



Getting From Here to There: The Transition Tax Issue

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Getting From Here to There: The Transition Tax Issue

*By J. Clifton Fleming Jr., Robert J. Peroni, and
Stephen E. Shay*

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If there is fundamental U.S. international income tax reform, regardless of the reform option chosen,

the United States must decide how to handle the \$2.4 trillion to \$2.6 trillion of previously untaxed foreign income accumulated by U.S. multinational corporations. In this report, Fleming, Peroni, and Shay argue that the proper approach is to treat the income as a subpart F inclusion in the year before the effective date of fundamental reform and to tax it at regular rates with an option to make the payments in installments that bear market-rate interest. The authors explain why the case for a low or deferred tax on this income is inferior to the case for full immediate taxation.

The authors thank Patrick Oglesby for comments on an earlier draft of this report. The views expressed in this report are those of the authors and do not reflect those of their universities, any organization for which any of the authors serves as an officer or renders pro bono services, or, in the case of Shay, any client. Shay discloses activities unconnected with his position at Harvard Law School, one or more of which may concern the subject matter of this report, at <https://helios.law.harvard.edu/public/ConflictOfInterestReport.aspx?id=10794>.

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Table of Contents

Introduction	69
Why Full Current Taxation Is Appropriate	70
Total (or Near Total) Forgiveness?	72
Continue Deferral?	72
A One-Time Immediate Transition Tax	74
The Obama and Camp Proposals	75
The Rate and Liquidity	76
A Deduction or Credit for Foreign Taxes?	77
Conclusion	78

Introduction

What should Congress do with the \$2.4 trillion to \$2.6 trillion¹ of profits that U.S. multinational corporations have earned primarily in low-tax foreign countries and that have been accumulated offshore and not yet borne a U.S. tax? The question is pressing, because it is a key transition issue for fundamental U.S. international income tax reform, which is now moving front and center and is widely

¹See letter from Thomas Barthold, chief of staff of the Joint Committee on Taxation (Aug. 31, 2016), reported in a release from House Ways and Means Committee Chair Kevin Brady, R-Texas, “Brady, Neal Highlight Another Reason for Pro-Growth Tax Reform, Joint Committee on Taxation Estimates Even More Foreign Earnings From U.S. Companies Stranded Overseas” (Sept. 29, 2016).

discussed across many divides — liberals and conservatives, Democrats and Republicans, academics, the business community, and tax professionals. Proposals for fundamental reform span a spectrum that includes replacing the corporate income tax with a hybrid destination-based cash flow tax,² adopting an exemption or territorial system as a replacement regime,³ and transforming the current U.S. international income tax system into a real worldwide system without deferral and cross-crediting.⁴ Regardless of which reform alternative is chosen, it will be necessary to tackle the question of what to do about U.S. multinationals' untaxed accumulated foreign income.⁵ Even if fundamental tax reform is abandoned, U.S. multinationals will continue to push for tax amnesty under the cover of "paying for" infrastructure or any other available legislative vehicle. Although this report focuses on the transition tax issue in the context of fundamental tax reform, the analysis also provides a strong case against an amnesty that is independent of tax reform.

In this report, we examine various candidates for a transition solution.⁶ We conclude that the best alternative would be mandatory deemed repatriation, treating previously untaxed foreign-source

earnings and profits as subpart F income at the close of the tax year of the controlled foreign corporation that ends on or before the effective date of revisions to the taxation of earnings of foreign corporations under a reformed system. We regard reliance on the familiar subpart F architecture as superior to creating a new tax regime that might have unanticipated consequences. The result would be a one-time CFC-shareholder-level tax at the shareholders' pre-reform tax rates on the accumulated untaxed foreign income. We would apply this approach regardless of whether a U.S. multinational corporation classified the earnings for financial statement purposes as indefinitely invested abroad. We would not use a bargain tax rate or continue deferral of U.S. income tax on previously untaxed foreign accumulated earnings. Doing either would provide a windfall inuring principally to U.S. multinational corporations that for U.S. tax purposes made an elective entity choice to benefit from deferral rather than be subject to current taxation. We address the liquidity problem with an option to pay the tax in a suitable number of annual interest-bearing installments.

