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Rangel Bill Proposes Sweeping Changes to Taxation of U.S.-Based Multinationals*

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I. Introduction

The Tax Reduction and Reform Act of 2007,[1] as introduced by Committee on Ways and Means Chairman Charles Rangel (D-NY), proposes major changes to the individual and corporate income tax. The bill would eliminate the alternative minimum tax, extend expiring provisions (including the research and experimentation (R&E) credit) and reduce the top corporate marginal tax rate to 30.5 percent. The bill is funded through a myriad of "revenue raisers," including a surtax on high-income individuals, repeal of the Code Sec. 199 domestic manufacturing deduction, repeal of the last in, first out (LIFO) inventory method, changes in the taxation of carried interests, codification of the economic substance doctrine, and sweeping and fundamental changes in the U.S. taxation of U.S.-based multinational companies.[2]

This article focuses on two of the proposed changes to the U.S. taxation of U.S.-based multinationals: (1) the deferral of deductions otherwise allowable to a U.S. taxpayer to the extent such deductions are allocated to un-repatriated income earned by the taxpayer's controlled foreign corporations (CFCs); and (2) a limitation on foreign tax credits based on an average foreign tax rate imposed on the sum of the foreign source income of the taxpayer and the un-repatriated income earned by the taxpayer's CFCs.[3] The stated purpose of these proposals is to counteract a perceived bias in the current rules that "encourages United States corporations to shift jobs overseas and to finance these overseas activities at the expense of taxpayers."[4] Thus, in effect, the apparent purpose of the proposals is to discourage U.S. corporations from maintaining or expanding their foreign operations, at least relative to the status quo.

The impact of these proposals on the U.S. taxation of U.S.-based companies with operations abroad is difficult to overstate. As a policy matter, the proposals appear intended to penalize foreign investment at the margin. Therefore, the proposals represent a dramatic departure from historic U.S. tax policy, the consistent purpose of which has been to promote neutrality in the taxation of domestic and foreign direct investment by U.S.-based multinationals, and thus neither encourage nor discourage foreign business activities. As a practical matter, the proposals would increase the marginal U.S. tax cost (on a cash and GAAP basis) to U.S.-based multinationals of expanding and maintaining their foreign activities, which could have the unintended effect of decreasing U.S. jobs that support such foreign activities.

Although it is unlikely that these proposals will be enacted in the short-term, the proposals provide important insight into Chairman Rangel's views as to future reform of the U.S. international tax rules. As such, the proposals merit serious analysis, discussion and debate.

II. Deferral of Deductions "Allocable" to Deferred Foreign Income

A. General Description

Proposed Code Sec. 975 generally would defer deductions allocable to un-repatriated earnings of CFCs until such earnings are actually repatriated or deemed repatriated under the subpart F rules. In particular, the rule would provide that the "foreign-related deductions" of a U.S. taxpayer for any tax year may be taken into account for that year only if they are "allocable to currently-taxed foreign income."[5] "Foreign-related deductions" are the total deductions that would be allocated or apportioned to foreign source income for the tax year if both "currently-taxed foreign income" and "deferred foreign income" were taken into account.[6]

"Currently-taxed foreign income" is foreign source income for the tax year, not including amounts repatriated from prior-year earnings, as discussed below.[7] Thus, currently-taxed foreign income appears to include foreign source income earned directly by the U.S. taxpayer, including subpart F income as well as dividends from CFCs to the extent of current year earnings, but does not include dividends from CFCs paid out of prior year earnings.

"Deferred foreign income" is the excess of the amount that would be includible under subpart F if all current year earnings and profits of all CFCs were subpart F income over the sum of current year subpart F inclusions and dividends from CFCs.[8] For this purpose, all CFCs of a U.S. taxpayer (and presumably a U.S. consolidated group) are treated as a single CFC.[9] Under this formulation, deficits in earnings and profits in one CFC apparently may offset earnings and profits in another CFC. Both currently-taxed foreign income and deferred foreign income are calculated net of foreign income tax.

