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Vive la Petite Difference: Camp, Obama, and Territoriality Reconsidered

by Reuven S. Avi-Yonah

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The recent tax reform proposals by House Ways and Means Committee Chair David Camp, R-Mich., and by President Obama seem to offer starkly contrasting visions of how to reform the taxation of foreign-source income earned by U.S.-based multinational enterprises.[1] Both acknowledge the problem, which is that U.S.-based MNEs currently have more than $1 trillion of ''permanently reinvested'' income offshore, which they cannot bring back to the U.S. without incurring a 35 percent tax penalty. However, they seem to offer radically different solutions: Under the Camp proposal, a participation exemption will enable U.S.-based MNEs to bring back the income without paying significant tax. Under the Obama proposal, deferral will be abolished and U.S.-based MNEs will have to pay a minimum tax on foreign-source income earned by their controlled foreign corporations as it is earned. The result would be that the tax penalty on repatriating that income would be reduced because dividends would only be subject to tax at the difference between the statutory rate (reduced to 28 percent under the Obama proposal) and the minimum rate.

However, a closer look reveals that these proposals have more in common than meets the eye. Specifically, the Obama proposal's minimum tax on foreign-source income of CFCs is perfectly compatible with exempting that income from further tax when it is repatriated, as the Camp proposal envisages. Conversely, the provisions to prevent income shifting in the Camp proposal can in practice result in precisely the minimum tax on the foreign-source income of CFCs that is the centerpiece of the Obama proposal. This level of agreement suggests that a compromise embodying elements of both proposals should not be impossible to reach when tax legislation is enacted after the November election.

Thesis: The Camp Proposal

Under the Camp proposal, 95 percent of dividends from CFCs of U.S.-based MNEs would not be subject to tax when paid to their U.S. parents.[2] The remaining 5 percent would continue to be taxed at the general corporate tax rate (envisaged as 25 percent, rather than the current 35 percent). This ''haircut'' is intended as a substitute for denying deductions associated with the earning of the newly exempt income.

Subpart F continues to apply, so that only dividends from active business income are eligible for the participation exemption.[3] No foreign tax credit is permitted for taxes imposed on that income by foreign countries, and the IRC section 902 indirect credit is repealed.[4] As a transition mechanism, previously deferred earnings of CFCs are subject to current inclusion at a reduced rate of 5.25 percent (the same rate that applied to repatriated earnings under the 2004 amnesty).

[1] *See* ''Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income'' (Oct. 26, 2011) (Camp proposal); ''The President's Framework for Business Tax Reform'' (Feb. 2012) (Obama proposal).

[2] Technically, this result is achieved by extending a 95 percent dividends received deduction to those dividends. Camp proposal, section 301.

[3] IRC section 956 is repealed, consistent with the enactment of a participation exemption.

[4] Also, the foreign tax credit baskets are repealed, so averaging is allowed for direct credit purposes.

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The Camp proposal includes three options to prevent increased income shifting that may result from the adoption of the participation exemption. Option A would treat excess income from transfers of intangibles to low-taxed affiliates as subpart F income.[5] Option B would treat low-taxed cross-border foreign income as subpart F income.[6] Option C would treat foreign intangible income as subpart F income and tax it currently, but at a reduced rate.[7]

Under Option A, income attributable to use or exploitation of intangibles that has not been subject to a specified minimum income tax in any jurisdiction is included in U.S. income to the extent that that income exceeds 150 percent of costs attributable to that income. Under the provision, if a U.S. person transfers intangible property from the United States to a related CFC, certain excess income from transactions benefiting from or connected with the transferred intangible property is includible in income as a new category of subpart F income, foreign base company excess intangible income.

Under Option B, income earned by a CFC that is neither derived from the conduct of an active trade or business in the home country of the CFC (''the home-country exception'') nor subject to an effective rate of foreign tax of at least 10 percent is includible in subpart F income as low-taxed cross-border income.

Option C creates a new category of subpart F income for worldwide income derived by CFCs from intangibles and it provides a deduction for a domestic corporation of 40 percent of its income from foreign exploitation of intangibles. As a result, the provision both increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC and decreases (from 25 percent to 15 percent) the U.S. tax on the income of a U.S. corporation from its use of its intangibles in foreign markets.

Antithesis: The Obama Proposal

Under the Obama proposal:

> [I]ncome earned by subsidiaries of U.S. corporations operating abroad must be subject to a minimum rate of tax. This would stop our tax system from generously rewarding companies for moving profits offshore. Thus, foreign income deferred in a low-tax jurisdiction would be subject to immediate U.S. taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on that income paid to the host country. This minimum tax would be designed to balance the need to stop rewarding tax havens and to prevent a race to the bottom with the goal of keeping U.S. companies on a level playing field with competitors when engaged in activities which, by necessity, must occur in a foreign country.[8]

The rate for this minimum tax is not specified in the Obama proposal (while the statutory tax rate is reduced to 28 percent).

The Obama proposal adopts the ideas (also included in the president's 2013 budget) of:

- taxing currently the excess profits associated with shifting intangibles to low-tax jurisdictions; and
- requiring that the deduction for the interest expense attributable to overseas investment be delayed until the related income is taxed in the United States.[9]

Synthesis

On the face of it, the Camp and Obama proposals are very different, primarily because the Camp proposal adopts a limited version of territoriality (the participation exemption) for future dividends from CFCs and only subjects previously deferred income to a reduced rate of 5.25 percent, while the Obama proposal would tax both previously accumulated and future income of CFCs at the unspecified minimum rate.