Why Full Current Taxation Is Appropriate

The alternatives for reform of U.S. taxation of foreign subsidiary earnings range from some form of territorial system, whether using an income or consumption tax base, to full current income taxation of those earnings either at the full pre-reform corporate tax rates or at a substantially reduced tax rate. The prospect of tax reform's termination of the deferral regime is the ostensible triggering event for addressing the transition issue of what to do about the massive pool of untaxed offshore earnings. The real driver, however, is revenue.

The political economy of the offshore earnings transition tax issue has been based on accelerating revenue into the 10-year budget window as a pay-for to fund either revenue-losing reform (for Republicans) or infrastructure expenditures (for Democrats). The business community has appeared to be willing to bear a modest one-time tax cost to achieve longer-term tax relief, either in the form of a lower corporate tax rate or exemption from U.S. taxation of foreign subsidiary earnings. Few commentators have given thought to the policy that should underlie the transition.

The academic literature of the past few decades emphasizes social welfare maximization in the

²See Tax Reform Task Force, "A Better Way: Our Vision for a Confident America," at 25-29 (June 24, 2016).

³White House and Treasury, "The President's Framework for Business Tax Reform: An Update," at 23-26 (Apr. 2016) (proposing a de facto territorial system with a 19 percent minimum tax on foreign earnings); and JCT, "Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV — Participation Exemption System for the Taxation of Foreign Income," JCX-15-14, at 24-28 (Feb. 26, 2014).

⁴See J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?" 36 *Mich. J. Int'l L.* 1, 18-29 (2014) (discussing the important components of transforming the U.S. international tax system into a real worldwide system); and David S. Miller, "How Donald Trump Can Keep His Campaign Promises, Grow the Economy, Cut Tax Rates, Repatriate Offshore Earnings, Reduce Income Inequality, Keep Jobs in the United States, and Reduce the Deficit," Tax Forum Paper no. 680, at 74-75 (Jan. 30, 2017); H.R. 1451, The Tax Dodging Prevention Act of 2017, 115th Cong., 1st Sess. (2017).

⁵We use the terms "untaxed" and "untaxed earnings" to refer to after-foreign-tax earnings that have not been subjected to U.S. taxation. A high portion of foreign subsidiary earnings are subject to low levels of foreign tax, although this will vary by industry. Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," 66 *Nat'l Tax J.* 671, 699, tbl. 3 (2013) (45.9 percent of earnings of CFCs in 2006 were taxed at an effective foreign rate of 10 percent or less).

⁶Regardless of how the transition tax is designed, there is likely to be litigation challenging its constitutionality that will depend on a retroactivity argument. The Supreme Court will just as likely find a way to uphold Congress's selection of a

(Footnote continued in next column.)

transition tax regime. Consequently, we are leaving this interesting, but speculative, constitutional law topic to others. Instead, this report deals with the first-order question of how a transition tax should be constructed.

analysis of tax transitions.⁷ One way suggested by professor Kyle D. Logue to understand the impact of that literature is to contrast the “old view” scholarship based on analysis of fairness to the affected taxpayer (arguing against uncompensated retroactive rule changes) with the “new view” that retroactivity can be welfare enhancing, and with subsequent work in which some relief from retroactivity is justified under a welfare analysis.⁸ Our shorthand translation is that the policy toward transition should not focus only on directly affected taxpayers but also on the remaining taxpayers who are indirectly affected in various ways. It is these “other” taxpayers who will bear the burden of relief for the directly affected taxpayers.

The directly affected taxpayers in this case are overwhelmingly the largest U.S. multinational corporations, concentrated mostly in the technology, pharmaceutical, and healthcare industries.⁹ Moreover, of an estimated \$2.4 trillion plus of indefinitely invested foreign earnings in 2015, 25 companies accounted for more than 60 percent (an estimated \$1.49 trillion) of those earnings.¹⁰ In light of the concentrated interests and evident ability-to-pay and influence of the directly affected taxpayers, it is especially important to ensure that the interests of “other” taxpayers are taken into account.

The territorial reforms under consideration are as or more generous than deferral in their nontaxation of foreign subsidiary income. Thus, this is not a case in which the directly affected taxpayers are losers under the new system, so it is difficult to justify compensating them in connection with the transition to a reformed system.¹¹ However, we favor accelerating the inclusion of deferred income to the effective date of the reform, which under certain

assumptions could result in an increase in tax. We justify this on several grounds.