The proposed rules further provide that foreign-related deductions are allocated to currently-taxed foreign income in the same proportion that currently-taxed foreign income bears to the sum of currently-taxed foreign income and deferred foreign income.[10] No methodology is provided for such allocation, and the proposed language suggests that allocation will be made on a *pro rata* basis based on income.

At this point, a simple numerical example is in order. Assume Company A, a U.S. corporation, has foreign-related deductions (*e.g.,* allocable interest expense, R&E expense, and headquarters expense) of 100 for Year 1. Company A has two CFCs, CFC X and CFC Y; CFC X has current earnings of –150, and CFC Y has current earnings of 950, 100 of which is subpart F income. Company A has 300 of currently-taxed foreign income—a foreign source royalty of 100, foreign source sales income of 100, and the subpart F inclusion of 100. Company A thus has 700 of deferred foreign income (950 (CFC Y earnings) – 150 (deficit in CFC X earnings) – 100 (subpart F inclusion)). Accordingly, only 30 percent of Company A's foreign-related deductions, or 30, may be taken into account in Year 1 based on the ratio of currently-taxed foreign income (300) to the sum of currently-taxed foreign income and deferred foreign income (1,000).

As noted above, deductions denied under this rule may be taken into account in later years to the extent that previously deferred foreign earnings are repatriated.[11] In particular, the proposal provides that if previously deferred foreign earnings are repatriated in a tax year, then the portion of deferred deductions allocated to such amounts may be taken into account as deductions allocable to foreign sources.[12] Such deductions, however, are not included in the calculation described above to determine the extent to which current year deductions must be deferred.[13]

The portion of previously deferred deductions allocated to repatriated foreign income is "the amount which bears the same proportion to such deductions as the repatriated income bears to the previously deferred foreign income."[14] Thus, the rules essentially provide for a single pool of deferred foreign income and deferred deductions allocated thereto on a *pro rata* basis.

Returning to the example above, assume that in Year 2 CFC Y distributes 350 in excess of current year earnings. The 350 would be regarded as repatriated from the 700 of previously deferred foreign earnings. Accordingly, Company A would be permitted to deduct in Year 2, 50 percent of the deferred deduction from Year 1, or 15, on the basis of the ratio between repatriated income and previously deferred foreign income. That 15 is treated as allocable to foreign sources for purposes of determining the foreign tax credit limitation, but is not again subject to deferral under the rules described above.

> Thus, currently-taxed foreign income appears to include foreign source income earned directly by the U.S. taxpayer, including subpart F income as well as dividends from CFCs to the extent of current year earnings, but does not include dividends from CFCs paid out of prior year earnings.

B. Preliminary Observations

Although a full technical and policy discussion of this proposal is beyond the scope of this article, some initial observations on the proposal can be made.

As a technical matter, the proposal puts tremendous pressure on the already creaky system of expense allocation,[15] in particular with respect to interest expense (especially when another aspect of Chairman Rangel's bill, the repeal of worldwide fungibility in the allocation of interest expense,[16] is considered in tandem). In some sense, it is unfair to criticize the operation of the expense allocation rules in this context as they were not designed for this purpose.

Notwithstanding the acknowledged bias of the expense allocation rules toward over-allocating expenses to foreign sources, the rules survived without major reconsideration from 1986 until 2004 in part because their effect for many U.S. companies is limited. For U.S. companies, the effect of the expense allocation rules is largely as an input to the foreign tax credit limitation, a side calculation that generally affects only the U.S. residual tax on foreign income and not the U.S. tax on U.S. income. Significantly, the rules neither affect the deductibility of the expenses for U.S. tax purposes, nor cause the expenses to be deductible for foreign tax purposes. The pressure on these rules has decreased over time because of two related factors: (1) the effective U.S. corporate income tax rate has become increasingly high on a relative basis as other developed countries have lowered their effective rates, and (2) U.S. multinational companies in many (but not all) industries became increasingly able to organize at least some of their foreign business operations such that they are subject to a substantially lower corporate income tax rate. The proposal, however, places the load of a dollar-for-dollar denial of U.S. deductions on the expense allocation rules, without any pressure valves to mitigate the inherent bias in the rules. That may be more than those rules can reasonably bear. The practical consequence may be that taxpayers push those expenses—and the economic activities that generate those expenses—into foreign jurisdictions, where the expenses can be deducted (albeit at a lower rate).

