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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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All or Nothing? The Obama Budget Proposals and BEPS

By Reuven S. Avi-Yonah[1]

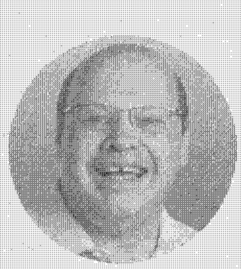
Introduction: The Current Mess

There is a wide bipartisan consensus that the U.S. international tax regime is broken. We have the highest corporate tax in the OECD, which at 35 percent imposes a real burden on corporations earning mostly U.S.-source income. At the same time, U.S.-based multinationals pay very low effective tax rates on foreign-source income earned through their subsidiaries, leading to a strong incentive to shift profits out of the United States. Finally, the United States is among the few countries to fully tax dividends paid by foreign subsidiaries to their domestic parents, leading to the "trapped income" phenomenon in which $2 trillion of low-taxed earnings of those subsidiaries cannot be repatriated because of the tax on repatriations and have to be declared as "permanently reinvested" overseas despite increasing difficulties to find something to do with this pile of money.

There is also a broad consensus about what needs to be done: reduce the corporate rate, broaden the base by taxing offshore profits and eliminate the tax on repatriations, which affects behavior in negative ways without raising revenue. President Obama's budget for fiscal 2016 does all three, but in a half-hearted way that does not fully address the problems and creates new ones.

The President presumably believes that what he proposed is just a starting point for negotiations with congressional Republicans, and that it was the most he could possibly expect to get. But it is not a good idea to begin negotiations by giving away half of what you want. A famous Talmudic story tells of two brothers who argued over a piece of land. One said it was all his, while the other, wishing to appear reasonable, said that each should get half. The judge held that since there was no dispute over one half, the intransigent brother should get it, and then the remaining half should be divided between them. A similar fate awaits Obama's proposals: Having conceded, for example, that the $2 trillion of trapped earnings should be taxed at 14 percent, or half the usual rate, he will be faced with Republican demands for a seven-percent rate.

There is, however, a better way. The G20 and OECD Base Erosion and Profit Shifting (BEPS) project has established that our major trading partners all want to eliminate double nontaxation and that they are willing to revise their controlled



REUVEN S. AVI-YONAH is Irwin I. Cohn Professor of Law and Director, International Tax LLM, at the University of Michigan.

foreign corporation (CFC) rules to do so, with specific proposals due in September 2015. The President should use this opportunity to convince the leaders of the G20 to eliminate deferral or exemption of CFCs at their normal corporate rate, which is always higher than 20 percent. Such a multilateral solution deals with all the normal objections to abolishing deferral unilaterally in the name of competitiveness, neutrality or the need to prevent corporate expatriations. It will enable the United States to achieve real corporate rate reduction and base broadening without leaving in place the incentives to invert or to shift profits overseas. And it will generate extra revenue that can be used to reduce the top marginal individual tax rate, a move that will please congressional Republicans and make tax reform easier to swallow for the nonincorporated sector of U.S. business.

The Obama Budget Proposals

The President's budget for fiscal 2016 contains three major proposals to address the current mess. First, the President proposes to reduce the corporate tax rate to 28 percent (25 percent for some domestic manufacturing activity), while raising the dividend and capital gains rate to 28 percent.[2] Second, the President proposes to impose a one-time transition tax of 14 percent (*i.e.*, half the new normal rate) on previously accumulated offshore earnings of U.S.-based multinationals, and then let them repatriate those earnings without further tax.[3] Finally, the President proposes to impose a per-country minimum tax of 19 percent on the future earnings of CFCs of U.S. multinationals, and thereafter let them repatriate those tax-free.[4] In addition, the budget contains many previously proposed items, including a reduction of the threshold to be treated as an inverted company (and taxed as a U.S. corporation) from 80 percent to 50 percent (or if the US corporation is bigger and continues to be managed from the United States with no substantial presence in the acquiring foreign corporation's country).[5]

Predictably, the proposals have been denounced by the Business Roundtable as anti-competitive and by others as a giveaway to the multinationals. But congressional Republicans have been more positive because these proposals are in fact quite similar to the tax reforms proposed by former Ways and Means Chair Dave Camp (R-Mich.) last year, with the main difference being the rates. Camp would have cut the overall rate to 25 percent, imposed a 3.5–8.75-percent tax on past earnings and taxed future earnings at 12.5–15 percent.[6] Thus, it is quite possible that the two sides could compromise somewhere in the middle between the two positions.