First, under the assumptions of the pre-reform regime, deferral is preferential for foreign income. The directly affected taxpayers have realized a benefit unavailable to other taxpayers. Because, in our view, the benefit is not normatively justified, termination of the benefit as of the effective date of the reform would be appropriate. That approach would also permit all taxpayers to be operating under the same rules thereafter, which would reduce unfairness to other taxpayers and reduce for the directly affected taxpayers and the government the ongoing administrative burden of maintaining different systems for pre-effective-date and post-effective-date earnings.

Nonetheless, acceleration of the timing of the tax could be considered as defeating the pre-reform expectations of the directly affected taxpayers, which raises the question whether the rate that is applied to the untaxed earnings should be reduced to attempt to preserve the present value equivalent of the tax that would be imposed if deferral were permitted to continue. Laying aside the administrative efficiency gains from starting all features of the new system for everyone at the same time, the justification for a reduced tax rate on prior untaxed accumulations based on a present-value-equivalent tax burden would be much the same as the justification for continuing deferral for old earnings. We discuss this issue more fully below, but the asserted justifications for deferral under current law do not support a reliance claim for indefinite deferral.

The accelerated inclusion of untaxed earnings also is consistent with a general preference to place the burden of law change on private parties who can create contractual protections, including insurance. In contrast, providing transition relief would promote reliance on an understanding that the government’s commitment to actually collecting deferred taxes is subject to special interest pleading and malleable. Indeed, the 2004 repatriation tax holiday makes the denial of special relief now especially important to limit the perverse incentives that were inadvertently created by that ill-conceived measure.

In 2004, Congress assured taxpayers that the holiday would be a one-time event needed to spur U.S. economic growth. The best evidence is that U.S. multinational corporations increased their deferral of foreign subsidiaries’ earnings.¹² A plausible

⁷See, e.g., Louis Kaplow, “An Economic Analysis of Legal Transitions,” 99 *Harv. L. Rev.* 511 (1986).

⁸See Logue, “If Taxpayers Can’t Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate,” 67 *U. Chi. L. Rev.* 1507, 1508 (2000); and Logue, “Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment,” 94 *Mich. L. Rev.* 1129, 1508 (1996).

⁹See Shay, “The Truthiness of ‘Lockout’: A Review of What We Know,” *Tax Notes*, Mar. 16, 2015, p. 1393, at p. 1397.

¹⁰See Citizens for Tax Justice, “Fortune 500 Companies Hold a Record \$2.4 Trillion Offshore: They May Be Avoiding Up to \$695 Billion in U.S. Taxes” (Mar. 4, 2016).

¹¹As we have previously written, we believe that full current taxation is the normatively justified rule. See Peroni, Fleming, and Shay, “Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income,” 52 *SMU L. Rev.* 455, 508-512 (1999) (describing a proposal for a real worldwide system with substantially curtailed deferral and cross-crediting). Accordingly, we would take the same position on transition in connection with a reform that imposes full current taxation as we would with a territorial tax reform.

¹²Thomas J. Brennan, “What Happens After a Holiday?: Long-Term Effects of the Repatriation Provision of the AJCA,” 5 *Nw. J.L. & Soc. Pol’y* 1, 2-3 (2010) (“Since the holiday window, (Footnote continued on next page.)

explanation for increased retentions is that companies believed they would obtain tax rate relief in the future. Accelerating the income inclusion in connection with tax law change is only a partial recompense for the 2004 policy error but doing so would push back against moral hazard by demonstrating that the government can increase as well as give away tax. For these reasons, we do not believe that full inclusion of the untaxed earnings under our proposal would justify a lower tax rate.

Total (or Near Total) Forgiveness?

An immediate tax at regular rates is, of course, hardly the preferred approach of directly affected taxpayers. U.S. multinational corporations would be pleased if their foreign subsidiaries' untaxed accumulated earnings could be distributed totally free of U.S. tax or at a substantially reduced rate of tax. That approach, however, would provide an unjustified windfall to benefitted multinationals and continue to promote the perverse incentives generated by the belief that government commitment to actually collecting deferred taxes is subject to special interest pleading and is malleable. Also, taxpayers that do not benefit would receive fewer services, have to pay more tax, or both. Moreover, to the extent that transition tax relief contributes to making international tax reform lose revenue rather than be revenue neutral, the taxpayers who would bear the burden would be future generations, who would have to pay more taxes to address the resulting U.S. deficits and increase in government indebtedness. This is normatively troubling.

