseas tax havens to avoid paying any taxes at all. And it's a tax code that says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo, New York.
>
> Now, understand, 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. This is something that I talked about again and again during the course of the campaign. The way we make our businesses competitive is not to reward American companies operating overseas with a roughly 2 percent tax rate on foreign profits; a rate that costs taxpayers tens of billions of dollars a year. The way to make American businesses competitive is not to let some citizens and businesses dodge their responsibilities while ordinary Americans pick up the slack.

The Obama plan for reforming U.S. international tax rules is incomplete, and it will no doubt be much amended in Congress. But it represents a crucial first step that is based on the realization that in our interdependent world, it is not possible to achieve either source- or residence-based taxation without the other form being effectively implemented, and that without taxing cross-border income, all income taxation becomes impossible, because income taxation requires taxing capital and capital is mobile across borders. If we want to preserve the income tax and retain some progressivity in our tax system, the Obama plan should be enacted as soon as possible.