Further, the apparent allocation of foreign-related deductions on a *pro rata* basis to currently-taxed foreign income and deferred foreign income is curious. This is particularly the case for interest expense, which has been allocable by statute based on asset value since 1986, and R&E expense, the allocation of which historically has been motivated by a desire to maintain such activities in the United States. The results in the case of interest can be anomalous; for example, interest expense could be allocated initially to foreign sources largely on the basis of high asset values that are associated with the currently-taxed foreign income, but nevertheless be allocated to deferred foreign income under the pro rata income rule. It is useful to compare the rule in the proposal to the expense allocation rules suggested by the Joint Committee on Taxation in the somewhat similar context of its territoriality proposal in 2005.[17] Under that proposal, interest expense would be allocated between taxable and exempt foreign income on the basis of asset value, and R&E expense would be allocated first to taxable royalty income.

More broadly, the proposal clearly would have the effect of penalizing foreign investment by U.S. companies. For example, assume that a U.S. company whose only foreign activities consisted of foreign procurement and export sales is considering whether to vertically integrate by acquiring its foreign suppliers and/or its foreign distributors. Assuming its foreign operations were profitable, the U.S. company immediately would face the following choice: (1) repatriate all of its foreign earnings each year, or (2) forego deductions for U.S. expenses that it had been allowed to deduct prior to the acquisition.

The first choice would result in a self-imposed end to the "benefit" of deferral, which is really the benefit of being permitted to operate in foreign markets on the same basis as other competitors. Indeed, in some sense, it would be worse than the repeal of deferral, as the U.S. company would actually have to repatriate the earnings or enter into transactions to constructively repatriate the earnings, which may result in substantial transaction costs, including foreign withholding taxes. Needless to say, this is a substantial departure from historical tax policy, which has considered the anti-deferral rules as punitive rules rather than as substantive norms applicable to income from active business operations of U.S.-based multinationals.

The second choice is similarly unpalatable. Such a proposed change to the basic direction of the U.S. international tax system, which will discourage foreign investment, should not be undertaken lightly. The stakes are high given global competition and global markets for capital; if the U.S. company is discouraged from sensible foreign expansion, another competitor surely will take its place, and another home economy will reap the incidental benefits from such expansion.

Finally, the broader economic effect of the proposal is to limit the deductibility, and therefore increase the cost, of U.S. expenses that represent U.S. activity, including the provision of U.S. headquarters or R&E services by U.S. employees in the United States. Even with respect to interest expense, under this proposal the financing of a new plant or other investment in the United States would be more expensive for a U.S. company with foreign operations because some of the interest expense will be allocable to foreign sources. Rather than directly increasing U.S. tax on foreign activities, the stated purpose of the proposal, the rules may operate to increase U.S. tax on U.S. activities by U.S. companies with foreign operations.

III. Foreign Tax Credit Limitation Based on Average Foreign Tax Rate

A. General Description

Proposed Code Sec. 976 would limit the foreign tax credits allowable to a U.S. taxpayer generally based on the average rate of foreign taxes paid by the U.S. taxpayer and all of its CFCs on all currently-taxed foreign income and deferred foreign income. In particular, proposed Code Sec. 976(a) limits the amount of foreign income taxes taken into account for a tax year to an amount that bears the same ratio to "total foreign income taxes" for that year as the "currently-taxed foreign income" for such year bears to the sum of the currently-taxed foreign income and the "deferred foreign income" for that year. This limitation is applied on a basket-by-basket basis and this applies to limit foreign tax credits that would have been allowable following the application of all otherwise applicable limitations. Currently-taxed foreign income and deferred foreign income are defined by reference to proposed Code Sec. 975, as described above.[18]