U.S. investors in controlled foreign corporations were fully aware of and assumed the responsibility for a future tax on the previously untaxed earnings accumulated in those foreign corporations. Assuming a rational investor, the future U.S. tax was factored into the multinational's choice of entity and investment decisions. To allow the multinationals' foreign subsidiaries' earnings now to escape meaningful U.S. taxation would confer an unjustified and substantial windfall¹³ that would undermine the perceived fairness of the tax system and the morale of taxpayers who did not receive a

there has been a dramatic increase in the rate at which firms add to their stockpile of foreign earnings kept overseas.”)

¹³See Treasury, “General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals,” at 13 (Feb. 2016); JCT, “Present Law and Issues in U.S. Taxation of Cross-Border Income,” JCX-42-11, at 97 (Sept. 6, 2011); Susan C. Morse, “A Corporate Offshore Profits Transition Tax,” 91 *N.C. L. Rev.* 549, 563-564, 601 (2013); and Daniel Shaviro, “The David R. Tillinghast Lecture: The Rising Tax-Electivity of Corporate Residence,” 64 *Tax L. Rev.* 377, 429 (2011).

comparable windfall on their own tax returns.¹⁴ And if the U.S. multinational corporations were betting that in some way they could ultimately avoid a meaningful U.S. repatriation tax, there is no reason to bail them out of their bet, particularly after they have enjoyed the benefit of deferral and an earlier tax holiday for untaxed earnings. In our view, one tax amnesty is more than enough, and the case for a zero or substantially reduced transition tax rate is therefore weak.

Continue Deferral?

Under the current U.S. system, U.S. tax on non-subpart F foreign income of U.S. multinationals is deferred until the income is repatriated to the United States.¹⁵ Thus, one approach to dealing with foreign income that has not previously borne U.S. tax would be to continue deferral so that those earnings would be subject to U.S. tax only when repatriated. We do not favor this approach unless the postponed tax bears an interest charge that would recapture the deferral benefit from the effective date of tax reform until earnings are distributed. Failure to impose the interest charge would grandfather the deferral benefit which, in turn, would continue the repatriation disincentive that results from deferral.¹⁶ Also, imposing an interest charge on a fixed amount of tax would prevent a tax rate windfall to the extent that tax reform results in a lower corporate tax rate at the time of repatriation than at the time the accumulated income was earned.¹⁷

¹⁴A zero or near-zero transition tax on untaxed, accumulated, non-subpart F earnings could be viewed as a form of tax amnesty provision and, as such, lead to serious taxpayer perceptions of the unfairness of the international tax reform bill. See generally Craig M. Boise, “Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty,” 14 *Geo. Mason L. Rev.* 667, 709-710 (2007) (discussing the tax policy implications of temporary reduction of the repatriation tax rate in section 965, enacted in 2004).

¹⁵See Charles H. Gustafson, Peroni, and Richard Crawford Pugh, *Taxation of International Transactions: Materials, Text and Problems* 24-26, 485-486 (4th ed. 2011) (discussing the deferral principle). As a practical matter, subpart F is the only significant anti-deferral regime of current U.S. tax law that applies to a CFC (i.e., a foreign corporation in which U.S. shareholders own more than 50 percent of the voting power or value of the corporation's stock). Under section 1297(d), enacted in 1997, the passive foreign investment company provisions (the other significant anti-deferral regime of current U.S. tax law) do not apply to U.S. shareholders of foreign companies during periods in which those companies constitute CFCs.

¹⁶See JCX-42-11, *supra* note 13, at 109. This is often referred to as the “lockout effect” of the deferral privilege. See *id.* at 74-75; and Gustafson, Peroni, and Pugh, *supra* note 15, at 492-493.

¹⁷See “President’s Framework,” *supra* note 3, at 24; and Miller, *supra* note 4, at 73-74. Although tax reform proposals today are focused on lowering tax rates, it is possible that as

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The principal defense made for deferral is that without it, U.S. multinationals would be rendered noncompetitive in low-tax foreign countries.¹⁸ We have previously explained our rejection of that defense.¹⁹ Even if the arguments for a U.S. multinational competitiveness subsidy were valid, they would not have force in relation to foreign income that has already been earned under earlier investment and business decisions. The competitiveness defense principally applies to future investment and income. In the context of a change in tax rules for foreign income earned through a foreign corporation, a one-time tax on previously earned income is unlikely to have any meaningful effect on future competitiveness.²⁰ The competitiveness defense in any event does not justify an indefinite perpetuation of deferral upon termination of that subsidy. Although the deferral benefit is related to the period of deferral, nowhere in the statute or elsewhere did Congress assure an indefinite subsidy. Thus, the reasons favoring the imposition of tax on previously untaxed earnings outweigh doubtful arguments for continuing to allow interest-free deferral.

