PRESENT LAW AND SELECTED PROPOSALS RELATED TO THE REPATRIATION OF FOREIGN EARNINGS

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
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Prepared by the Staff
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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on June 24, 2015, to examine the taxation of repatriated foreign earnings as a source of funding for the Highway Trust Fund. Part I of this document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law related to the repatriation of foreign earnings as well as the financial accounting treatment of undistributed earnings of foreign subsidiaries under U.S. generally accepted accounting principles ("GAAP"). Part II describes two recent tax reform proposals that have included a deemed repatriation as part of a transition to a new international tax system: former House Ways and Means Committee Chairman Dave Camp's Tax Reform Act of 2014[2] and the Administration's Fiscal Year 2016 Revenue Proposals.[3] Part III provides a discussion of the economic impact and design of a one-time tax on historic foreign earnings. This part of the document highlights some issues concerning whether the one-time tax is mandatory or voluntary, and whether it is enacted as part of broader reform of the international tax system, but for sake of simplicity confines most of the analysis to the hypothetical case of a mandatory one-time tax enacted outside the context of international tax reform.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Selected Proposals Related to the Repatriation of Foreign Earnings*, (JCX-96-15), June 22, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[2] H.R. 1, 113th Congress.

[3] http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

I. PRESENT LAW AND BACKGROUND

Background

Domestic corporations generally are taxed on their worldwide income, including income earned from the direct conduct of a foreign business by the domestic corporation (by means of direct sales, licensing or branch operations in the foreign jurisdiction) or through a pass-through entity such as a partnership. Income earned indirectly by domestic corporations from the foreign operations conducted by their foreign corporate subsidiaries is generally not subject to U.S. tax until the income is distributed to the domestic parent corporation. Thus, the U.S. tax on foreign earnings of foreign corporate subsidiaries is said to be "deferred." This result is circumscribed by the anti-deferral regimes of the Code.

Anti-deferral regime of Subpart F

The anti-deferral regime known as subpart F departs from the general rules by requiring that certain U.S. shareholders' proportionate shares of the earnings of certain foreign corporations be subject to U.S. income tax on a current basis, even if the earnings are not distributed to the shareholders. Subpart F provides special rules for a controlled foreign corporation ("CFC") and each "U.S. shareholder." A CFC is a foreign corporation in which more than 50 percent of the corporation's stock (measured by vote or value) is owned by U.S. persons (directly, indirectly, or constructively) who own at least 10 percent of the stock (measured by vote only).[4] Only a U.S. person who owns at least 10 percent of the stock of a CFC is a U.S. shareholder within the meaning of subpart F. A U.S. shareholder is subject to current U.S. taxation on its pro rata share of certain earnings and profits ("E&P") of the CFC that constitute either subpart F income or includible investments in U.S. property.[5] Where the foreign country in which the CFC is tax-resident for foreign tax purposes imposes an income tax on the income of the CFC, a foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income,[6] in which case the net U.S. tax owed is the difference between the U.S. tax otherwise applicable to the income and the foreign tax imposed on the income.

Subpart F income

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another and consists of foreign base company income,[7]

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[4] Secs. 951(b), 957, and 958.

[5] Sec. 951(a).

[6] Secs. 901, 902, 960.

[7] Sec. 954. Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.

insurance income,[8] and certain income relating to international boycotts and other violations of public policy.[9]

There are several exceptions to the broad definition of subpart F income. First, under the same-country exception, dividends and interest (which generally are foreign personal holding company income, one category of subpart F income) received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized may be excluded from subpart F income. In addition, rents and royalties (which are also generally foreign personal holding company income) received by a CFC from a related corporation for the use of property within the country in which the CFC is organized are not included in subpart F income.[10] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception from foreign base company income and insurance income is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[11]

In addition to the above exceptions, there are two exceptions that have expired and remain applicable only for taxable years of a CFC beginning after 2004 and before 2015, and the taxable years of the U.S. shareholders with or within which such taxable years of the CFC ends. The first, known as the "CFC look-through" rule, excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent not attributable or properly allocable to the payor's subpart F income or to the payor's income that is effectively connected with the conduct of a U.S. trade or business.[12] The other exception, often referred to as the active finance exception, applies to income derived in the active conduct of banking, financing, or insurance business[13] and requires, among other things, that the CFC be predominantly engaged in such business and conduct substantial activity with respect to such business.

<u>Other inclusions under subpart F: investments in U.S. property</u>

To stop taxpayers from avoiding U.S. tax by repatriating untaxed CFC earnings through non-dividend payments such as loans to the U.S. parent company, subpart F also requires that 10-percent U.S. shareholders of a CFC include in income their pro rata shares of a CFC's

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[8] Sec. 953.

[9] Sec. 952(a)(3)-(5).

[10] Sec. 954(c)(3).

[11] Sec. 954(b)(4).

[12] Sec. 954(c)(6).

