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US SENATE'S INTERNATIONAL TAX REFORM WORKING GROUP HAS SPOKEN… SORT OF…

On July 8, 2015, the International Tax Reform Working Group, which is co-chaired by Senators Rob Portman (R-OH) and Chuck Schumer (D-NY), released its long-awaited report that Senate Finance Committee Chairman Orrin Hatch (R-UT) has said is the precursor to comprehensive tax reform in the United States.

What does the report say? What does the release of the report mean? And where do we go from here? The answers to those questions and others are contained herein… to the extent they exist!

2015 Comprehensive Tax Reform – Where We Are Now

On January 15, shortly after Congress convened, Senate Finance Committee Chairman Hatch and Ranking Member Ron Wyden (D-OR) announced the launch of five separate bipartisan Tax Reform Working Groups, formed to "spur congressional comprehensive tax reform efforts in the 114th Congress." The five groups were to focus on: (1) Individual Income Tax; (2) Business Income Tax; (3) International Tax; (4) Savings & Investment; and (5) Community Development & Infrastructure. Specifically, the groups were tasked with analyzing current tax law and examining policy trade-offs and available reform options within their designated topic areas. All of this was to be done in a bipartisan manner.

On July 8, the Senate Finance Committee released the reports of all five working groups, including the one we focus on here – the International Tax Reform Report (the Report). So are we now on the brink of comprehensive tax reform as Senators Hatch and Wyden had hoped? Probably not. Despite lawmakers' best efforts this Congress, comprehensive tax reform, by which we mean reform of both the US individual and corporate income tax laws, is largely considered to be off the table until after the 2016 elections. The two political parties simply hold too diametrically opposed views on individual tax reform. Moreover, while some had hoped that perhaps business-only tax reform was achievable before 2016, that now looks highly unlikely to occur. Significantly, however, the more limited objective of international tax reform has gained traction given the actions that countries are taking with respect to the OECD's Base Erosion and Profit Shifting project (BEPS) to address a variety of tax avoidance practices of multinational business enterprises. Congress also needs sources of revenue to refinance the US Highway Trust Fund.

To be sure, the Portman-Schumer working group's efforts are not the only steps taken towards international tax reform. In recent years, there have been numerous proposals to reform the US system of taxation with a particular focus on international reforms, including the Simpson-Bowles Commission, the President's Export Council, the President's Council of Advisors on Science and Technology, and the President's Council on Jobs and Competitiveness.

Moreover, last Congress, former House Ways and Means Committee Chairman Dave Camp (R-MI) released the Tax Reform Act of 2014 ("TRA 14"), which proposed, among other things, to: (1) establish a 95% dividend received deduction; (2) create a new category of subpart F income for intangible income derived by controlled foreign corporations (CFCs) and provide a phased deduction for a domestic corporation for income from its foreign exploitation of intangibles; (3) limit the deductibility of net interest expense of a US corporation that is a US shareholder with respect to any CFC if both the CFC and US corporation are part of a worldwide affiliated group; (4) modify the limitation on the deduction for interest expense under section 163(j); and (5) generally require that, for the last taxable year beginning before the participation exemption takes effect, any 10% US shareholder of a CFC or other 10% owned foreign corporation include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation.

More recently, earlier this year President Obama released the Administration's FY 2016 Budget Proposal ("President's Proposal"), which would, among other things: (1) impose a 19% tax on foreign income; (2) modify present-law rules for allocating interest expense incurred by the US parent in support of its foreign operations; and (3) impose a 14% one-time tax on previously untaxed foreign income.

What does this all mean? While ideas and concepts are developing and beginning to form, law makers are considering the political ramifications that will impact reform, and choices are being made. In reviewing these two most recent proposals – TRA 14 and the President's Proposal – while differences remain, the common themes generally supported by both parties are a territorial system of taxation, implementation of a one-time transition tax and discussion of anti-abuse rules.

Summary of the Report

With the stage set for international tax reform, the remainder of this article will provide a review of the Report. Specifically, this article discusses: (1) ending the "lock-out" effect; (2) creating an "innovation box" regime; (3) preserving the base; (4) implementing a deemed repatriation tax on existing earnings; (5) expanding interest expense limitations; (6) enhancing foreign investment in US property; and (7) addressing individual international tax issues.

The "Lock-Out Effect" and Transition to a More Territorial System

The Report observes that one of the most pressing issues in US international tax is the "lock-out effect" that results from our current system. Simply stated, because the US system generally taxes worldwide income yet allows for deferral of many types of income in offshore companies, there is an incentive to retain and reinvest non-US earnings offshore. Recent estimates are that US multinational corporations have more than US$2 trillion invested offshore.

According to the Report, if the US moves to a more territorial tax system in which offshore earnings are taxed lightly or not at all when repatriated to the US, the incentive to build up offshore earnings would be relieved and onshore investment would occur unencumbered by "effective tax rate" management concerns. As noted in the Report, 28 of the 34 OECD member countries and every member of the G-7 other than the US have territorial tax systems that exempt from domestic tax 95% to 100% of dividends from offshore subsidiaries paid from active earnings.

