A Simpler Offshore Profits Transition Tax

by Susan C. Morse

Susan C. Morse is an assistant professor at the University of Texas School of Law in Austin.

U.S. multinationals have close to $2 trillion parked offshore.[1] U.S. income tax on distributions from non-U.S. subsidiaries to U.S. parents produces a lockout effect that discourages multinationals from bringing the cash back. But some proposals to reform the U.S. corporate income tax, including the Camp[2] and Baucus[3] discussion drafts, would change this. If such a reform eliminated this lockout effect, U.S.-parented multinationals might pay some tax currently on the earnings of their non-U.S. subsidiaries, but no additional U.S. income tax would be due on repatriation to the U.S.

If such a reform occurred, what should be done about the undistributed non-U.S. earnings and profits — the tax measure that roughly corresponds to earnings parked offshore?[4] Some tax should be imposed. This would avoid giving a windfall to companies that should have assumed they would eventually pay some tax when they repatriated overseas profits. A transition tax would also raise needed revenue, though only on a one-time basis.[5]

Since the transition tax idea emerges from a corporate income tax context, it might at first seem like a special edition of the income tax. For example, one might try to design a transition tax based on the backward-looking concept that in the past, U.S.-parented multinationals should have paid current tax on all of the earnings of their non-U.S. subsidiaries. A precise attempt to activate a backward-looking concept might echo the passive foreign investment company regime. It would ask a U.S.-parented multinational to go back to each past tax year and determine the tax that would have been due if the non-U.S. income of such subsidiaries had been subject to U.S. tax. This would raise not only monumental practical obstacles but also substantive due process concerns.[6]

Instead, the transition tax design is an exercise in rough justice. Precision adds relatively little value. The Baucus draft simplifies in some ways, but it could do more.

In particular, the Baucus draft simplifies the timing of the tax. But they could streamline further by declining to run the transition tax through the income tax system at all. This would permit the application of a tax rate that loss-making planning could not affect. It would also replace the allowance of foreign tax credits against the transition tax with a deduction for foreign taxes paid, for purposes of calculating the base of the transition tax.

The Baucus discussion draft uses a deemed-inclusion mechanism for the transition tax. That is, it adds the undistributed non-U.S. E&P of a multinational's non-U.S. subsidiaries to the subpart F income of a U.S. parent at the date specified in the enacted law.

---

[1] *See, e.g.*, David Kocieniewski, ''For U.S. Companies, Money 'Offshore' Means Manhattan,'' *N.Y. Times*, May 21, 2013.

[2] *See* House Ways and Means Committee, discussion draft of Tax Reform Act of 2011 (Oct. 26, 2011).

[3] Joint Committee on Taxation technical explanation (JCX-15-13).

[4] Publicized estimates of cash parked offshore typically derive from proxies in accounting figures, including measures of permanently reinvested earnings. Tax measures of undistributed earnings and profits differ. Internal tax information regularly maintained by firms should include undistributed E&P figures, at least for post-1986 earnings.

[5] *See* Daniel Shaviro, ''The Rising Tax-Electivity of U.S. Corporate Residence,'' 64 *Tax L. Rev.* 377 (2011) (providing the first analysis of this transition tax issue).

[6] *See, e.g.*, *United States v. Carlton*, 512 U.S. 26 (1994).

The drafts allow the U.S. parent to deduct a portion of the included earnings, thus arriving at an effective rate that is less than the top-shelf U.S. corporate income tax rate. The effective rate in the Baucus draft is 20 percent. The effective transition tax rate in the Camp discussion draft circulated by the House Ways and Means Committee in October 2011, which uses a similar income inclusion and partial deduction mechanism, is 5.25 percent.

These proposals sound like they would impose a transition tax on undistributed earnings of, respectively, 20 percent and 5.25 percent. But this is not what the proposals would do. Rather, 20 percent and 5.25 percent serve as a ceiling rate for transition tax liability, not as an actual tax rate.