By looking deeper, however, it is possible to see that the differences are less fundamental. Ignore for a moment the treatment of previously accumulated income, which is basically a transition issue (and, I suspect, one on which the parties could reach a compromise by settling on a rate somewhere between 5.25 percent and 28 percent on the $1 trillion of currently deferred income). For the future, there is nothing in the Obama proposal that would preclude adopting a participation exemption for income that was subject to the president's minimum tax. Let's assume that the minimum tax rate is set at 25 percent (that is, 3 percent less than Obama's proposed rate for domestic income). In that case, adopting a participation exemption would only mean giving up on the additional 3 percent, and eliminating the indirect credit and adopting the 5 percent haircut and interest disallowance provisions of the Camp proposal would presumably be enough to compensate for any loss of revenue.

Conversely, the anti-income-shifting provisions of the Camp proposal are consistent with the Obama proposal. The excess intangible provision is identical to the one in the Obama proposal and in the administration's budget. Option C, the minimum tax of 15 percent on income from intangibles, is very similar to the Obama proposal's overall minimum tax, especially if one assumes that most of the income shifted overseas

[5] Camp proposal, section 331A.

[6] *Id.* at section 331B.

[7] Camp proposal, section 331C. The Camp proposal also limits excess interest deductions attributable to borrowing related to income eligible for the participation exemption.

[8] Obama proposal, p. 14.

[9] *Id.* at p. 15.

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results from the exploitation of intangibles. The Camp proposal on limiting interest deductions and the 5 percent haircut are similar to the Obama proposal's limits on interest deductions associated with deferred income.

Finally, the practical effect of Option B of the Camp proposal is quite similar to the Obama minimum tax provision. Under the Camp proposal, any foreign-source income that is not earned from real business operations in the ''home country'' and that is not subject to a foreign tax rate of at least 10 percent will be subject to current inclusion (at 25 percent) and not eligible for the participation exemption. Under the Obama proposal, all income of CFCs will be subject to a minimum tax of, let's say, 25 percent. The difference between the two is that income from operations in Ireland, for example, which is taxed by the Irish at 12.5 percent, will not be includible under the Camp proposal but will be under the Obama proposal.[10] But income from real tax havens, which is subject to no tax and does not result from business operations therein, would be subject to tax under both, and if the minimum tax rate is set at 25 percent, at the same rate.

The Obama proposal has a chart showing income of CFCs of U.S.-based MNEs in selected countries relative to those countries' GDP. It shows that the income of CFCs in the Bahamas is 43 percent of its GDP, Bermuda 646 percent, the British Virgin Islands 355 percent, the Cayman Islands 547 percent, Jersey 35 percent, Liberia 61 percent, and the Marshall Islands 340 percent of GDP. All of that income would be subject to current tax at 25 percent under *both* the Camp and the Obama proposals.

Thus, it seems to me that if the Camp proposal is adopted with all three options for preventing base-shifting included, then the practical effect would not be so different from adopting the Obama proposal.[11] Under those circumstances, I believe it is worthwhile to adopt the Camp proposal even though it includes a limited version of territoriality and departs from the principle established in 1913 that U.S. resident taxpayers should be subject to tax on all of their income ''from whatever source derived.''

Conclusion

At the end of the current year, the Bush tax cuts expire, a sequester of $1.2 trillion kicks in, and the debt ceiling must be raised. The combination of these deadlines indicates that we are likely to see tax legislation enacted in late 2012 or early 2013 regardless of which party wins the White House in the fall election.

This tax legislation should include international tax reform. The trapped income phenomenon is real, and the fact that U.S.-based MNEs have $1 trillion of income that they cannot repatriate indicates that taxing dividends from CFCs imposes real costs (that is, affects behavior) while raising little revenue. The Obama and Camp proposals both offer a way out of this dilemma.

The above analysis has shown that these two proposals are more similar than appears at first glance. Of course, the devil is in the details. But it seems to me that if the Republicans in Congress are willing to live with the anti-base-erosion provisions of the Camp proposal, then even a reelected President Obama should be willing to live with limited territoriality, since the combined effect of these provisions is quite similar to his minimum tax. The result would be that low-taxed foreign-source income of CFCs would generally be subject to tax currently, while high-taxed income would be exempt. This is quite consistent with the intent of the drafters of subpart F, who believed that it is not possible to earn active income overseas without incurring significant foreign tax (and therefore dividends from that income would be exempt in that they carry foreign tax credits).[12]

I have always believed that corporate taxation should be primarily source-based — that is, territorial.[13] The trick is how to achieve this outcome while preventing massive double nontaxation. Adopting the Camp proposal for a participation exemption with all three anti-base-erosion options included is a good step in that direction. ◆

[10]The Irish income could even be taxable under Camp Option A or C if it is attributable to intangibles or if the Irish effective tax rate is below 10 percent.

[11]It may be argued that including all three Camp options is overkill, but given the ingenuity of tax planners, I think it is important to have all three of them (they all create subpart F income) and just provide an ordering rule to prevent the same income from being taxed twice.

[12]*See* Reuven Avi-Yonah, ''U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective,'' *Tax Notes Int'l*, June 8, 1998, p. 1797, *Doc 98-18031*, or *98 TNI 109-15*.

[13]For the normative basis for this preference, see Reuven Avi-Yonah, ''The Structure of International Taxation: A Proposal for Simplification,'' 74 *Tex. L. Rev.* 1301 (1996).

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