The Report concludes that the US must catch up to the rest of the developed world in its approach to international tax, stating that "[i]n order to move the U.S. international tax system in a direction that keeps the U.S. economy globally competitive with their foreign rivals, the co-chairs believe that it is imperative to adopt a dividend exemption regime in conjunction with robust and appropriate base erosion rules." The Report suggests that a dividend exemption less than 100% could be a reasonable way to approximate the effects denying deduction in the US of costs allocable to exempt offshore income (i.e., using a small "haircut" in the exemption as a much simpler way to achieve the same result).

A more territorial system of US international tax will create many novel and challenging issues that will need to be addressed. The Report mentions two specific issues – the treatment of income earned in unincorporated offshore branches and the treatment of foreign dividends received by S corporations. In both cases interesting timing questions are raised.

In addition, it appears the focus a territorial system based on dividend exemption will likely focus on active offshore earnings and so some form of the current Subpart F anti-deferral regime will continue to be necessary. Indeed, other portions of the Report discuss the need for a more permanent "look through" rule that simplifies intercompany transactions between and among commonly controlled CFCs and other Subpart F issues, such as changes to the "active financing exception". The perceived need to make changes to Subpart F reinforces the suggestion that a new territorial system will favor active offshore earnings, which is typical of other such systems of taxation.

Creation of a Patent or "Innovation" Box Regime

The creation and exploitation of intellectual property are now principal drivers of economic growth around the world. To a great extent the "winners" in the current global economy and the economy of tomorrow are those countries that foster, encourage and attract innovation. The Report catalogs 11 specialized tax regimes that are in place or being developed by other countries to reward innovators with significantly lower tax on the fruits of their innovation. These so called "patent box" or "innovation box" regimes take many forms and provide differing levels of benefits for different types of intellectual property but the objective of each such regime is the same: to attract innovation, R&D and all the economic activity that comes along with them.

The Report also observes that one consequence of the BEPS project will likely be increased economic substance or nexus requirements in a country in order for its patent box regime to be available to taxpayers. As a result, the Report foresees innovation capital and workforces attracted with an accelerating – almost gravitational – pull to countries with patent box regimes and states that "the anticipated impact of the new nexus requirements on innovation box regimes will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base."

While noting that several complex issues will need to be resolved, including which types of intellectual property should be covered, what nexus to the US is appropriate and mechanisms for "on shoring" existing offshore IP, the Report nonetheless urges a swift US response, specifically stating that "[t]he co-chairs agree that we must take legislative action soon to combat the efforts of other countries to attract highly mobile U.S. corporate income through the implementation of our own innovation box regime that encourages the development and ownership of IP in the United States, along with associated domestic manufacturing."

Preserving the Base

Recent discussions have suggested that the adoption of any territorial tax system would also need to include provisions that limit the ability of multinationals to shift their tax base to low tax jurisdictions. The Report mentions that TRA 14 and the President's Proposal have tried to address this issue and that the Portman-Schumer working group analyzed why those two proposals were structured in the ways they were. In light of this, the co-chairs note they are committed to drafting proposals that will impose a minimum rate of tax on non-US earnings, identify the type of income subject to such minimum tax, and at the same time maintain the competitiveness of US multinationals. They note that any drafting should create "clear, manageable standards" that address the fact that tax losses generated in the US can create low effective tax rates and also provide incentives for companies to not utilize tax havens to shelter non-US earnings. The Report does not provide any specificity on how these general parameters might be achieved. Furthermore, there is no discussion of the impact of "country by country" reporting or permanent establishment definitions (discussed as part of BEPS) as a way to curtail the current "proliferation of tax havens."

Deemed Repatriation of Existing Earnings

The Proposal indicates that international tax reform must also address deferral of US tax on active non-US earnings. The co-chairs note that TRA 14 and the President's Proposal have discussed imposing a one-time toll charge on such non-US earnings at a low corporate tax rate and they note how they generally agree with such an approach. They also note that TRA 14 provides for a dual rate structure with a lower rate applicable to non-cash holdings, and that both proposals allow the tax to be paid over several years, will allow for the use of foreign tax credits and specifically allocate funds raised under such a plan to be used for transportation infrastructure costs. The co-chairs note their general agreement with a lower rate, availability of foreign tax credits and a transition period.

The Proposal makes no comment about the tax rate that could potentially be applicable to any deemed repatriated earnings. They also do not comment on the implications of creating a cash tax obligation for companies with insufficient offshore cash to pay such tax. Finally, they make no comment about companies that have represented their non-US earnings to be permanently reinvested outside the US and could be negatively impacted from a financial statement perspective if a deemed repatriation tax is imposed.

Interest Expense Limitations

Given widespread concerns among both Congressional and Administration policymakers with the use of so-called "earnings stripping" transactions following inversion transitions undertaken by US companies in recent years, it is not surprising that the Report addresses such transactions, which are currently subject to the limitations of section 163(j) of the Internal Revenue Code (the Code). It is a bit surprising, however, that the Report does so in the context of recommending a more broadly based examination of the use of leverage by both domestically-controlled businesses and non-US multinationals that have US operations.