[13] Sec. 954(h), (i).

untaxed earnings invested in certain items of U.S. property.[14] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[15] Exceptions to the definition of U.S. property, include U.S. bank deposits, certain export property, and certain trade or business obligations.[16]

Adjustment of tax attributes to reflect subpart F inclusions

Subpart F includes rules for the computation of earnings and profits and for basis adjustments to avoid taxing earnings that have been previously taxed under subpart F. Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under section 956 as investments in U.S. property, then under subpart F, and then out of other earnings and profits.[17] Other rules ensure that previously taxed earnings and profits are not taxed again when actually distributed to a 10-percent U.S. shareholder of a CFC, whether the previous exclusion was based on subpart F income or as a result of increased investments in U.S. property.[18] A 10-percent U.S. shareholder's basis in the stock of a CFC is increased by the amount of the shareholder's subpart F inclusions in respect of the CFC stock and is decreased by the amount of any distributions received from the CFC that are excluded from the shareholder's income as previously taxed income.[19]

Foreign tax credit

Subject to certain limitations, U.S. taxpayers are allowed to claim credit for foreign income taxes they pay. The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles) to mitigate double taxation of foreign-source income without allowing an offset against U.S. tax on U.S.-source income.[20] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. The foreign tax credit limitation

[14] Secs. 951(a)(1)(B), 956.

[15] Sec. 956(c)(1).

[16] Sec. 956(c)(2).

[17] Sec. 959(c).

[18] Sec. 959(a)(2).

[19] Secs. 961(a), 961(b).

[20] Secs. 901, 904.

applies separately to each of two categories of foreign-source income: passive (such as portfolio interest and dividend income) and general (all other income).[21]

A 10-percent corporate U.S. shareholder is generally allowed a deemed-paid, or indirect, credit for foreign taxes based on the proportion of taxes paid by a foreign corporation on the earnings and profits it distributes relative to its accumulated earnings and profits.[22] This is called a deemed-paid credit to reflect the fact that the foreign income tax is actually paid by the foreign subsidiary but is allowed as a credit to a 10-percent corporate U.S. shareholder. Similarly, under subpart F, a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is also allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation when the related income is included in the domestic corporation's income under the anti-deferral rules.[23] If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[24]

A foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[25]

Temporary dividends-received deduction for repatriated foreign earnings

Section 965 provided a one-time deduction of 85 percent for certain dividends received by a U.S. corporation from its CFCs. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date. The dividend amount eligible for the temporary deduction was subject to several limitations and was accompanied by a proportional disallowance of credit for foreign taxes paid with respect to dividends for which the deduction was allowed.[26] The amount of dividends eligible for the 85

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[21] Sec. 904(d). In certain instances, passive income is treated as general category income (for example, income earned by a qualifying financial services entity or income that is taxed at a foreign tax rate determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends, subpart F inclusions, interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made. A number of other provisions of the Code create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, *e.g.*, secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[22] Sec. 902.

[23] Sec. 960, 1291(g).

[24] Sec. 904(c).

[25] Sec. 909.

[26] Sec. 965(d)(1).

percent deduction could not exceed the amount by which the cash dividends exceeded the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. A separate limitation capped the eligible dividends to the greater of $500 million or the amount identified on the taxpayer's recent audited financial statements as earnings invested indefinitely outside the United States. Increases in related party indebtedness in the year further limited the availability of the deduction. The dividends were required to be invested in the United States in accordance with a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[27]

Financial accounting and reporting of CFC earnings under U.S. generally accepted accounting principles ("GAAP")

Under U.S. GAAP principles, the earnings of a foreign subsidiary are generally included in the consolidated financial statements of the U.S. parent during the period in which they are earned. However, for U.S. tax purposes, tax is deferred for earnings that are not distributed to the U.S. parent or otherwise includible, such as under subpart F. These undistributed earnings of a foreign subsidiary that are included in financial statement consolidated income but which are deferred from U.S. taxation represent a temporary difference for which a tax liability and associated tax expense is currently accrued, unless the relevant tax laws provide a means by which the investment in the subsidiary can be recovered tax-free.[28] It is generally presumed for U.S. GAAP purposes that all undistributed earnings of a foreign subsidiary will be repatriated to the U.S. parent entity.

A firm may overcome the presumption that it will repatriate all undistributed earnings of a foreign subsidiary to the U.S. parent company by providing evidence of specific plans for reinvestment of the undistributed earnings that demonstrate that remittance of the earnings will be postponed indefinitely and by demonstrating that the U.S. parent company has adequate cash flows from other sources and will not require remittances from the foreign subsidiary. These criteria required to overcome the presumption are sometimes referred to as the "indefinite reversal criteria."[29]

When a parent entity makes an assertion regarding its intent to indefinitely reinvest foreign earnings, and has demonstrated its ability to do so, it is required to disclose the gross amount of foreign earnings in the footnotes of its financial statements. The parent entity is also required to disclose the nature of events that would give rise to taxation of the earnings in the parent jurisdiction, as well as an estimate of the tax liability associated with the foreign earnings or a statement that providing a reasonable estimate of the tax liability is impractical.

Management of each multinational firm makes a decision and reports in its financial statement regarding its indefinite reinvestment posture based on its facts. Some firms assert

[27] Sec. 965(b)(4).

