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Under these conditions, why should the U.S. reward Ireland and other jurisdictions that have a low tax rate by enabling shifting profits to them, when economically these profits are earned in the large developed economies?

Instead, we should simply determine what the corporate rate is that would put U.S.-based MNEs on a level playing field with the G-20, and impose that rate on all future income (past income should be taxed at the full 35 percent, since that does not affect competitiveness). If the rate is 17 percent, so be it, as long as it is imposed on both U.S. and foreign income. Then, we negotiate a coordinated tax floor of 20 percent or 25 percent with the other G-20 countries, which will go along to prevent shifting income into the U.S. This will be much simpler than the very complex TRA 14 anti-BEPS proposals.

This proposal would deal with competitiveness, neutrality, and corporate expatriations at once. Since the vast majority of MNEs are based in the G-20, there would be no competitive disadvantage, no violation of capital export neutrality, capital import neutrality, or capital ownership neutrality, and no incentive to expatriate, even if we should still adopt “managed and controlled” and impose a deemed sale of assets corporate exit tax to prevent corporate expatriations to non-G-20 jurisdictions.

TRA 14 says that the rationale for departing from the over-a-century-old rule of taxing U.S. resident corporations on all income from whatever source derived is to “allow U.S. companies to compete on a more level playing field against foreign multinationals when selling goods and services abroad” and to “eliminate the ‘lock-out’ effect that results from the U.S. residual tax under current law, which discourages U.S. companies from bringing their foreign earnings back into the United States.” The above proposal would achieve both of these aims while also preventing BEPS and not putting domestic U.S. businesses at a competitive disadvantage compared with U.S.-based MNEs.

♦ Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan. The author would like to thank Jeffery Kadet, Omni Marian, Peter Merrill, Fadi Shaheen, Stephen Shay, and Bret Wells for very helpful comments.

Camp’s Anti-Base-Erosion Provisions Raise Questions

by Kristen A. Parillo

The scaling back of the foreign base company sales income (FBCSI) rules in the discussion draft of House Ways and Means Committee Chair Dave Camp, R-Mich., appears to assume that the proposed anti-base-erosion provisions will act as an effective backstop to the inappropriate shifting of profits to no- or low-tax jurisdictions.

However, some observers question whether the plan’s anti-base-erosion proposal — namely, the creation of a new category of subpart F income called foreign base company intangible income (FBCII) — would effectively deter multinationals from shifting profits out of the United States. Camp’s plan, released February 26, would modify the subpart F rules so that only low-taxed foreign income would be subject to current U.S. taxation. Section 4201 of the plan proposes changing the high-tax exception threshold of IRC section 954(b)(4) (which excludes from subpart F treatment any income that has been subject to an effective foreign tax rate of at least 90 percent of the U.S. tax rate) by applying different thresholds for different categories of foreign income.

For foreign personal holding company income, the threshold would be increased to 100 percent of the U.S. corporate tax rate (which would amount to 25 percent, after the proposed new 25 percent corporate rate is fully phased in). However, for FBCII the threshold would be reduced to 60 percent of the U.S. rate (that is, 15 percent), and for FBCSI it would be reduced to 50 percent (that is, 12.5 percent). The high-tax exception would no longer be elective.

Section 4202 of the plan explicitly excludes from FBCSI treatment income earned by a controlled foreign corporation that is eligible for treaty benefits as a qualified resident of a country that has a comprehensive income tax treaty with the United States. According to the Joint Committee on Taxation’s technical explanation, the exclusion is intended to be limited to “those companies that satisfy the robust limitation on benefits provisions of income tax treaties.”

As indicated above, section 4201 also excludes from FBCSI treatment income that has been taxed at an effective rate of 12.5 percent or greater (when the corporate rate phases down to 25 percent). Section 4202 provides that only 50 percent of that income will be...
treated as subpart F income; the other half will be eligible for the 95 percent dividends received deduction when the earnings are distributed to the foreign subsidiary’s U.S. corporate shareholders.