Specifically, the Report suggests a need to discourage excessive leverage that is created simply to "lower tax bills" and, after noting criticisms of the proposals made by the Administration and others to address the issue, states that work will continue to "determine the appropriate net limitation to allow appropriate intragroup lending while at the same time stopping disproportionate lending to avoid U.S. tax and gaming of the interest expense limitations in place". The Report also notes the importance of providing a level playing field and suggests that consideration should also be given to whether "additional" limits should be placed on interest expense deductions allowable to US companies that engage in inversion transactions.

As a result, the question of interest expense limitations for intragroup lending for both domestic and non-US based business enterprises is now on the table, but as with many of the issue areas examined by the working group, the manner in which the broad recommendations, such as that for an "appropriate net limitation" on intragroup interest expense, remain for future decision by the Congressional tax committees as the legislative process moves forward in the coming months.

Investments in US Real Property

Under the provisions of the Code originally enacted in 1980 as the Foreign Investment in Real Property Tax Act (FIRPTA), US federal income tax payment and return filing requirements are imposed on otherwise passive non-US investors that dispose of specified interests in US real property. The domestic real estate industry and others have long advocated that FIRPTA either be repealed in its entirety or significantly narrowed in its scope on the ground that, in its present form, FIRPTA discourages much needed equity investments in the US real estate sector by global investors. As noted in the Report, bipartisan legislation (H.R. 2128) has been introduced to relax FIRPTA in certain respects. Moreover, earlier in 2015, the Senate Finance Committee approved a bipartisan package of FIRPTA amendments. Our assessment of the Senate Finance Committee package can be accessed online.

The Report expresses general support for the bipartisan reform legislation, but specifically endorses only those proposals that would (1) raise from 5% to 10% the holdings of publicly-traded real estate investment trusts (REITs) that would be exempt from FIRPTA, and (2) exempt foreign pension plans from FIRPTA on the grounds of creating a level playing field with tax-exempt domestic pension plans. As currently structured, this latter provision would not apply to other foreign institutional investors, including sovereign investment funds that are currently exempt from US tax under section 892 on many categories of US source passive investment income.

With its inclusion in the Report, the case for FIRPTA reform has received a significant boost, but it remains to be seen if the reforms ultimately adopted will continue to be comparatively narrow in scope and, irrespective of the breadth of the reforms ultimately agreed to, whether the revenue cost ascribed to those reforms will be offset by other restrictive changes to FIRPTA.

Individual International Issues

The Report indicates that one of the most active and numerous areas of public comment it experienced was with regard to individual international tax issues, in particular the mounting challenges faced by US expatriates. The convergence of FATCA and FBAR requirements has made individual US tax compliance increasingly complicated and costly for US taxpayers living abroad. In addition, there are numerous reports of such taxpayers experiencing difficulty opening and maintaining financial accounts with non-US financial institutions. The free movement of talented US individuals to work and live abroad has provided many benefits to the US economy and several US tax policies, such as the foreign tax credit and the foreign earned income exclusion, have encouraged those activities. There is a growing sense that current trends in US tax compliance – including FATCA and FBAR – is discouraging such activities. The Report does not suggest changes to those US tax programs but urges both the House and the Senate to consider these issues.

Looking Ahead

In looking ahead to the next phase of international tax reform discussion in this Congress, a significant influencing factor will be how lawmakers proceed with the Highway Trust Fund, which is poised to run out of funding by July 31. Presently, it appears that there are two possible approaches. In the Senate, Majority Leader Mitch McConnell (R-KY) is pushing to pass a two-year highway bill, as well as a package of two-year tax extenders, before funding runs out. If such an approach prevails – which appears unlikely given timing constraints – it is almost certain that tax-writers will not move forward with international tax reform this year.

Alternatively, House lawmakers are in favor of using a short-term (i.e., through the end of the year) patch, with hopes of passing a six-year highway bill, a package of permanent tax extenders and international tax reform at some point later in the year. Notably, such a proposal may use deemed repatriation described above to help finance both the highway bill and a transition to a hybrid territorial system of taxation. In fact, confirming the House's commitment to such an approach, House Ways and Means Committee Chairman Paul Ryan (R-WI) announced on July 9 that Congress will need to act before month's end to enact another short-term highway funding extension, which will set the stage to move forward with international tax reform and other tax priorities when Congress returns from the upcoming August recess.

All of this is to say that the likelihood Congress will ultimately be able to pass international tax reform this year remains unclear. While there seems to be a broad bipartisan consensus on the general parameters for an international tax reform package, there are equally broad areas of uncertainty with respect to many of the critical details that remain to be resolved before international tax reform can successfully navigate the Congressional process and convert that broad consensus into final legislation. The topic will remain at the forefront of debate for tax-writers for the balance of this year, however, particularly in light of the two political imperatives for reform (BEPS and the need for revenues) and the fact that the US system for taxing international income is arguably out of step with contemporary international norms.

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