[28] Accounting Standards Codification ("ASC") 740-30-25-3.

[29] ASC 740-30-25-17.

indefinite reinvestment of all untaxed (that is, non-subpart F) foreign earnings. Other firms assert indefinite reinvestment of some, but not all, of their foreign earnings. However, their actual repatriation of taxable dividends in any given period may be less than the amount of earnings in respect of which they have accrued a U.S. tax liability for financial statement purposes. The decision to accrue a U.S. tax liability on foreign earnings does not indicate that earnings will be repatriated in the current year. Some firms may not assert indefinite reinvestment of any foreign earnings and therefore accrue a U.S. tax liability with respect to all these earnings irrespective of the amount of their actual repatriations. Because U.S. GAAP rules related to recognition of income and tax amounts in relation to undistributed foreign earnings are not based on whether a firm actually repatriates these earnings, financial statements may not allow clear inferences about the amount of a firm's actual repatriations.

The decision to assert indefinite reinvestment with respect to foreign earnings does not necessarily mean that the firm has not used the earnings in the United States. Specifically, it is believed that some firms have made an indefinite reinvestment assertion for financial statement purposes, even while using the earnings in the United States, whether on a temporary basis or otherwise, so long as the use of the earnings does not give rise to a current taxable inclusion for U.S. tax purposes. One example is a position taken by taxpayers that certain short-term CFC loans to the U.S. parent do not give rise to a current taxable inclusion under relevant IRS guidance, and therefore this use of earnings does not conflict with their assertion regarding indefinite reinvestment.

If a parent entity has asserted indefinite reinvestment of foreign earnings, it must record in its financial statements a tax liability in respect of undistributed earnings if it subsequently plans to or actually repatriates these earnings. To the extent that a firm's managers are concerned with increases in the firm's reported U.S. tax expense, and the corresponding decrease in the firm's earnings per share, managers may delay the repatriation of foreign earnings. Some commentators therefore have observed that the financial accounting rules provide an incentive to delay repatriations. On the other hand, the tax on earnings repatriations may also discourage firms from paying dividends from foreign subsidiaries to U.S. parent companies. The extent to which these tax and financial accounting rules distort decisions whether to reinvest or repatriate earnings may vary from one firm to another.

II. DESCRIPTION OF PROPOSALS FOR TAX ON HISTORIC FOREIGN EARNINGS

While there may not be a direct connection between untaxed foreign earnings and funding of the Highway Trust Fund, proposals have been made in recent years to use estimated tax collections from a proposed one-time tax on untaxed foreign earnings under a reduced tax rate as a means of long-term funding for the Highway Trust Fund. The proposals vary in several respects including the tax rate, whether the tax should be applied to certain corporate shareholders or all shareholders, whether the one-time tax should be mandatory or voluntary, and whether the tax should be applied as a stand-alone provision or as part of broad tax reform. Two recent proposals that have included mandatory transition taxes as part of broad international tax reform are former House Ways and Means Committee Chairman Dave Camp's Tax Reform Act of 2014[30] and the Department of Treasury's international tax proposals in the Administration's Fiscal Year 2016 Revenue Proposals.[31]

Chairman Camp's Tax Reform Act of 2014

In connection with transition to a participation exemption system with respect to future foreign earnings, Chairman Camp's proposal includes a one-time mandatory tax on untaxed foreign earnings.

Treatment of deferred foreign income upon transition to exemption system

The proposal generally requires that, for the last taxable year beginning before the participation exemption takes effect, any 10-percent U.S. shareholder of a CFC or other 10-percent owned foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation.[32] A deduction of a portion of the inclusion results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. In determining the increase in a 10-percent U.S. shareholder's U.S. tax liability as a result of the mandatory inclusion, the Code generally is applied as in effect before enactment of the proposal. For example, the corporate tax rate remains unchanged and the separate foreign tax credit limitation rules of present law section 904 apply.

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. The proposal provides that in the last taxable year of a specified foreign corporation that ends before a specified date, which is that foreign corporation's last taxable year before the participation exemption system begins, the subpart F income of the foreign corporation is

[30] H.R. 1, 113th Congress, sec. 4003.

[31] See http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

[32] Under the proposal, the accumulated earnings and profits amount that is subject to the transition tax is not reduced by distributions made by a CFC during the year. Under the normal rules of subpart F, therefore, distributions during the year are not taxed as dividends.

increased by the accumulated deferred foreign income of the corporation determined as of the close of that taxable year. In contrast to the participation exemption deduction, which is available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders[33] of a specified foreign corporation, which includes any foreign corporation in which a U.S. person owns 10 percent of the voting stock. Consistent with the general operation of subpart F, each 10-percent U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated deferred foreign income.[34]

In order to achieve the desired effective tax rate on the mandatory inclusion of accumulated deferred foreign income, a 10-percent U.S. shareholder of a specified foreign corporation is allowed a deduction in an amount determined by reference to the portion of deferred earnings and profits that are held in cash or liquid assets.[35] The non-cash portion is eligible for a deduction of 90 percent (with the result that the tax rate on this portion is 3.5 percent); the U.S. shareholder aggregate foreign cash position is eligible for a deduction of 75 percent (with the result that the tax rate on this portion is 8.75 percent).

