1-23-2012

Territorial W&M Discussion Draft: Change Required

Jeffrey M. Kadet
University of Washington School of Law

Territorial W&M Discussion Draft: Change Required

By Jeffery M. Kadet

Jeffery M. Kadet

Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses as a part-time lecturer in the LLM program at the University of Washington School of Law.

The House Ways and Means Committee discussion draft that would implement a territorial system for the United States includes a dividends received deduction of 95 percent rather than 100 percent as a mechanism to disallow expenses that are attributable to exempt foreign earnings. That deduction causes the receipt of a dividend to be a taxable event. The draft also proposes eliminating the section 956 investment in U.S. property rules. This elimination along with a dividend being a taxable event will continue encouraging U.S. multinational companies to stockpile earnings overseas in tax havens and will encourage intercompany loans of funds that will further reduce the U.S. tax base from the interest charged. The author suggests changes that will eliminate these detrimental effects.

The proposed territorial system is intended to free foreign earnings from U.S. tax and eliminate the current disincentive against dividend distributions that has caused the stockpiling of otherwise distributable cash overseas. Does the territorial income structure proposed in the House Ways and Means discussion draft (WMDD) released October 26, 2011,[1] accomplish this? And will there be any effect on the U.S. tax base?

As discussed below, there's a real need for a different mechanism if these goals are to be achieved. I believe the proposals, as currently drafted, will not only continue the stockpiling of earnings outside the United States, but they also will reduce the U.S. tax base.

Background and Summary Concerns

As we all know, a major argument for changing from our current deferral system to a territorial system is that U.S. multinational corporations (MNCs) will in fact repatriate their accumulated foreign earnings through actual dividends and use those repatriations within the United States, thereby creating U.S. jobs. With those actual dividend distributions, the domestic group members of U.S. MNCs would no longer borrow money while their foreign group members stockpile massive amounts of cash held permanently outside the United States (avoiding the current system's up to 35 percent toll charge on repatriation). I strongly believe that the WMDD, as currently structured, will not produce actual distributions of future exempted earnings back to the United States.

In brief, the proposed territorial system with its effective 1.25 percent tax (proposed 25 percent tax rate on 5 percent taxable portion of dividends), along with the proposed elimination of section 956 (subpart F investment in U.S. property rules), will result in many intercompany loans from foreign group members of U.S. MNCs to domestic group members. The interest flow from those loans will reduce the U.S. tax base and provide significant tax arbitrage benefits, despite some improvement from the proposed tightening of interest deductions on those intercompany loans. And the lack of dividend distributions will mean that the 1.25 percent tax is not paid, thereby further reducing the U.S. tax base.

In summation and as detailed below, the proposed participation exemption regime must be sufficiently changed to achieve the desired repatriation of overseas earnings as dividends and to avoid a serious erosion of the U.S. tax base.

Explanation of Issues

Under the proposed participation exemption, there will be an effective 1.25 percent tax on actual dividend distributions. As such, unless there are rules to somehow gently encourage actual distributions or some mechanical change that eliminates this 1.25 percent tax on actual distributions, U.S.

---

[1] Ways and Means Discussion Draft of the Tax Reform Act of 2011 (Oct. 26, 2011), *Doc 2011-22576*, *2011 TNT 208-27*. Throughout this article, the 25 percent corporate tax rate proposed in the discussion draft is assumed to be in effect whenever the U.S. corporate tax rate is mentioned.

shareholders will find ways to avoid the need for actual distributions while still using their accumulated overseas earnings in the United States. With the elimination of section 956 from subpart F, there will be complete freedom for controlled foreign corporations to make legitimate loans to their U.S. shareholders at arm's-length interest rates.

Everyone appears to assume that this 1.25 percent tax is a small price that taxpayers will be happy to pay. That is incorrect. In my 32 years of experience working with major U.S. MNCs, if there are two legal ways to accomplish something without differing tax risk, the way that achieves the objective at the lowest tax cost invariably will be chosen.

How important is this 1.25 percent? Given that many major U.S. MNCs are earning billions of dollars annually within their foreign group members, it is fair to ask what 1.25 percent of $1 billion is. It's $12.5 million. Amounts much smaller than this motivate in-house corporate tax departments as well as outside attorney and accounting tax advisers to find ways to reduce their clients' tax costs.

And speaking of motivation, remember that the accounting rules allow this 1.25 percent to be excluded from financial statement tax expense, thereby increasing reported earnings — if it is indefinitely reinvested overseas. Is there any corporate tax director in America who wouldn't jump at the chance to reduce his company's tax expense? This is a measure of his performance, just like earnings per share and share price are performance measures for a CEO.

What about the IRS? Won't it jump on this? Generally, no. Under existing tax law and principles, the IRS can of course assert shareholder taxability for a constructive dividend when a corporation has effectively passed its assets to a shareholder. However, those assertions are likely limited to situations in which unsophisticated taxpayers haven't been careful with their paperwork and documentation. That's why provisions like section 956 had to be put in place to turn a legitimate loan into a constructive dividend.