First, the mechanism of including the undistributed earnings in a firm's income tax base means that transition tax liability is subject to the circumstances of the firm in the year of inclusion. Some firms may have net operating losses, for example. Some may plan so as to realize or create offsetting losses, deductions, or credits in that year. Such planning will lower effective tax rates and will do so in a way that is uneven across firms and that reflects the companies' tax facts and tax planning capacity in the year of transition, rather than, for example, in prior years.

Second, the Baucus and Camp transition tax proposals would allow a foreign tax credit against the transition tax liability, but would disallow both a foreign tax credit and a deduction for foreign taxes for the portion of the deemed-included income that is deducted from gross income. Certainly a full foreign tax credit should not be allowed against a low-rate transition tax. But allowing only a partial foreign tax credit is enormously complex. The usual challenges exist. These include separating taxes, inclusions, and distributions into passive, general, and other specialized baskets; and calculating tiered-up foreign taxes from lower-tier and/or partly owned subsidiaries. But the usual challenges are just the beginning.

For example, although the discussion drafts are not perfectly clear on this point, the approach of disallowing some foreign tax deductions presumably requires companies to add back income taxes earlier subtracted to arrive at earnings and profits. This addback would avoid the effect of a deduction for foreign taxes from the deductible portion of the deemed inclusion, akin to the approach of section 78. There must be ordering rules for the deductible portion, includible portion, and any previously taxed portion of distributions, subpart F inclusions, and transition tax inclusions. And foreign income, withholding, and other taxes available for credit must be apportioned among these buckets.

There is a simpler way. A transition tax could impose a flat percentage tax on all undistributed non-U.S. E&P, with no foreign tax credit.[7] Some allowance would be made for the payment of foreign taxes, since the E&P calculation automatically incorporates a deduction for foreign taxes paid by subsidiary corporations. This tax does not pretend to mimic the impact of a historic worldwide consolidation approach; it would not function through a subpart F inclusion, run through the income tax base, or interact with the calculation of income tax liability based on other factors. It is a rough-justice way of cleaning off the earnings slate that involves less work and less wasted energy.

Because this simpler flat rate, no-foreign-tax-credit transition tax would be imposed directly on the tax base of undistributed non-U.S. E&P, without reference to the income tax system, it would not be vulnerable to income tax planning. Instead, tax would be charged at the stated rate. This flat rate aspect of a simplified transition tax is an unmitigated advantage. Equity does not require that a firm be allowed to use current-year losses, deductions, and credits to reduce a transition tax liability that also relates to other years. Allowing such losses creates a strong incentive for inefficient tax planning and will likely require significant administrative resources in response.

The denial of any foreign tax credits under the simpler, flat rate, no-FTC transition tax imposed directly on undistributed non-U.S. earnings arguably produces inequities that weigh against the advantage of greater simplicity. (These inequities might be trumped by the principled argument that a deduction for foreign taxes is better policy, anyway, than a credit,[8] but I set that argument aside here.)

This can be illustrated by comparing the stylized foreign tax credit situations of a hypothetical multinational energy firm with a hypothetical multinational information technology (IT) firm. Energy firms generally face higher foreign tax rates than IT firms and so would have more foreign tax credits to use to reduce their transition tax liability under the deemed income inclusion approach.[9] In the example presented in the table, the energy firm pays foreign income tax at a rate of 30 percent and the IT firm pays foreign income tax at a rate of 10 percent.

---

[7]Shaviro proposes this approach in ''The Rising Tax-Electivity of U.S. Corporate Residence,'' *supra* note 5, and I develop it in ''A Corporate Offshore Profits Transition Tax,'' 91 *N.C. L. Rev.* 549 (2013).

[8]Shaviro, *Fixing International Taxation* (2013); Kimberly Clausing and Shaviro, ''A Burden-Neutral Shift from Foreign Tax Creditability to Deductability,'' 64 *Tax L. Rev.* 431 (2011).