Foreign income taxes are income, war profits or excess profits taxes[19]; it is not clear whether taxes in lieu of income taxes constitute foreign income taxes. Total foreign income taxes is the sum of foreign income taxes paid or accrued during the tax year and the increase in foreign income taxes that would be paid or accrued during the tax year if all of the earnings and profits of all CFCs were subpart F income.[20] As in the case of proposed Code Sec. 975, for this purpose all CFCs of a U.S. taxpayer would be treated as a single CFC.[21]

Again, a numerical example is in order. Assume a modified version of the Year 1 facts for Company A, described above: Company A has 300 of currently-taxed foreign income, including a 100 subpart F inclusion from CFC Y, and allocable expenses of 100. Under the current rules, Company A's foreign tax credit would be determined on the basis of the foreign taxes associated with that foreign source income, including the foreign taxes paid by CFC Y and allocable to CFC Y's earnings pool. Assuming that 100 of tax was associated with the 200 of net foreign source income, the U.S. taxpayer would be entitled to a foreign tax credit of 100 against the U.S. tax that otherwise would be owing on the foreign source income (the U.S. tax would be 35 percent of 300 (the amount of net foreign source income grossed up by the amount of foreign tax, or slightly more than 100), assuming no foreign tax credit limitation other than the overall limitation applied.

The proposal would change these results dramatically if the rate of foreign tax associated with income earned by other CFCs is substantially different than that associated with currently-taxed foreign income. Thus, assume that CFC X had 700 of earnings in Year 1 that are deferred, and that CFC Y had no earnings other than those represented by the subpart F inclusion. If the taxes associated with CFC X's earnings were 100, the new proposal would limit the foreign tax credits allowable to Company A as follows: the ratio of currently-taxed foreign income to the sum of currently-taxed and deferred foreign income is 300/1,000, or 30 percent. This ratio would be applied to total foreign taxes, 200, to limit the foreign tax credits allowed in that year to 60. Thus, 40 of otherwise allowable foreign tax credits for Year 1 would be denied.

"Deferred foreign income" is the excess of the amount that would be includible under subpart F if all current year earnings and profits of all CFCs were subpart F income over the sum of current year subpart F inclusions and dividends from CFCs.

As with respect to proposed Code Sec. 975 in the case of expenses, proposed Code Sec. 976 applies special rules to taxes associated with repatriated deferred foreign income, thereby potentially allowing foreign tax credits deferred in prior years to be taken into account in later years.[22] In particular, the proposal provides that if previously deferred foreign earnings are repatriated in a taxable year, then the portion of deferred foreign income taxes allocated to such amounts may be taken into account as in that tax year.[23] Such foreign income taxes, however, are not included in the calculation described above to determine the extent to which current foreign tax credits must be deferred.[24] The portion of previously deferred foreign income taxes allocated to repatriated foreign income is "the amount which bears the same proportion to such taxes as the repatriated income bears to the previously deferred foreign income."[25] Consistent with the parallel rules related to deductions, these rules essentially provide for a single pool of deferred foreign income and deferred foreign taxes allocated thereto on a *pro rata* basis.

Returning to the example above, assume that in Year 2 CFC X distributes 350 in excess of current year earnings. The 350 would be regarded as repatriated from the 700 of previously deferred foreign earnings. Accordingly, Company A would be permitted to take into account in Year 2, 50 percent of the deferred foreign income taxes from Year 1, or 20, on the basis of the ratio between repatriated income and previously deferred foreign income. That 20 presumably must be analyzed under the panoply of foreign tax credit limitations of current law, but is not again subject to deferral under the rules described above.

B. Preliminary Observations

Again, although a full technical and policy discussion of this proposal is beyond the scope of this article, some initial observations on the proposal can be made.

The purpose of the foreign tax credit is to mitigate double taxation of the same income, thereby furthering the policy of neutrality in the tax system as between domestic and foreign investment. It has been long recognized that the theoretical ideal in this regard would be an item-by-item framework, under which foreign taxes imposed on an item of income were creditable against U.S. taxes otherwise imposable on the same item of income. Of course such a framework would be impractical as an administrative matter, but it is nevertheless useful as a norm. Acceding to these practical realities by allowing foreign taxes and foreign income to be aggregated allows "cross-crediting" of high-tax income and low-tax income, which Congress and the Treasury have sought to limit to varying degrees by segregating from general business income certain categories of income that are thought to be subject to manipulation or otherwise suspect, such as passive income. The proposal moves in another direction altogether, by combining currently taxable foreign income with deferred foreign income to force cross-crediting across both buckets.