<u>Accumulated deferred foreign income</u>

A specified foreign corporation's accumulated deferred foreign income that must be taken into account as subpart F income is the portion of the foreign corporation's post-1986 undistributed earnings that is not attributable to (1) income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax, (2) subpart F income (determined without regard to the mandatory inclusion rule) of a CFC that is included in the gross income of a 10-percent U.S. shareholder of the CFC and with respect to which the CFC has not made distributions that are excludable from gross income under section 959, (3) or, for a passive foreign investment company, an amount that would be treated as an excess distribution or attributable to an unreversed inclusion. Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the corporation's last taxable year that ends before the date specified in the proposal.

A U.S. shareholder's income inclusion under this transition rule is reduced by the portion of aggregate foreign earnings and profits deficit allocated to that person by reason of that person's interest in one or more E&P deficit foreign corporations. An E&P deficit foreign corporation is defined as any specified foreign corporation owned by the U.S. shareholder as of February 26, 2014, that has a deficit in post-1986 earnings and profits as of that date. The U.S.

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[33] Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10 percent or more of the voting classes of stock of a foreign corporation.

[34] For purposes of taking into account its subpart F income under this rule, a noncontrolled 10/50 corporation is treated as a CFC.

[35] To prevent taxpayers from reallocating assets to manipulate their aggregate foreign cash position, a special rule provides that the aggregate foreign cash position is the greater of: (i) the end-of-year cash position as of the close of the last taxable year that begins before January 1, 2015, and (ii) the average cash position for the two taxable years ending before February 26, 2014 (the date of release of draft proposal.)

shareholder aggregates its pro rata share in the foreign E&P deficits of each such company and allocates it among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E&P deficit allocable to a specified foreign corporation is the same ratio as the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income of all deferred income companies of such shareholder.

Foreign tax credit

Like present law section 965, the proposal disallows a credit for a portion of the foreign taxes paid with respect to the pre-effective-date undistributed CFC earnings inclusion that corresponds to the portion of such earnings that are allowed as a deduction. The proposal also denies a deduction for any foreign tax for which a credit is disallowed. A 10-percent U.S. shareholder's income is not increased under section 78 by the amount of tax for which a foreign tax credit is not allowed.

A special rule is included such that the required inclusion of deferred foreign income under this provision is disregarded for purposes of determining the amount of income from foreign sources that a U.S. shareholder has for purposes of the recapture rules applicable to overall foreign losses.

Installment payments

A 10-percent U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in eight installments, in the following amounts: installments one through five in an amount equal to eight percent of the net tax liability; a sixth installment of 15 percent of the net tax liability; the seventh is 20 percent and the eighth, 25 percent. The net tax liability that may be paid in installments is the excess of the 10-percent U.S. shareholder's net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit. The timely payment of an installment does not incur interest.

A special rule permits an election to defer the transition net tax liability for shareholders of a 10-percent U.S. shareholder that is an S corporation (*i.e.*, a flow-through entity) until a triggering event occurs, such as transfer of shares in the S corporation, liquidation, or change in status of the company. When such an event occurs, the shareholder of an S corporation that elected deferral under the special rule for S corporation shareholders may be eligible to elect to pay the net tax liability in installments, subject to rules similar to those generally applicable upon transition absent the special transition election for S corporation shareholders.

Highway Trust Fund

The proposal provides that income tax payments relating to the net tax liability for deemed repatriation of pre-effective date foreign earnings will be transferred to the Highway Trust Fund. The Highway Trust Fund, established in 1956, is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs.[36] The Highway Trust Fund is currently funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. Of the receipts received in the Treasury as a result of the deemed repatriation provision (and not otherwise appropriated), an amount equivalent to twenty percent will be transferred to the Mass Transit Account, with the remaining balance transferred to the Highway Account.

Administration's fiscal year 2016 revenue proposals

In connection with transition to a new system for international taxation that is based on a 19-percent per-country minimum tax with respect to future foreign earnings, the Administration's proposal includes a one-time mandatory tax on previously accumulated deferred foreign earnings.

One-time tax on previously accumulated deferred foreign earnings

The proposal imposes a one-time tax of 14-percent on deferred earnings and profits of CFCs accumulated for taxable years beginning before January 1, 2016. The Administration presents the one-time tax on deferred income as a transition rule to be enacted together with its proposed 19-percent per-country minimum tax on foreign earnings. In the absence of draft statutory language with respect to the proposal, several aspects of the proposed transition tax require clarification.

In describing the mandatory, deemed repatriation, the Administration refers to imposition of a tax on CFC earnings, but does not specify whether all U.S. 10-percent shareholders of CFCs are taxed or if only domestic corporate 10-percent shareholders are taxed. If, as in former Chairman Camp's proposal, the transition tax were imposed by means of an increase in the subpart F income of a CFC by the amount of the CFC's untaxed earnings, and no modifications were made to subpart F's inclusion rules, all 10-percent U.S. shareholders, not just domestic corporate shareholders would be taxed. In contrast, the 19-percent per-country minimum tax proposal applies only to domestic corporations with respect to their CFCs.