[9]Harry Grubert and Rosanne Altshuler, ''Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,'' in: John W. Diamond and George R. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices, and Implications* (2008) 319, 348. The existence of untaxed offshore earnings does not necessarily mean that the earnings have only been suject to low rates of foreign tax. This has been empirically demonstrated for the related accounting concept of permanently reinvested earnings.

(Footnote continued on next page.)

Hypothetical Comparison of Energy vs. IT Firm Tax Liability under (1) Deemed-Inclusion Transition Tax (Baucus Proposal); (2) Simpler Flat Rate, No-FTC Transition Tax; and (3) Repatriation, Existing Law

	Energy Firm	IT Firm
Assumptions		
Non-U.S. tax rate	30%	10%
U.S. tax rate	35%	35%
Pretax non-U.S. income	$100	$100
Non-U.S. income tax paid	$30	$10
Undistributed non-U.S. earnings and profits	$70	$90
(1) Deemed-inclusion transition tax		
Target percentage (Baucus)	20%	20%
''Applicable percentage'' for deduction	42.86%	42.86%
Unadjusted deemed inclusion	$100	$100
Deduction	$42.86	$42.86
Adjusted deemed inclusion	$57.14	$57.14
Tentative U.S. income tax	$20.00	$20.00
Allowed foreign tax credit	$17.14	$5.71
Final U.S. income tax (that is, transition tax)	**$2.86**	**$14.29**
(2) Flat-rate, no-FTC transition tax		
Tax rate	10.71%	10.71%
E&P tax base	$70	$90
Transition tax	**$7.50**	**$9.64**
(3) Results assuming dividend distribution of all undistributed non-U.S. E&P		
Inclusion in income after 78 gross-up	$100	$100
Tentative U.S. income tax	$35	$35
Allowed foreign tax credit	$30	$10
Final U.S. income tax	**$5**	**$25**

This table first presents calculations made according to the Baucus proposal, with its effective transition tax rate of 20 percent subject to proportional allowance of foreign tax credits. As the table shows, $100 of pretax non-U.S. earnings (that is, determined without any reduction for a deduction on account of foreign income taxes) results in the following transition taxes under the deemed-inclusion transition tax proposed in the Baucus draft, after allowed foreign tax credits:

- $2.86 for the energy firm; and
- $14.29 for the IT firm.

The table next shows hypothetical liability under a simpler transition tax imposed at a flat rate on non-U.S. undistributed E&P. Under this approach, E&P is calculated in the usual way and so reduced by foreign income taxes. Foreign tax credits are not allowed. A transition tax rate of about 10.71 percent is required to raise the same amount of revenue from these two hypothetical firms as would be raised by the Baucus draft transition tax, setting aside the likelihood that tax planning will reduce the Baucus draft's tax. A 10.71 percent transition tax will produce the following per $100 of pretax earnings:

- $7.50 for the energy firm; and
- $9.64 for the IT firm.

The energy firm still pays less than the IT firm because the foreign taxes paid by each firm are deducted from the tax base of undistributed non-U.S. E&P.

See Jennifer Blouin, Linda Krull, and Leslie Robinson, ''The Location, Composition, and Investment Implications of Permanently Reinvested Earnings'' (Oct. 2013 draft), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154662.

The energy firm pays more under the simpler transition tax alternative — $7.50 compared with $2.86 under the deemed-inclusion Baucus proposal. If one believes in the validity of the foreign tax credit system, or in respecting taxpayers' expectations based on past access to foreign tax credits, these figures suggest that there is some cost to the simpler transition tax that does not allow foreign tax credits. This cost is the relatively high taxation of the hypothetical energy firm and others like it that pay high rates of foreign income tax.