The interest charge approach would require an ordering rule specifying that corporate distributions and stock sale profits come first out of historic

deficits grow, tax rates will be increased to cope with substantial projected deficits. Our position would not be altered if rates were to increase, although we expect that with notice taxpayers would be able to avoid rate increases on prior earnings if they so choose.

¹⁸See Fleming, Peroni, and Shay, "Worse Than Exemption," 59 *Emory L.J.* 79, 106 (2009).

¹⁹See, e.g., *id.* at 107-110.

²⁰To the extent that competitiveness means "incentive to compete," a one-time tax on income previously earned but not yet taxed by the United States should not have an anti-competitive effect. This is because the occasion for imposing the tax — adoption of a radically different U.S. international tax regime — is unlikely to be repeated in the foreseeable future. Therefore, the tax should not act as a disincentive. See generally JCT, "Present Law and Selected Proposals Related to the Repatriation of Foreign Earnings," JCX-96-15, at 13, 16 (June 22, 2015); and Miller, *supra* note 4, at 74. It is possible, of course, that a reform adopted without bipartisan support would be quickly repealed if control of the government passes to the other party. But see Miller, *supra* note 4, at 39-40 (outbound transfers of intangibles are insurance against reversal of destination-based cash flow tax). If, on the other hand, competitiveness refers to "resources with which to compete," it seems unlikely that a tax on historic accumulations, much of which have been held in liquid investments (see David Kocieniewski, "For U.S. Companies, Money 'Offshore' Means Manhattan," *The New York Times*, May 21, 2013; Shay, "Truthiness," *supra* note 9; and Lee A. Sheppard, "Debunking the Overseas Cash Meme," *Tax Notes*, May 25, 2015, p. 847, at p. 848-849), will significantly affect the capacity of U.S. multinationals to carry on or expand foreign activities. Our recommendations below for installment payments will address the liquidity issue.

untaxed accumulated foreign earnings and then earnings that have been subjected to post-reform taxation, from the reverse of those two sources, or proportionately from each of them. Moreover, regardless of how distributions and stock sales profits are divided between taxed and untaxed foreign earnings, the latter would have to be allocated to prior years in order to apply the interest charge with precision. This would not be easy, at least for taxpayers with poor recordkeeping.²¹ One way to simplify things, at the cost of precision, would be to take the approach of section 1291 and specify an arbitrary rule for allocating the previously untaxed foreign portion of the distribution or sale profit over the holding period for the stock. The passive foreign investment company rule is ratable allocation,²² but another rule could be adopted. Any such rule should be mandatory, not elective, or else it would add burdens and not address complexity.

However, these computational issues are not a justification for abandoning the interest charge.²³

²¹See JCX-42-11, *supra* note 13, at 96-97; and Morse, "Transition Tax," *supra* note 13, at 581.

²²See Gustafson, Peroni, and Pugh, *supra* note 15, at 618-620 (discussing and giving an example applying the section 1291 rules).

²³Of course, the international income tax provisions should not be more complicated than necessary to accomplish their policy objectives. However, in the international income tax area, complexity is often an exaggerated concern. This is because the bulk of the taxpayer population that must deal with complexity is well-resourced and sophisticated. C corporations claim the vast majority of FTCs. Thus, for example, in 2011, individuals reported total FTCs of slightly less than \$16.5 billion (see Scott Hollenbeck and Maureen Keenan Kahr, "Individual Foreign-Earned Income and Foreign Tax Credit, 2011," 33 *SOI Bull.* 139 (Spring 2014)), while C corporations claimed just over \$107 billion of FTCs for the same year. See Melissa Costa, "Corporate Foreign Tax Credit, 2011," 35 *SOI Bull.* 180 (Winter 2016). The individual-claimed credits were concentrated among high-income taxpayers. Taxpayers with adjusted gross incomes of \$500,000 and above accounted for approximately 70 percent of the 2011 FTC claims by individuals. See Hollenbeck and Kahr, *supra*, at 162. This indicates that among individuals, the FTC is primarily a concern of taxpayers who are sufficiently sophisticated to deal with FTC complexity or who can afford professional assistance. For C corporations, taxpayers with \$500 million or more in total assets were responsible for 98 percent of the total 2011 FTC claims by C corporations. The total number of C corporations reporting FTCs in 2011 was 6,278. See Costa, *supra*. These 6,278 credit-claiming corporations represented only 0.38 percent of the 1,664,553 C corporations that filed 2011 returns. See JCT, "Background on Business Tax Reform," JCX-35-16, at 15 (Apr. 22, 2016). Thus, among C corporations, the FTC is mostly the concern of a comparatively small population of sophisticated taxpayers who can handle complexity. For example, this taxpayer group has dealt with the distinction between manufacturing and non-manufacturing income required by section 199, with the limitations on the section 965 temporary dividends received deduction, with various look-through rules in the FTC and subpart F provisions, and with the

