

Taxing the \$2.5 Trillion

By Susan C. Morse

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In this article, Morse discusses a transition tax on deemed repatriated foreign earnings, arguing for a simple, rough-justice design and no offset for foreign tax credits.

Tax reform is in the air and with it the question of revenue offsets.¹ The foreign subsidiaries of U.S. multinationals have earned more than \$2 trillion in profit — let's call it \$2.5 trillion — that has not been taxed by the U.S. corporate income tax system. Also, the U.S. corporate income tax system might change, which would make the \$2.5 trillion a vestige of the old system.

If the opportunity presents itself, how should we tax the \$2.5 trillion? In a word: simply.

We could design the transition tax as yet another ornate variation on the current mess of a system. We could run it through the income tax system and address foreign tax credits with partial crediting and deduction disallowance, in the manner of the repatriation holiday provided by section 965 in 2004 and proposed elsewhere since then.²

Or we could think of the transition tax as a pressure washer, designed to put an end to the mess of the old system efficiently and with minimum fuss.

A key innovation of this practical approach is that before the effective date of the transition tax, taxpayers would have the opportunity to repatriate offshore income under the existing system. This

would substantially clear out corporations' supply of allowable FTCs. After the opportunity for repatriation under the current system, the transition tax would apply to the remaining unrepatriated offshore profit, which should not be related to substantial foreign taxes and need not be reduced significantly to account for FTCs. This would reduce the ability of taxpayers to game the transition tax. It would mean lower administrative and taxpayer compliance costs. And it would provide greater revenue estimate certainty.

Here are some design principles.

1. Should we tax all \$2.5 trillion, regardless of whether it is distributed to U.S. parent companies?

Yes. There are two reasons why the tax should be mandatory. First: Revenue. Second, we need to address all offshore profit in order to close out the current system. After the effective date of the tax, companies could repatriate offshore profit without any additional U.S. federal income tax. (Of course, some of the profit is already held in U.S. bank accounts.³) To modify the tax base because of liquidity concerns using a proxy of cash on hand makes little sense. Cash balances are manipulable, and liquidity includes borrowing capacity.

2. Should the tax run through the existing income tax system?

No. If we taxed the whole \$2.5 trillion in accumulated profit all at once, we could take the transition tax out of the four corners of our existing corporate income tax system. We should grab the opportunity to make this transition tax simple.⁴ If we pushed it through the existing calculation of taxable income, the intricacies of the current system would make it easier for corporations to minimize tax liability. For instance, corporations could offset transition tax liability with net operating losses or accelerate the accrual of deductions.

3. Should the transition tax include an offset for FTCs?

¹Mindy Herzfeld, "What's on Trump's International Tax Agenda?" *Tax Notes Int'l*, Nov. 14, 2016, p. 629.

²Joint Committee on Taxation, "Present Law and Selected Proposals Related to the Repatriation of Foreign Earnings," JCX-96-15 (June 22, 2015).

³Stephen E. Shay, "The Truthiness of 'Lockout': A Review of What We Know," *Tax Notes*, Mar. 16, 2015, p. 1393.

⁴Susan C. Morse, "A Simpler Offshore Profits Transition Tax," *Tax Notes Int'l*, Feb. 17, 2014, p. 629.

No. The transition tax would not be an income tax, and there would be no requirement to allow credits for foreign taxes. An FTC offset would expand multinationals' planning opportunities and give foreign governments an opportunity to soak up U.S. transition tax revenue. Also, an FTC offset would increase the complexity of the transition tax, making it more difficult to administer.

4. What should the effective date of the tax be?

Ninety days after enactment. This is two or three times the amount of time a company has to respond to a tender offer. The gap between enactment and effective date accommodates companies that have paid high foreign taxes. These companies might prefer to repatriate their profits under the existing system rather than pay the transition tax because they could then make use of their FTCs under the existing system. A company that prefers to repatriate under the existing system could do so by declaring a dividend within the 90-day grace period. This design principle acknowledges a choice corporations generally have in any event to isolate offshore profit subject to high foreign taxes.⁵ It should leave a base for the transition tax that carries a relatively low foreign tax burden.

5. What should the tax rate be?

The pressure washer design works regardless of the transition tax rate.