But there is a better way to address any concern about fairness to firms that pay high rates of foreign income tax. The transition can be fashioned to permit firms with high foreign tax credits to plan to make maximum use of those credits. The mechanism would be simple. In particular, the transition tax could be imposed at the start of a taxpayer's first tax year that begins on or after a date that falls several months after the enactment of the tax reform bill as law. If a firm finds that it can shelter distributions with foreign tax credits under existing law, it can make distributions before the effective date. If it does not, it will find itself subject to the simplified transition tax instead.

In the case of the energy firm with a 30 percent foreign tax rate, it could repatriate and pay only $5 in U.S. income tax per $100 of pretax foreign income. It would presumably do so instead of paying a $7.50 transition tax. In fact, the capacity of companies to cross-credit and distill[10] their foreign income tax credits for maximum effect may permit the energy firm to take even greater advantage of available foreign tax credits.

Currently, the discussion drafts anticipate a transition tax on E&P measured in the year of enactment but (at least in the Baucus draft) without reduction for distributions made earlier in that year. A delayed effective date would allow firms to reduce the E&P subject to the transition tax by actually repatriating earnings before the effective date. But delaying the effective date would cause the proposal to differ only in degree from the existing discussion drafts, because firms could always repatriate in anticipation of a transition tax before it was actually enacted. In fact, under the current proposals, the circumstance of when a firm's taxable year happens to end would make it easier for some firms to execute pre-enactment repatriation planning compared with others.

The calculations above do not mention withholding taxes. But imposing the transition tax on a date that falls after the enactment of the bill could also allow firms to take advantage of the foreign tax credits associated with non-U.S. withholding taxes imposed on dividend distributions to the extent allowed by existing law — as long as they actually repatriated offshore profits before the date on which E&P was measured for purposes of imposing the transition tax. This might make it easier to establish a prospective rule that withholding taxes payable on pre-enactment E&P, if later repatriated, would not be creditable under U.S. law.

There may be other reasons for the more complicated, deemed-inclusion transition tax mechanism presented in both the Camp and Baucus drafts. Concerns raised by treaty partners and goals for negotiating the passage of a reform bill are two possible sources of advantage for the more complicated tax. I do not know enough to have a definite view about either possibility, but can at least speculate about likely concerns.

Treaty partners will likely view a U.S. transition tax as a new issue, since similar provisions were not included in two parallel recent situations involving adoptions of territoriality in Japan and in the U.K. Treaty partners might be interested in the creditability of the transition tax against their own tax, although the prevalence of territorial systems reduces concerns about foreign tax credits for many jurisdictions. A creditability issue might arise, for example, if a non-U.S. parent owned a first-tier U.S. subsidiary that owned a second-tier non-U.S. subsidiary, and the first-tier U.S. subsidiary paid a transition tax. Perhaps it is slightly harder for treaty partners to argue that a more complex transition tax, designed as a subpart F inclusion, is not a creditable income tax. It runs through the firm's income tax return, and that probably helps the taxpayer's case, even if it is not clear whether the deemed inclusion would meet any applicable realization requirement under non-U.S. law.[11]

Regarding the task of actually enacting an international corporate tax reform package, it is possible that a simpler transition tax is worse than the more complex, deemed-inclusion approach proposed in the Baucus and Camp drafts. Maybe increased simplicity and transparency in terms of what different firms would pay in transition tax is a disadvantage for the advocates of international tax reform. This could be so because it is easier for opponents of the reform to criticize a provision that is easier to understand.

But in a sensible world, companies should be thankful for a simpler, flat-rate, no-FTC transition tax that allows them a rough-justice clean slate without unnecessary headache. Legislators should be better able to negotiate a reform package if it is easier to understand the transition tax and its impact. And taxpayers should be glad to have a revenue number — even if it is a one-time sum — that will not shrink before their eyes because of tax planning machinations and the absorption of administrative resources in response. ◆

[10] *See* Edward D. Kleinbard, "Stateless Income," 11 *Fla. Tax Rev.* 699 (2011).

[11] Reg. section 1.901-2(a)(3).