Camp’s plan would essentially create a minimum 12.5 percent worldwide tax rate for income treated as FBCSI. The intent is to impose a minimum tax of 15 percent on the portion of FBCII that is foreign intangible income and 25 percent on the portion that relates to U.S. market sales; however, in effect the minimum rate is a blended rate that depends on the foreign percentage.

Giving Treaty Country CFCs a Pass?

Because the drafters of Camp’s October 2011 discussion draft decided to hold off on proposing possible reforms of the subpart F rules (other than the plan’s three antiabuse options) until after the plan’s basic structure was in place, the narrowing of the scope of the FBCSI rules in the February 26 draft may have come as a pleasant surprise to some people.

Ramon Camacho of McGladrey LLP said the rationale behind the new draft’s FBCSI exclusion for treaty resident CFCs may be that because U.S. parents that set up foreign subsidiaries in jurisdictions with which the United States has negotiated a tax treaty that includes a strict LOB article — and those subs qualify for benefits under those treaties — the parents are probably doing a sufficient amount of legitimate, bona fide business activity in those jurisdictions that having them “jump through hoops” to qualify for an exception to the FBCSI rules seems unnecessary.

“What this provision essentially says is that if you have a CFC that happens to qualify for benefits under a treaty, or if you want to structure yourself in a treaty country, now you wouldn’t have to worry so much about the extensive rules that govern exceptions to FBCSI,” Camacho said.

Peter M. Daub of Baker & McKenzie said that Camp’s plan would make it easier for taxpayers to get out of the FBCSI cross hairs. “If you had a principal company resident in Ireland or Switzerland that was the subsidiary of a publicly traded U.S. parent,” he said, “then income that under current law would otherwise be treated as FBCSI because the CFC didn’t make a substantial contribution to the manufacture of the product it sold, and because the CFC purchased raw materials from, or sold finished goods to, a related person, would not be treated as FBCSI under this proposal.”

If the proposed rules were enacted, a practical effect would be that much of the time and effort that went into Treasury’s drafting of the 2008 final and temporary contract manufacturing regulations (T.D. 9438) would “seem to be irrelevant for years covered by the new proposal,” Daub said.

Daub said the Camp plan’s proposed scaling back of the FBCSI rules is striking when compared with a proposal in the Obama administration’s fiscal 2015 budget plan that would expand the FBCSI category to include a CFC’s income from the sale of property manufactured on behalf of the CFC by a related person. Treasury’s green book explanation said the measure is necessary to prevent the avoidance of FBCSI treatment through manufacturing services arrangements.

“The administration and Camp seem to be going in opposite directions in this area,” Daub said.

FBCII as Effective Backstop?

Peter Merrill of PricewaterhouseCoopers LLP said the Camp plan’s drafters may feel confident that the anti-base-erosion regime encompassed by the proposed new FBCII rules will cast a wide enough net that the U.S. base will be sufficiently protected.

“If you follow that logic, then you don’t need the FBCSI rules as much, and you can liberalize the other CFC rules,” he said. “Even if foreign income doesn’t get picked up as FBCSI, you’ve got a huge backstop in FBCII. In effect, the plan imposes a minimum tax on intangible income.”

Merrill pointed out that it wouldn’t always be advantageous to avoid FBCSI treatment because that income would be subject to a 12.5 percent minimum tax and would be subtracted from FBCII, which is subject to a higher minimum tax rate (15 to 25 percent, depending on the foreign percentage).

Merrill noted that the JCT estimates that the new FBCII regime, along with some of the other proposed subpart F modifications, would increase revenue by $115.6 billion over 10 years. “We’d be getting more money out of foreign subsidiaries with a lower corporate tax rate,” he said. “Once you have a robust anti-base-erosion regime in place, you don’t need to worry as much about FBCSI.”

Edward D. Kleinbard of the University of Southern California Gould School of Law had a different take on the JCT’s revenue estimates. “Against a background of trivially small U.S. revenue collections today on international income, as revealed both in IRS statistics and financial statements, the draft bill actually would lose an additional $100 billion over 10 years, once the one-time repatriation tax is stripped away,” he said.