Why the Obama Proposals Are Inadequate

Nevertheless, in my opinion the Obama budget proposals are inadequate. They give away too much while leaving the current perverse incentives in place, or even exacerbating some of them. The following discusses these proposals in turn.

First, the 14-percent tax on past earnings. There is no policy justification for this rate in the budget, and it is hard to think of one. Past earnings are by definition past, and therefore taxing them cannot affect either the competitiveness of U.S. multinationals or their incentives. Not taxing them in full is therefore a pure windfall that cannot be defended in the name of either competitiveness or neutrality. Most logically, they should be taxed at the 35-percent rate that would have applied when earned. I can at least see logic in applying the full new 28 percent as an alternative.

Presumably, the reason to cut that rate in half is to assuage the opposition by the multinationals, who object to any taxation of their offshore earnings because they have not taken a reserve for such taxes (disingenuously declaring them "permanently reinvested" overseas) and will therefore take a hit to their financials. But U.S. multinationals have been earning record profits of late, and this kind of "one-time hit" is something that capital markets will understand. As such, U.S. multinationals can be expected to bear this hit, having benefitted from decades of earning income that belongs in the United States without paying tax on it to any jurisdiction.

Second, the proposed 19-percent minimum tax is actually lower than that because of an "allowance for corporate equity" designed to accommodate multinationals with real business operations in a given country. The result would be that U.S. domestic earnings are taxed at 28 percent, or at least 25 percent, while offshore earnings are taxed at less than 19 percent. Since there is no longer a tax on repatriations, there will still be strong motivation to shift profits from the United States to offshore CFCs with no longer any concern that the income will be trapped overseas. We are, after all, talking about billions of dollars in tax, so that every percentage point translates into a huge saving for the multinationals.

On the surface, 19 percent is higher than the effective rates imposed on foreign profits by our major competitor countries, which generally exempt active foreign income when it is earned and when it is repatriated. However, with the existing CFC rules of other countries, as well as the expected strengthening of CFC regimes that will come out of the BEPS process, this 19 percent (actually lower than 19 percent per the above) will competitively be either better or worse than

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47, Dec. 15,550 (1947).

[44] Emphasis added.

[45] Given that Code Sec. 267(a)(3)(B) merely defers a deduction, rather than denying it permanently, it is generally believed that a corporation's earnings and profits under Code Sec. 312 are reduced by the deferred amount only when it is recognized for purposes of calculating income. There is some confusion on this point, given that Reg. §1.312-7(b)(1) states that losses disallowed under Code Sec. 267 reduce earnings and profits currently. Given that the regulation was last amended in 1972, it appears to be referring to cases where section 267 permanently denies a deduction. Since the regulation was issued, Code Sec. 267(a)(2), Code Sec. 267(a)(3) and Code Sec. 267(f) have been amended or added to provide for temporary deferral, rather than permanent denial of deductions.

[46] *See, e.g.*, Reg. § 1.1441-2(e)(1) ("A payment is considered made to a beneficial owner if it is paid in partial or complete satisfaction of the beneficial owner's debt to a creditor").

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the tax rates applied to the earnings of those competitor multinationals.[7] The winner or loser will be fully dependent on factors such as industry, tax structures employed, home countries, *etc.* Despite the noise that U.S. multinationals will make about how they are being hurt competitively, we should ignore it as a red herring.

Irrespective of the red-herring nature of this competition issue, this 28-percent–19-percent structure will violate the usual neutralities (CEN, CIN and CON). Further, all the noise about competition issues may result in a spate of inversions until the new anti-inversion rule kicks in, in December 2015. After that, we may see an increase in actual takeovers of U.S. multinational by larger foreign multinationals, since even the President's anti-inversion proposal cannot block those (and they can result in larger job losses and emigration of intellectual property than inversions, since the new enterprise will actually be headquartered abroad).