As with proposed Code Sec. 975, this proposal also may penalize foreign investment. Take again our U.S. company whose only foreign activities consist of foreign procurement and export sales and which is considering whether to vertically integrate by acquiring its foreign suppliers and/or its foreign distributors. Assume that the distribution market was in a relatively high-tax location (*e.g.,* Canada), but that the suppliers were located in relatively low-tax locations (*e.g.,* southeast Asia, perhaps benefiting from tax holidays or other incentives). Depending on the U.S. company's tax profile, the purchase of the Asian supplier may have the effect of reducing the extent to which the Canadian taxes imposed on Canadian income were creditable against the U.S. tax on that same income.

As applied to this example, the proposal affects not only perceived foreign tax credit abuse in the classic sense, but the "benefit" of deferral itself, which is really the benefit of being permitted to operate in foreign markets on the same basis as other competitors. As noted above, the stakes are high given global competition and global markets for capital; if the U.S. company is discouraged from sensible foreign expansion, another competitor surely will take its place, and another home economy will reap the incidental benefits from such expansion.

As a final technical observation, it is interesting that both proposals effectively aggregate all foreign income earned by a U.S. taxpayer directly and "indirectly" through all of its CFCs for purposes of deferring benefits such as deductions or foreign tax credits. One wonders whether, if this is going to be U.S. tax policy going forward, the anti-deferral rules applicable to foreign-to-foreign transactions, including for example the foreign base company sales and services rules[26] and the rules for related party payments of dividends, interest, and royalties[27] (absent the temporary look-through rule),[28] should be reconsidered.

IV. Conclusion

The proposals described above would fundamentally change the U.S. taxation of U.S.-based multinational corporations. As a practical matter, the proposed deferral of otherwise allowable deductions and foreign tax credits would discourage foreign investment as they would increase the marginal U.S. tax cost (on a cash and GAAP basis) associated with expanding and maintaining foreign operations.

Endnotes

* The views expressed here are the authors' own and not necessarily those of CCH or any other person.

1 H.R. 3970 (2007).

2 *See generally* Committee on Ways and Means Summary of H.R. 3970, *The Tax Reduction and Reform Act of 2007* (Oct. 29, 2007) (hereinafter, the "W&M Summary").

3 H.R. 3970, §§ 975, 976 (2007).

4 W&M Summary, at 8.

5 Proposed Code Sec. 975(a)(1).

6 Proposed Code Sec. 975(c)(1).

7 Proposed Code Sec. 975(c)(2).

8 Proposed Code Sec. 975(c)(3).

9 *Id.*

10 Proposed Code Sec. 975(a).

11 Proposed Code Sec. 975(a)(2), 975(b).

12 Proposed Code Sec. 975(b)(1).

13 *Id.*

14 Proposed Code Sec. 975(b)(2).

15 *See* Code Sec. 864(e), 864(f), 864(g).

16 H.R. 3970, §3203 (2007). Legislation has also been introduced that would delay the effective date of the worlwide interest allocation election. *See* H.R. 3920, §402 (2007) (three-year delay); H.R. 3996, §621 (2007) (eight-year delay); H.R. 4351, §221 (2007) (eight-year delay).

17 Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), at 190.

18 Proposed Code Sec. 976(c)(4).

19 Proposed Code Sec. 976(c)(3).

20 Proposed Code Sec. 976(c)(2).

21 *Id.*

22 Proposed Code Sec. 976(b).

23 *Id.*

24 *Id.*

25 Proposed Code Sec. 976(b)(2).

26 Code Sec. 954(d), 954(e).

27 Code Sec. 954(c).

28 Code Sec. 954(c)(6).