The measures proposed in section 4202 of the plan “would appear to encourage U.S. firms to shift from a model of directly exploiting intangibles to a model of incorporating them into finished product that can be sold to customers, because only one-half of FBCSI will be taxed in general, and none of FBCSI will be taxed if earned by a resident of a tax treaty country,” Kleinbard said.

“Legislators in tax treaty countries no doubt would push the edge of the envelope in designing new regimes to suit,” he said.

Bret Wells of the University of Houston Law Center also expressed concern over whether Camp’s plan has
sufficient controls in place to combat base erosion. “I’m not sure why we’d care that another country has a tax treaty with the U.S. for purposes of the FBCSI rules,” he said. “It seems to be mixing apples and oranges in my mind.”

He noted that Congress originally implemented the FBCSI rules because it was concerned about U.S. companies shifting income to base companies located in low-tax jurisdictions. “The FBCSI rules were viewed as a way to backstop the U.S. transfer pricing rules so that profits didn’t inappropriately migrate to a low- or no-tax jurisdiction,” Wells said.

Under the proposed legislation, he said, FBCSI no longer would include income earned by a foreign subsidiary that is incorporated in a country that has a comprehensive income tax treaty or has been taxed at an effective tax rate of 12.5 percent or greater. And FBCSI treatment would be excluded if the income has been subject to tax at an effective rate below 15 percent. “If we’re going to allow FBCSI and FBCII profits to obtain tax concessionary rates substantially below 25 percent, then this is an open invitation to taxpayers to recast U.S. profits into FBCSI or FBCII,” he said.

Under that new paradigm, Congress would need to carefully think through section 482 and how it would apply absent any effective subpart F backstop regime, he added.

The Camp plan’s proposed FBCII rules don’t appear as though they would sufficiently protect against base erosion, Wells said. “The FBCII rules provide for a 15 percent rate, which is a pretty low foreign tax rate that these excess intangible returns are subject to,” he said. “If that’s the backstop, then it’s saying you can use FBCSI trading patterns and earn profits that are classified as FBCII, and as long as you pay an effective tax rate that’s above 15 percent, you can do that to your heart’s content and avoid subpart F treatment.”

Giving a “free pass” from FBCSI treatment to taxpayers that qualify for treaty benefits regardless of the tax rate they pay on that income—doesn’t seem to make sense from a policy standpoint, Wells said. Tax treaties are designed to address issues regarding withholding taxes, permanent establishment, and double taxation, he said, while the FBCSI rules were designed to address the problem of profit shifting and to protect against inappropriate transfer pricing results. The proposed FBCII rules would not prevent base erosion planning from occurring, he said.

Wells added that it’s not clear why the plan’s minimum rates for shutting off the FBCII and FBCSI provisions are so much lower than the statutory rate. “If the rate is below the U.S. rate, then there is an incentive to have the profits be characterized as FBSCI or FBCII,” he said. “It’s difficult to see how these provisions protect the tax base. They are in fact motivating tax restructuring exercises to maximize the income that can be categorized as FBSCI or as FBCII.”

If the United States were to move to a regime in which U.S. territorial profits are taxed at 25 percent and FBSCI and FBCII are taxed at significantly lower tax rates, then the section 482 rules would need to be carefully thought through, Wells said, because that new paradigm would have no effective backstop regime to protect the tax base from the inevitable reactive tax planning that such legislation would encourage.

Camacho, however, pointed out that the plan’s drafters likely had to keep competitiveness concerns in mind when developing the proposals. “Overall, the principal policy justification typically advanced for reducing the tax burden on foreign income is competitiveness,” he said, adding that taxpayers have long argued that reducing the U.S. tax burden will allow them to compete on a level playing field with non-U.S.-based firms that typically face reduced tax rates, or even full exemption, in their home countries.

“While it may seem to some that the Camp proposals provide unjustifiable tax benefits to foreign income—especially intangible income—the question for policy makers is whether the reduced rates allow U.S. firms to be more competitive with foreign firms,” Camacho said.

Many developed foreign countries have special tax regimes for intangible income “that reduce the rate of tax on such income to almost nothing, so a minimum 15 percent rate perhaps doesn’t seem so bad, especially if it helps American businesses be more successful,” he said.

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