Other technical questions that the proposal does not explicitly address include (1) whether pre-1987earnings are subject to the transition tax and (2) the treatment of actual dividend distributions in the taxable year of transition.

Foreign tax credit

The proposal allows a credit for the foreign taxes associated with the deferred earnings, multiplied by the ratio of the one-time tax rate (14 percent) to the maximum U.S. corporate tax rate in 2015 (35 percent), or 40 percent.

[36] Sec. 9503(e)(1).

Installment payments

The one-time tax is payable ratably over five years. The proposal does not specify whether interest would be imposed on the installment payments.

Highway Trust Fund

Revenues from the proposal are targeted by the Administration to pay for its surface transportation reauthorization proposal and any shortfalls between revenue and surface transportation spending under present law for the proposal period.[37]

[37] http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf, page 23.

III. ECONOMIC ANALYSIS AND DESIGN OF A MANDATORY ONE-TIME TAX ON HISTORIC FOREIGN EARNINGS

A. Introduction

The deemed repatriation provisions in the Camp and Administration proposals are meant to be taxes imposed as part of a transition to a reformed international tax system in which active income earned by CFCs is subject to little or no residual U.S. tax. The proposals make substantial changes to the tax treatment of foreign earnings, and the transition tax rules help answer the important question of how untaxed earnings accumulated before the enactment of the new regimes should be treated. A deemed repatriation need not occur in the context of tax reform, however, but such a tax will have a different effect than a one-time tax enacted as part of broader changes to international tax rules. For example, the ability of the government to credibly commit to the one-time nature of the deemed repatriation may be limited if the current system of deferral is preserved and if taxpayers expect that the government will enact another deemed repatriation as the stock of untaxed CFC earnings accumulates again over time. Moreover, if there is no underlying policy for the deemed repatriation outside of the need to raise revenue, taxpayers may expect the government to enact another deemed repatriation as revenue needs arise in the future. These taxpayer expectations may distort their future investment decisions, although the direction and magnitude of the impact will depend on other details of the deemed repatriation (such as the rate and whether it is elective). However, the question of whether the government can credibly commit to a one-time deemed repatriation under the Camp and Administration proposals is less relevant, or irrelevant, because, prospectively, active income earned by CFCs bears little or no residual U.S. tax, so that the stock of untaxed CFC earnings may accumulate slowly over time (if at all). If this is the case, little or no revenue can be collected from another deemed repatriation.

The effect of a one-time tax on historic foreign earnings also depends on whether the tax is mandatory or voluntary.[38] For example, a voluntary one-time tax at a 34 percent rate may have little if any impact on government receipts and the repatriation decisions of U.S. multinationals. The rate is close to the rate that taxpayers face under present law (35 percent) and taxpayers can choose which, if any, foreign earnings to repatriate. As a result, it may be more beneficial for U.S. multinationals to delay repatriation of foreign earnings than repatriate them under the voluntary one-time tax. In contrast, a mandatory one-time tax at a 34 percent rate has a larger impact on repatriation decisions. Such a tax is not elective, and taxpayers cannot choose which earnings to repatriate—they must repatriate all their untaxed foreign earnings. Therefore, the base on which the mandatory one-time tax is levied is substantially larger than the base on which the voluntary one-time tax may be imposed. As a result, revenue collected from a mandatory one-time tax, at least in this scenario, is greater than revenue collected from a voluntary one-time tax.

[38] For a discussion of taxpayer behavior under a voluntary one-time repatriation, see Edward Kleinbard and Patrick Driessen, "A Revenue Estimate Case Study: The Repatriation Holiday Revisited," *Tax Notes*, vol. 120, no. 12, Sept. 22, 2008.

This part of the document highlights selected issues concerning the economics and design of a one-time tax on historic foreign earnings. General statements about the impact of certain design features of a one-time tax are difficult to make without fully specifying the context in which such a tax is enacted and the manner in which it is implemented. To simplify the analysis, it is generally assumed that the one-time tax is mandatory and is enacted outside the context of broader international tax reform. Relaxing these assumptions may impact the importance of certain design features of the tax and the policy questions that need to be addressed when structuring the tax.

B. Economic Analysis of a Mandatory One-Time Tax on Historic Foreign Earnings

Economic principles

Tax policy can affect economic decisions through multiple channels. To evaluate the economic impact of a one-time tax on historic foreign earnings, it is useful to focus attention on two distinct channels through which taxation may affect the allocation of economic resources, such as labor and capital, by taxpayers in an economy. Taxation itself reduces the amount of resources that taxpayers have at their command, which limits their ability to make purchases and investments; in the context of taxation of individuals this is sometimes referred to as an "income effect." However, taking the level of resources as given, taxation may also affect how those resources are allocated by changing the after-tax returns to economic activity and the relative attractiveness of certain types of economic activity. Taxation leads to a less efficient allocation of resources if it reduces the amount of output that an economy can produce for a given level of resources. Therefore, taxation affects the allocation of resources by (1) reducing the amount of resources available to taxpayers and (2) changing how those resources are allocated to produce goods and services. Separately analyzing these two channels helps highlight some of the basic issues that arise when designing tax policy.

