US Corporate Tax Reform — Stuck In Neutral

Law360, New York (February 21, 2014, 2:12 PM ET) -- Three significant international tax reform proposals in the United States have been released in the past three years: the International Tax Reform Discussion Draft released by House Ways & Means Committee Chairman Dave Camp, R-Mich., in October 2011, President Barack Obama's Framework for Business Tax Reform released in February 2012, and the Staff Discussion Draft on International Business Tax Reform released by Sen. Max Baucus, D-Mont., chairman of the Senate Finance Committee, on Nov. 19, 2013.

Despite these efforts, the United States seems no closer to fundamental corporate tax reform. And although certain structural similarities in the proposals might suggest areas for compromise, gridlock in Washington, the ongoing debate over appropriate corporate taxation levels and personnel shifts in Congress continue to dim the prospects for tax reform.

The Baucus Proposal

The most recent international tax reform proposal — Baucus' Staff Discussion Draft — may be the most far-reaching. The discussion draft would eliminate the system of worldwide taxation and deferral for foreign subsidiary income and replace it with a greatly expanded system of current taxation. This would include a limited exemption system for certain specified categories of foreign income, likely in the context of a reduced corporate tax rate (though no such rate reduction appears in the discussion draft itself).

In transitioning into this system, the proposal would impose a 20 percent tax on all accumulated, unrepatriated foreign subsidiary income; those earnings would not be subject to any further U.S. taxation upon repatriation. Given the magnitude of foreign earnings currently held by controlled foreign corporations (CFCs) and the relatively high tax rate imposed by the discussion draft (as compared to the 5.25 percent tax proposed under Camp's proposal), this tax burden would likely be substantial.

Under the discussion draft, future CFC earnings would be subject to one of two expanded regimes — labeled Options Y and Z — both of which would impose full current U.S. taxation on CFC income from the sale of goods or the provision of services to persons located in the United States.

In that sense, both resemble the base erosion Option C from Camp's discussion draft, which likewise would tax CFC earnings from U.S.-destined sales and services. However, both Options Y and Z differ significantly from Option C in their taxation of CFC income from non-U.S. sales and services, including in the following ways:

- ***Option Y*** would impose a minimum tax on foreign earnings at a rate equal to 80 percent of the U.S. statutory rate (24 percent, assuming a 30 percent U.S. statutory rate). Items of foreign income subject to a higher local rate of tax would be exempt from U.S. taxation; items of foreign income bearing a lower local tax rate would be subject to a current U.S. residual tax that effectively subjects such income to an overall tax rate equal to 80 percent of the U.S. statutory tax rate, with no further tax upon the repatriation of such earnings.

- ***Option Z***, in contrast, would provide a partial exemption for active income derived from non-U.S. markets, subjecting 60 percent of such income to full current U.S. taxation with a credit for any taxes paid on such income, and exempting the remaining 40 percent from U.S. taxation with no credit for the foreign taxes paid on such exempt income. Any income that does not qualify as active foreign market income would be subject to full current U.S. taxation.

The Baucus proposal also contains "anti-base erosion" provisions that would (1) deny an exemption in the United States for any CFC dividends that are treated as deductible payments in the CFC's home jurisdiction and (2) deny a deduction in the U.S. for related-party payments that are not subject to tax in the payee's jurisdiction.

Status of the Camp Proposal

Since the release of Camp's discussion draft in October 2011, its proposals have been at the center of the policy debate regarding international tax reform. Further developments on that front had been expected in late 2013, with Camp suggesting that a legislative markup was likely. However, any release of draft legislative language has been delayed, presumably due in part to the challenging policy compromises that such legislation would necessarily involve.

Whenever such legislation is released, it is anticipated that it will include a base erosion provision along the lines of Option C contained in Camp's original discussion draft. The provision will include full taxation of profits from intangible property attributable to U.S.-destined sales or services, reduced taxation — likely at a 15 percent rate based on a statutory rate of 25 percent — of all other profit from intangible property, and a similarly reduced rate on intangible profits from exported property.

Common Themes in U.S. Tax Reform Proposals

Despite the substantial differences between the various reform proposals that have been released, some common themes suggest a potential path forward. These include (1) corporate tax rate reduction, (2) base erosion protections that focus on increased taxation of foreign income earned with respect to the U.S. market, and (3) a narrowing of the U.S. worldwide taxation regime to reduce U.S. taxation on other foreign income and eliminate the disincentive under current law to repatriate foreign earnings.

Of course, substantial disagreements remain within those broad parameters, not the least of which is the political debate over whether any corporate tax reform should be revenue-neutral or revenue-raising over some relevant time horizon.

Both the Camp and Baucus proposals claim revenue neutrality, but they adopt very different notions of the concept. While Camp's proposal claims revenue neutrality over a 10-year horizon, the Baucus proposal claims revenue neutrality in a "steady-state," excluding most importantly its one-time 20 percent tax on accumulated CFC earnings.

Taking into account this one-time tax, the Baucus proposal likely is a substantial revenue raiser, which means substantial additional tax costs for many U.S. multinational corporations. If any progress is to be made on tax reform in the United States, policymakers will need to reach some agreement on the revenue goals of such reform.

Even if the issue of revenue neutrality were resolved in 2014, the prospects for reform have been dimmed by Baucus being confirmed as ambassador to China, resulting in his resignation from the Senate.

U.S. Tax Reform and the OECD BEPS Project

Despite the seeming tax reform inertia in the United States, the international community appears to be moving ahead with various of the tax reform items identified in the Organisation for Economic Cooperation and Development's project on base erosion and profit shifting (BEPS) (see "Base Erosion and Profit Shifting: Key UK Issues").[1]

With the BEPS project moving forward and U.S. tax reform stuck in neutral, it becomes increasingly likely that the BEPS project's goals and proposals will find their way into any future U.S. tax reform legislation, with potentially significant consequences for U.S.-based multinational corporations.

Indeed, that trend already is on display in the Baucus discussion draft. As noted above, the Baucus proposal would disallow deductions in the United States with respect to payments made to foreign affiliates in so-called "base erosion arrangements."

These arrangements include those involving hybrid instruments, hybrid entities and conduit financing arrangements. Likewise, the Baucus proposal would disallow an exemption in the United States for dividends that give rise to a deduction in the payor's jurisdiction. Baucus' focus on these types of hybrid arrangements that give rise to so-called double nontaxation is consistent with — and likely informed by — the BEPS project's focus on similar arrangements.

This apparent interplay between U.S. tax reform and the broader BEPS project means that both the content and the timing of U.S. tax reform, as unpredictable and even unlikely as its prospects may be, could have substantial — and potentially adverse — consequences for both U.S. multinationals with non-U.S. operations and non-U.S. multinationals with operations in the United States.

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This article was originally published in 2014 Insights, Skadden's sixth annual collection of commentaries on the critical legal issues businesses will be facing in the coming year. To see additional articles from Insights, including discussions on capital markets, corporate restructuring, financial regulation, global litigation, global M&A, governance and regulatory issues, please visit this link: http://insights.skadden.com/

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[1] See also "International Taxation – OECD Reboot for the 21st Century," Skadden Client Alert (July 19, 2013), available at http://www.skadden.com/insights/international-taxation-oecd-reboot-21st-century.