The point of this discussion is that the existence of the 1.25 percent tax, payable only when an actual dividend distribution is made, means that few actual dividend distributions will be made.

Now for a different perspective on this 1.25 percent tax on actual dividend distributions.

Although on the surface it appears that the new participation exemption is applying a 1.25 percent tax to dividend distributions received by U.S. shareholders, it is not intended to be a tax on foreign earnings. Rather, the intent is that distributed foreign earnings will be fully tax free to U.S. shareholders, with the 5 percent that's included in taxable income merely being an offset to correct the otherwise overstated expenses that are deductible against normal domestic income. In the words of the technical explanation provided with the WMDD:

> This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred [by the U.S. shareholder] to generate exempt foreign income.

This means that if actual dividends are not paid, there will be no 5 percent offset recognized by the U.S. shareholder, resulting in an overstatement of expenses against domestic U.S. income.

To summarize the issue, because the 5 percent offsets only excess expenses that have been deducted against domestic income, any delay of the payment of actual dividends, and therefore delay in recognition of this 5 percent offset, means that current domestic taxable income is being understated.

This is a real reduction of the domestic tax base.

If the effect is only 1.25 percent of the amount of distributions, how significant is this tax from a government revenue perspective?

I am not an economist and have not attempted to calculate or find any numbers to support my strong suspicions about the proposal's material effect on the U.S. tax base. That said, my views are based on the following aspects of the WMDD as currently drafted:

- the ability to permanently defer actual distributions because of the ease of making legitimate loans to domestic group members of a U.S. MNC, especially once section 956 is stricken from the tax law;
- the fact that there will be continued reinvestment of foreign earnings in new foreign businesses and investments,[2] meaning that the reinvested foreign earnings will never be repatriated as dividend distributions to U.S. shareholders; and
- the seriously high quantum of foreign earnings (not only annually, but especially when those earnings are accumulated over several years).

And, of course, the accounting rule that allows the 1.25 percent to be eliminated from financial statement tax expense if the related income is indefinitely reinvested is another strong incentive to not repatriate those overseas earnings.

[2]Those reinvestments are clearly real and material in amount, as evidenced by the financial statement disclosures of U.S. MNCs over the past decade.

In my mind, it is crystal clear that this reduction of the domestic tax base will be significant in amount, especially as the numbers grow over the years.

And, as noted above, the territorial system changes that come with the elimination of section 956 will result in many loans by CFCs to their U.S. shareholders and other domestic group members, and those loans will trigger interest charges. Yes, the proposed changes to section 163 adding new subsection (n) and amending existing section 163(j) will reduce the effect some, but these interest payments will still cause some reduction of the U.S. tax base.

One might also say that such interest income in the hands of a CFC lender will be foreign personal holding company income and therefore create subpart F income, thereby causing an offset to any interest expense achieved within domestic group members. While this is true, that interest income will often be excluded from subpart F income by the de minimis rule of section 954(b)(3)(A). When a U.S. MNC and its in-house tax personnel and advisers can achieve this (and you can bet that they will consciously work hard to do so), there's a pretty nice tax arbitrage: a full interest expense against group domestic income, providing a 25 percent tax benefit and interest income within the CFC that will likely never be subject to any U.S. tax (or if it is distributed, at a maximum rate of 1.25 percent).

How to Change the Proposed Legislation

There's a serious erosion of the domestic tax base, and U.S. MNCs will continue to stockpile their foreign earnings. If the United States is going to pursue a territorial tax system that features a participation exemption, how can we change the system to eliminate the stockpiling of foreign earnings and the detrimental effect on the U.S. tax base?

The stated intent of the participation exemption is to eliminate 100 percent of the tax from foreign earnings. As noted above, Congress considers the 5 percent taxable portion (when actual dividends are paid) a substitute for the disallowance of deductions for expenses incurred by the U.S. shareholder to generate exempt foreign income.

To achieve that intent, the new tax law must simultaneously impose zero tax on foreign earnings and a 25 percent tax on ''pure'' domestic taxable income. To calculate pure domestic taxable income, there must be an annual adjustment to domestic taxable income to achieve the ''deduction disallowance.''

Under the WMDD, the event causing this deduction disallowance adjustment is the payment of an actual dividend. And, as explained above, because this event causes the 1.25 percent tax liability, the many creative taxpayers out there will work hard to avoid paying dividends — or to at least defer their payment for as long as possible. Because of this situation, this approach in the proposed legislation is clearly flawed. The payment of the dividend simply can not be the event that generates the deduction disallowance within the U.S. shareholder. That ''event'' must be changed.