Economic efficiency

Discussions of economic efficiency take the amount of resources as given and focus on how those resources are allocated. Economists typically use the allocation of resources that arises in a perfectly competitive economy as a benchmark to evaluate how taxes may affect economic efficiency. In a perfectly competitive economy, in the absence of taxes, economic theory predicts that labor and capital to flow to those sectors in which they are expected to generate the highest economic rate of return.[39] For a given level of economic resources, these flows result in an allocation that generates the greatest amount of economic output and maximizes social welfare, at least in the absence of market failures, in which case taxes may serve a corrective role.[40] Taxes may distort economic behavior and lead to an inefficient

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[39] More precisely, non-lump-sum taxes, such as income and excise taxes, are absent in the perfectly competitive economy described here. When deriving theoretical results concerning social welfare in an economy with perfectly competitive markets, economists typically assume that lump-sum taxes and transfers can be used. Lump sum taxes are described in subsequent sections of this document. For more background, see Anthony B. Atkinson and Joseph E. Stiglitz, *Lectures on Public Economics*, Princeton University Press, 2015 (originally published in 1980).

[40] If there are market failures, taxation can lead to a more efficient allocation of resources. A common economic rationale for government intervention in certain markets (including many aspects of energy markets and the market for innovation) is that often there exist "externalities" in the consumption or production of certain goods. The externalities lead to "market failures," wherein either too little or too much of certain economic activity occurs relative to what is the socially optimal level of activity. An externality exists when, in the consumption or production of a good, there is a difference between the cost (or benefit) to the participants in the market for the good from its consumption or production and the cost (or benefit) to society as a whole. When the economy-wide, or "social," costs of a certain economic activity (*i.e.*, production or consumption of a certain good) exceed the private

allocation of a given level of resources by altering the returns to economic activity pursued by individuals and firms (*e.g.*, creating a wedge between pre- and after-tax returns).[41] Taxes on wage income, for example, reduce the after-tax return to labor and may lead individuals to work less, reducing economic output. In addition, differential tax treatment of investments made in different types of property, such as those arising from special cost recovery provisions, may result in an inefficient pattern of investment that reduces overall economic output; too much investment may flow to more lightly taxed sectors and too little investment may flow to more heavily taxed sectors.

Not all taxes, however, distort economic activity. A pure "lump-sum" tax—that is, a tax in which the liability is fixed and does not depend on any action that the taxpayer can take—does not alter the relative after-tax returns to economic activity and therefore does not reduce economic efficiency. The tax is independent of variables under the taxpayer's control, such as the amount of income the taxpayer earns. No economic decision made by taxpayers, such as the amount of labor they supply, can affect their tax liability.

A one-time tax on historic foreign earnings shares some of the same properties as a lump-sum tax.[42] Such a tax is levied on the basis of historic earnings and taxpayers cannot change how much they earned in the past (although a separate issue arises if taxpayers have discretion, under the provisions of a one-time tax, over the amount of historic earnings they report). From an efficiency perspective, a one-time tax on historic foreign earnings is a more attractive method of raising revenue than increasing the tax burden on future earnings. It does not alter the returns to future investment and does not, by itself, distort investment patterns. In contrast, increasing the tax burden on future earnings lowers the after-tax return on investment and may distort investment decisions. However, if the government cannot credibly commit to imposing the tax only once, taxpayers may expect a similar tax in the future. This expectation may affect the expected after-tax returns to future investment and influence investment decisions, thereby distort economic behavior. A lump-sum tax, in contrast, does not influence investment decisions because it does not change the after-tax returns to future investment. Under a lump-sum tax, variations in investments made by taxpayers do not influence their tax liability.[43]

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costs of that activity, a negative externality exists, and the level of that activity is above that which is socially optimal. In contrast, when the social benefits from a certain activity exceed the private benefits, a positive externality exists, and the level of that activity is below that which is socially optimal.

To correct these market failures, policymakers can promote activities that create positive externalities through a tax subsidy to lower the after-tax price of the good to the consumer or increase the after-tax profit to the producer. In addition, they can discourage activities that lead to negative externalities by taxing those activities to raise the after-tax price to the consumer or decrease the after-tax profit to the producer.

[41] A more comprehensive discussion of tax policy and economic efficiency can be found in Alan J. Auerbach and James R. Hines, "Taxation and Economic Efficiency," in Alan J. Auerbach and Martin Feldstein (eds.), *Handbook of Public Economics*, vol. 3, pp. 1347-1421.

[42] A lump-sum tax is not necessarily a one-time tax and can be imposed multiple times.