It may be desirable to set the rate so that the transition tax is not intentionally worse or better than corporate taxpayers' expectations under the existing tax system. The fallout from the EU's Apple ruling⁶ gives an idea of the possible backlash if the transition tax produces a systematically worse result. One relevant factor that could justify a rate lower than the statutory rate of 35 percent is that the transition tax would not allow FTCs. However, the foreign tax burden for the transition tax base should be low because companies would have the opportunity to clear out high foreign taxes by repatriating before the effective date of the transition tax. Another relevant factor is that under the current system, many corporations need not pay any federal income tax until they repatriate. Companies likely

⁵Edward D. Kleinbard and Patrick Driessen, "A Revenue Estimate Case Study: The Repatriation Holiday Revisited," *Tax Notes*, Sep. 22, 2008, p. 1191.

⁶J.P. Finet, "Ireland Accused of Giving Apple €13 Billion in State Aid," *Tax Notes Int'l*, Aug. 31, 2016, p. 827.

predict that they will never pay tax on some part of their offshore profit because they will never repatriate it.

A 15 percent transition tax rate is about consistent with (1) a 7 percent foreign tax rate for the unrepatriated profit subject to the transition tax and (2) the assumption that half of the offshore profit would have stayed offshore permanently under the existing system.⁷

6. Would the transition tax violate tax treaties?

No. These treaties deal with income taxes, and a well-designed tax on accumulated offshore profit should not fall within the four corners of the U.S. income tax system.

The question arises because of treaty prohibitions against double taxation of the same income. No double taxation provision should apply; but even if it did, the transition tax should not violate a treaty. The promise to alleviate double taxation generally applies only to the extent that another country has *already* taxed income. For example, when the United States imposes tax on a deemed subpart F inclusion, the United States gives an FTC only for non-U.S. income taxes that have already been imposed on the profit in question. The transition tax would not prevent multinationals from fully claiming FTCs for already-paid foreign income taxes. They can do so by repatriating before the effective date.

7. Should the tax be due on the effective date?

Yes. The full amount should be due on the effective date, in part because of collateral issues such as the priority of the government claim. Companies might negotiate payment plans with the IRS, including applicable interest rates. The timing for payment plans might be limited to facilitate budget window calculations. Existing law and practice can support such payment plans.

8. What about financial accounting?

There are at least three issues, and lawmakers might care about them because companies care about them. First, the transition tax should presumably be recorded as an immediate, one-time charge. Second, some companies might record the offsetting income or tax benefit simultaneously with their transition tax accrual because they could reverse their

⁷For translation from the FTC rate to the foreign tax deduction rate, see Kimberly Clausing and Daniel Shaviro, "A Burden-Neutral Shift From Foreign Tax Creditability to Deductibility," 64 *Tax L. Rev.* 431 (2011). For adjustment based on forecast that some offshore profit will never be repatriated, see Morse, "A Corporate Offshore Profits Transition Tax," 91 *N.C. L. Rev.* 549 (2013).

prior recording of positive tax expense regarding earnings that are not permanently reinvested. Third, companies would prefer a tax design that does not reduce operating income or cash flow from operations.

9. What should the tax base be?

The tax base should be untaxed offshore profits, from both before and after 1986. Because the goal of the transition tax is to clean up after the legacy international corporate income tax system, it should not be restricted to cash and cash equivalents, and it should not be restricted to post-1986 earnings. It is easier to get information about the post-1986 tax base because a corporation will have reported accumulated foreign earnings and profits on Form 1118 when it claimed FTCs. For the tax base before 1986, a proxy could be developed to measure accumulated foreign earnings. It might make use of accounting information as well as tax return information, or it could be based on a formula. If it is impracticable to discover foreign E&P before 1986, the rate might be adjusted upward to compensate.

10. Is the transition tax constitutional?

Yes. A transition tax that does not use an income tax base but instead taxes a particular kind of property held by multinational corporations is a new tax, not a retroactive tax change. It is not unconstitutional. Indeed, no modern tax change has been held unconstitutional by a federal court because of retroactivity, although the Supreme Court has recently received requests to consider the constitutionality of state tax law retroactivity.⁸ The concern would be more acute if instead of implementing a transition tax, Congress repealed the subpart F anti-deferral regime for prior years and asked companies to amend prior years' tax returns to include offshore profit. However, that repeal is not on the table. ■

⁸Eric Yauch, "U.S. Supreme Court Asked to Review Another State Tax Retroactivity Case," *State Tax Notes*, Sep. 22 2016, p. 995.

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