The current subpart F mechanism provides us an approach to calculate and make a deduction disallowance adjustment to arrive at pure domestic taxable income within the U.S. shareholder. In brief, a new category of subpart F income would be defined to include a calculated percentage of all the CFC's gross income (before any deductions as allowed by section 954(b)(5)).[3] That calculated amount of subpart F income would be included in the income of the U.S. shareholder under section 951(a)(1)(A) and would not be affected by the section 954(b)(3)(A) de minimis rule, section 954(b)(5) deductions, or the section 952(c) earnings and profits limitations.

The above recommends calculating the deduction disallowance adjustment based on a percentage of the CFC's gross income. An alternative approach could be to define this new category of subpart F income as a percentage of some defined base of the U.S. shareholder's expenses or even an actual expense allocation based on good regulatory guidance.[4] This recommended approach of using the CFC's gross income as a base seems simplest in application and also recognizes the relative size and importance of the CFC and its activities, which arguably would be reflected in how much time and effort the U.S. shareholder's management and supporting personnel pay to the CFC.

Regarding what percentage of gross income to use, I have no suggestion for any specific percentage. Those considering this should research the issue and determine an appropriate percentage.

To illustrate the beneficial effects of this suggested approach, say that it is determined that 1.5 percent of each CFC's gross income represents a reasonable estimate of applicable U.S. shareholder expenses that relate to foreign exempt income. Including this 1.5 percent in a new category of subpart F income would be the mechanism used as a replacement for the proposed 5 percent of actual dividends paid. And with this new mechanism in place, the section 245A dividends received deduction would be increased from 95 to 100 percent.

[3]Gross income must be used as the base and not net earnings after all expenses. That will prevent situations in which a CFC may operate at a loss, causing there to be no adjustment to the U.S. shareholder. Whether a CFC itself has net income or loss, there will still be real expenses within the U.S. shareholder that must be disallowed as deductions.

[4]For example, reg. section 1.861-8.

With that 100 percent dividends received deduction, there would no longer be any federal income tax reason to delay actual dividend payments. This will mean that CFCs can distribute their earnings to their U.S. shareholders based on commercial need and other legal and tax factors.[5]

Note that U.S. shareholders will have various legitimate reasons for wanting some of their CFCs to retain earnings and not regularly distribute actual dividends. Those reasons could include, for example, local legal restrictions on dividend payments, a business or local credit need for a larger local balance sheet, or a significant local dividend withholding tax that is not fully exempted by an applicable tax treaty.

Recognizing that there may be local reasons for not regularly distributing dividends, consideration could be given to including in the proposed legislation regulatory authority for Treasury to exempt from section 482 coverage any non-interest-bearing or below-market interest rate loans from those CFCs to domestic members of their group.[6] Presumably, taxpayers would make those non-interest-bearing or below-market interest rate loans only when local tax authorities allow it.

To further prevent any of the above described tax arbitrage that could arise from interest on loans by CFCs to U.S. shareholders, the section 954(b)(3)(A) de minimis rule should provide that any foreign personal holding company income from interest income received from a U.S. related party will not be protected by the de minimis rule. That would ensure that interest expense deductible against 25 percent taxed income will be offset by a section 951(a)(1)(A) inclusion that will be included in 25 percent taxed income.[7]

If the above suggestion to eliminate the 1.25 percent tax at the time of dividend payment is not made and the taxable event remains the actual receipt of a dividend distribution, it is imperative that section 956 remain in effect. To eliminate it means that through simple intercompany loans and other devices, the 1.25 percent tax will be easily deferred and in many cases never paid. In addition to retaining section 956, appropriate changes to existing rules would need to be made to allow section 956 investments in U.S. property in excess of section 951(a)(1)(A) recognized income to be taxable at the 1.25 percent effective rate rather than at the 25 percent rate that would otherwise apply.

If it is necessary to keep section 956 in effect, appropriate portions of sections 959 and 961 should logically be retained as well.

Conclusion

The present structure of the WMDD causes any payment of a dividend out of foreign earnings to be a taxable event to the recipient U.S. shareholder. Combined with the proposed elimination of the section 956 investment in U.S. property rules, that means many U.S. MNCs will choose to make loans of their earnings to related U.S. group members rather than pay dividends. These loans will provide opportunities for tax arbitrage and will reduce the U.S. tax base. Further, the attempts to avoid paying the effective 1.25 percent tax when dividends are distributed will reduce the U.S. base because the intended expense offset mechanism for expenses attributable to foreign earnings will not work.

Changing the taxable event from the dividend itself to a factor such as the CFC's gross income will eliminate the federal tax disincentive to paying dividends and provide a working expense offset mechanism.

---

[5]Other tax factors that would continue to exist include, for example, foreign withholding taxes and state tax consequences of dividend distributions.

[6]Reg. section 1.7872-5T already allows this but does not override any potential section 482 application. *See* reg. section 1.482-2(a)(3).

[7]For other reasons, I believe that on implementation of a territorial system, the section 954(b)(3)(A) de minimis rule should be fully deleted from subpart F. The why of this is a story for another day.