[43] The efficiency of the one-time tax also depends on the extent to which it is anticipated and the degree to which taxpayers change their economic behavior in response to that anticipation. Therefore, even if a one-time tax

The efficiency property of a one-time tax does not generally vary with the base of the tax or the rate. For example, the manner in which a one-time tax set at a 35-percent rate is efficient is the same as the manner in which a one-time tax set at a five-percent rate is efficient. The key to the efficiency of the tax is that it does not alter the returns to future investment, a result which hinges in part on the ability of the government to credibly commit to levying it only once. The amount of money raised through the tax, and the overall effect it has on the resources available to firms, however, do depend on the base of the tax and the rate.

A one-time mandatory tax on historic foreign earnings also interacts with the "lockout effect" to the extent that it removes further tax costs to repatriating those earnings and "unlocks" them for use by U.S. multinationals to make investments in the United States or distribute earnings to shareholders, among other uses.[44] The "lockout effect" is a colloquial reference to the possibility that the overseas earnings of U.S. multinationals are being "locked out" and not reinvested in the United States because U.S. multinationals have a tax incentive, created by deferral, to reinvest foreign earnings rather than repatriate them. This may occur if U.S. multinationals choose to make foreign investments, rather than domestic investments, because the ability to defer payment of residual U.S. tax liability on the returns to the foreign investments may make those foreign investments more attractive on an after-tax basis, even if they yield the same pre-tax return as a domestic investment. The lockout effect disappears if repatriation of overseas earnings has no tax consequence, as is the case under the Administration's proposal, and, to a large extent, the Camp proposal.

A number of economists have studied the distortions created by deferral, and the lockout effect, and find the that burden of residual U.S. tax liability on repatriated earnings distorts a corporation's decision concerning how much to repatriate (and from which foreign subsidiaries), and that the economic cost of this distortion—which could cause U.S. multinationals to incur more debt, or invest less in the United States, than they would if they had no residual U.S. tax liability on their foreign earnings—can be significant.[45] Some economists find that the cost of this distortion increases as the accumulated stock of deferred income increases.[46] If that is the case, then a one-time tax may reduce the cost of this distortion to the extent that it results, at least temporarily, in a lower accumulated stock of deferred income. A one-time tax on historic foreign earnings that is implemented outside the context of international tax reform, however, does not address the general distortions created by deferral, and such a tax could potentially

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is not actually enacted, news that policymakers are considering such a tax may influence the beliefs that taxpayers have about the possibility that a similar tax may be enacted in the future, thereby altering their investment decisions. An unanticipated tax is a generally more efficient way to raise revenue than a tax that can be anticipated to some degree.

[44] However, cash assets may already be invested in the United States in forms that do not trigger income inclusions as investments in U.S. property under section 956.

[45] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Repatriation Taxes and Dividend Distortions," *National Tax Journal*, vol. 54, no. 4, December 2001, pp. 829-851.

[46] Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3, September 2013, pp. 671-712.

exacerbate those distortions depending on how it is designed (*e.g.*, the rate of tax and whether it is mandatory or voluntary).

Fairness, equity, and the level of economic resources

When designing the one-time tax on historic foreign earnings, policymakers may want to consider the impact of the tax on the resources of U.S. multinational enterprises. While the one-time tax may be a relatively efficient way to raise revenue, it impacts the investment decisions of firms because it changes the resources available to them. The one-time tax may reduce the financial resources of a firm and thereby limit a firm's ability to make future investments or alter a firm's capital structure (*e.g.*, require it to seek further financing through debt or equity). Policy concerns over the burden of the one-time tax on firms may affect decisions concerning the rate at which the tax is imposed as well as the base.

Concerns about fairness and equity may also inform policy decisions about which classes of taxpayers should be subject to the tax and the base on which the tax is imposed. However, it is difficult to determine what is fair and equitable without considering the broader policy objectives in which the one-time tax is levied. For example, if the sole purpose of the one-time tax is to fund certain spending projects, decisions concerning the classes of taxpayers on which to impose the tax may depend on who benefits from the spending projects. If the one-time tax is imposed as part of a transition to a reformed international tax system, as in the Camp and Administration proposals, the base and rate of the tax may reflect how the new tax rules impact certain classes of taxpayers or certain categories of income.

C. Design of a Mandatory One-Time Tax on Historic Foreign Earnings

Taxpayers subject to tax

Taxpayers who are shareholders of CFCs can vary along a number of dimensions, such as organizational form (*e.g.*, corporate vs. non-corporate) and the extent of their ownership of CFCs. As a result, policymakers considering a one-time tax on historic foreign earnings must determine which taxpayers are subject to the tax. Out of considerations of fairness and equity, however, policymakers may want to exempt, or provide special rules for, certain classes of taxpayers from the one-time tax, but determining what is fair and equitable may require more information about the broader goals of policymakers.

Concerns about fairness and equity may need to be balanced by the distortionary effects of treating certain classes of taxpayers differently. Even if policymakers decide to exempt certain taxpayers from the one-time tax, those taxpayers may form expectations that they could be subject to a similar tax in the future. Moreover, once policymakers have defined the category of taxpayers that should be exempted from the tax, firms may alter the organizational form in which they conduct their business activity, or change the extent of their ownership of CFCs, to reduce expected tax burdens from another "one-time" tax; the actual decisions they make depend on the expectations they have about which taxpayers may be subject to a similar tax in the future. For example, if non-corporate shareholders are exempted from the one-time tax, shareholders may opt to organize themselves as corporations if they expect non-corporate shareholders to be subject to a similar tax in the future. These distortionary effects can be limited to the extent that the government can credibly commit that it will not impose a similar tax in the future.