Finally, the new 28-percent (or 25-percent) corporate rate is significantly below the top individual rate (nominally 39.6 percent, but because of the restrictions on exemptions and deductions, plus potentially the 3.8-percent net investment income tax, it is usually well over 40 percent, and with state taxes it can be over 50 percent). The result will be a distinct bias in favor of C corporations and against businesses operating transparently as S corporations, LLCs or partnerships because even with higher taxes on dividends and capital gains, the fact that these taxes can be delayed means that it is frequently better to be a C corporation and pay 28 percent than to be a passthrough and pay over 40 percent.

All of these biases will be exacerbated if, as expected, negotiations with the Republicans further reduce the minimum rate on offshore income below 19 percent and do not affect the overall corporate rate much (the latter cannot be further reduced without eliminating other tax expenditures that also benefit the unincorporated sector, such as accelerated depreciation, which would make the bias in favor of C corporations even worse).

BEPS: An Opportunity for Real Reform

But there is a better way. The G20 all have corporate tax rates above 20 percent, and they all wish to eliminate double nontaxation of offshore income, as evidenced by the actions already adopted under BEPS.

By September, the BEPS project is supposed to address changes in the CFC rules to limit BEPS.[8] The President has an opportunity to use the BEPS project to achieve a coordinated tax reform, in which all the G20 commit to taxing the offshore income of their multinationals at their normal tax rate, with no deferral or exemption.[9]

Such an outcome achieves the best of all possible worlds. First, because most multinationals are based in the G20, there will be no adverse impact on competitiveness for any of them because they all will be subject to current tax at 20 percent or above on both past and future earnings. Second, we will simultaneously achieve all the neutralities, since it is well established that CEN, CIN and CON can all be satisfied at the same time if rates are coordinated. Third, there will be no barriers to repatriating offshore funds. Finally, there will be no incentive for tax-motivated takeovers or inversions to G20 countries, although a tough anti-inversion rule is still needed to prevent moves outside the G20. I would suggest a corporate-level exit tax (deemed sale of assets), in addition to the President's proposal.

Would the Republicans ever agree to anything like this? They might, if there is a sweetener: using any excess revenue to reduce the top individual rate to be the same as the top corporate rate. If the rate structure returns to where it was in 1986–1990, *i.e.*, ordinary income, capital gains and dividends taxed at 28 percent, plus a 28-percent corporate rate imposed on worldwide income, all of the biases discussed above (including the bias in favor of C corporations and against passthroughs) are largely eliminated.

Conclusion: The Lessons of the FCPA

The basic conclusion from the U.S. experience with tax reform is that in a globalized world, it is hard to do tax reform alone. There is no way to unilaterally address the biases in our system without affecting competitiveness.

There is a useful historical precedent for the above proposal for multilateral action. In 1977, the United States adopted the Foreign Corrupt Practices Act (FCPA), which put U.S.

multinationals at a distinct competitive disadvantage because they were the only ones who could not pay bribes to obtain business overseas (the Germans allowed bribes as a tax deduction, while others simply ignored them). The solution was not to relax or abolish the FCPA, but to get the OECD to adopt a binding multilateral treaty in 1995. Once all of our trading partners were subject to the same regime the problem became much less acute.

The same results can be achieved for tax if the Obama Administration makes a serious effort in the context of BEPS. Without a multilateral solution, I fear its proposals will, if enacted, only make the existing mess even messier.

ENDNOTES

1. I would like to thank Jeff Kadet for helpful comments on a previous version.
2. General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals ("2016 Green Book") (Department of the Treasury, February 2015), 156.
3. 2016 Green Book, 23.
4. 2016 Green Book, 19.
5. 2016 Green Book, 37.
6. For a discussion of these proposals see Reuven S. Avi-Yonah, *The Devil in the Details: Reflections on the Camp Draft*, 73 Tax Notes Int'l 1054 (March 24, 2014).
7. *See* Reuven S. Avi-Yonah and Yaron Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals*, 65 Tax L. Rev. 375 (2012).
8. OECD, Action Plan on Base Erosion and Profit Shifting (2013), Action 3 (due September, 2015).
9. For a more detailed discussion of this proposal see Reuven S. Avi-Yonah, Advanced Introduction to International Tax Law (Elgar, 2015), ch. 14.

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