Earnings subject to tax

When imposing a one-time tax on historic foreign earnings, policymakers must also determine what is meant by "historic" (*i.e.*, the time period in which the relevant earnings were generated). The deemed repatriation in the Camp proposal applies only to post-1986 undistributed earnings, while the Administration's proposal applies to all undistributed earnings. It is unclear why earnings generated in one year should be treated differently from earnings generated in another year. However, some commentators contend that the one-time tax should be imposed only on post-1986 earnings because earnings accumulated before 1987 are not reliably tracked and a tax on those earnings imposes a compliance burden on taxpayers that is disproportionate to the revenue gain from including those earnings.

Policymakers may also need to take into account the treatment of actual dividend distributions in the year of the one-time tax. In particular, is the amount of earnings subject to the tax reduced by the amount of distributions made during the year of the tax, with those distributions taxed under present law, or are distributions disregarded in determining the amount of earnings subject to the one-time tax? The relative efficiency of the one-time tax is limited if firms are able to reduce their tax liability by altering the timing of the distribution of earnings from their CFCs; the efficiency of the one-time tax is predicated on the taxpayers' inability to alter their tax liability. The relative efficiency of the tax is further limited if the transition tax liability is not applied uniformly, which is the case if certain classes of taxpayers are treated differently and the rate at which the tax is applied varies by the form in which undistributed earnings are held (*i.e.*, as a cash or non-cash asset).

Rate of tax

A one-time tax on historic earnings is a more efficient method of raising revenue than increasing the tax burden on future earnings. Reducing the tax burden on future earnings generally promotes economic efficiency since future earnings (in contrast to historic earnings) reflect decisions the taxpayer can still make, and a tax on those earnings may distort investment decisions. In that sense, efficiency considerations may suggest that the one-time tax should be set at the maximum corporate rate of 35 percent if policymakers are deciding between raising revenue through the one-time tax or through an increased tax on future earnings, or if revenue from the one-time tax is used to lower the tax burden on future earnings. These may not be the tradeoffs under consideration by policymakers, however.

Policymakers may also wish to set the rate of tax so that it reflects other policy concerns, such as fairness, taxpayer liquidity, and the impact of the one-time tax on taxpayer resources and on their investment and employment decisions. A comprehensive analysis of the appropriate rate of tax also depends on how the government chooses to use the revenue raised from the tax. For example, if the government chooses to increase spending on certain programs or projects with the revenue, analysis of the economic impact of those programs and projects is necessary.

Some may argue that historic foreign earnings held in the form of cash assets should be taxed at a higher rate than those earnings that have been reinvested in non-cash assets. One reason may be that it is easier for taxpayers to liquidate cash assets, versus non-cash assets, to pay the one-time tax. However, the classification of assets as cash assets or non-cash assets may be difficult to do in practice, which increases compliance and administrative burdens and reduces the efficiency of the tax to the extent that taxpayer's have some, albeit limited, discretion in how they classify their assets; this discretion is a function of, among other things, how policymakers define what constitutes a cash asset and non-cash asset. In addition, policymakers could address the liquidity concern through how they structure features related to how the tax is to be paid, including the time period in which it must be paid (*e.g.*, within the budget window or beyond it), the pattern of installment payments (*e.g.* equal payments over each period or increasing payments over time), and the interest charge (if any) levied on delays in payments. For example, a company may have insufficient funds to pay its full tax liability immediately, but if it expects to earn profits in the future, it may generate the necessary funds to pay the tax liability over time if policymakers set the time period in which the payment must be paid sufficiently long or backload required payments, among other policy variations.

Policymakers may also want to treat cash assets less favorably than non-cash assets for purposes of the one-time tax if they view the accumulation of cash assets as a less desirable activity under present law than investment of those assets in active business operations (whether at home or abroad). In particular, policymakers may be concerned that taxpayers are delaying repatriation of foreign earnings solely to defer paying residual U.S. tax on those earnings. As a result, policymakers may want to treat purely tax-motivated reinvestment of earnings offshore differently than non-tax motivated reinvestment, and the amount of cash assets held by a company may be a rough measure of the tax-motivated component of a company's offshore investment profile. However, reinvesting foreign earnings in cash assets need not necessarily be tax-motivated or tied to the taxpayer's possible goal of deferring payment of residual U.S. tax. Purely domestic companies with no tax-deferred foreign earnings, for example, may reinvest some of their earnings in cash assets for working capital needs (*e.g.*, cash held to acquire companies or other assets in the future). Likewise, multinational enterprises may require working capital for their overseas operations, although it is difficult to measure the amount of working capital they need. Therefore, it may be difficult for policymakers to identify the amount of reinvested foreign earnings that is not repatriated purely for tax reasons.