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Even if deferral were continued without an interest charge after international tax reforms, recordkeeping and computational requirements would persist because it would be necessary to distinguish distributions out of post-tax-reform accumulations from distributions out of untaxed (by the United States) pre-tax-reform accumulations.²⁴ Otherwise, the pre-tax-reform earnings would receive the presumed more favorable post-reform treatment, a windfall outcome unsupported by sound policy.²⁵

A One-Time Immediate Transition Tax

Still, the deferral-with-interest-charge regime would be unsatisfactory because of the large amounts of accumulated foreign earnings kept indefinitely offshore, much of which are in liquid form.²⁶ Obviously, a tax that was deferred until repatriation, even with an interest charge, would not reach those earnings. It seems to us that a one-time, lump-sum transition tax on section 951(b) U.S. shareholders,²⁷ imposed through the subpart F regime and including even earnings indefinitely reinvested, would be an appropriate, balanced solution²⁸ that avoids the burden of an interest charge regime described above.²⁹ The provisions protecting against a second tax on earnings previously taxed under subpart F (in section 959) would ensure that earnings subject to the transition tax could be distributed, or realized through a stock sale, without incurring further taxation.

We recommend that the tax be imposed by treating previously untaxed foreign-source E&P as subpart F income in the year preceding transition to the reformed system. This is the approach advocated in former Ways and Means Committee Chair Dave Camp's 2014 international tax reform proposal.³⁰ It would allow net operating loss deductions to be taken into account to the extent they are otherwise available. We regard this as an appropriate element of a balanced proposal.

section 902 deemed paid credit and its collateral complexities, such as the section 909 anti-splitter rules.

²⁴See JCX-42-11, *supra* note 13, at 96.

²⁵See JCX-96-15, *supra* note 20, at 20. We expand on this point below.

²⁶See also Morse, "Transition Tax," *supra* note 13, at 576 ("The assumption that non-U.S. subsidiaries will eventually repatriate earnings to the U.S. parent under current law is almost certainly not correct."). See generally Shay, "Truthiness," *supra* note 9; and Sheppard, *supra* note 20.

²⁷See Morse, "Transition Tax," *supra* note 13, at 601; see also Shaviro, "Tax-Electivity," *supra* note 13, at 426.

²⁸See Shaviro, "Tax-Electivity," *supra* note 13, at 425 ("Perfection is likely to be unobtainable. . . . Rough justice may be good enough, however.")

²⁹See *supra* text accompanying notes 20-22.

³⁰See JCX-15-14, *supra* note 3, at 29.

As an alternative approach, professor Susan C. Morse has advocated a new, independent regime for imposing the transition tax that would be simpler than subpart F.³¹ Still, we recommend the subpart F approach for several reasons. First, its complexity for the transition tax issue would be a one-time event rather than a continuing matter. Moreover, the affected taxpayers would have already been dealing with subpart F and would be prepared to handle it. Also, using the known structure of subpart F would avoid the possibility of unintended consequences that would arise with a newly created regime. Finally, as explained above,³² we do not regard complexity as a controlling policy criterion in the international income tax area.

Because we would rely on subpart F's architecture to impose the transition tax, the shareholders who bear the tax would be those who satisfy the section 951(b) definition of a U.S. shareholder — that is, a U.S. person³³ who owns, actually or constructively, "10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation."³⁴ Thus, shareholders below the 10 percent threshold would not incur the transition tax. We would make one change, however, which would be to treat a foreign partnership the same as a domestic partnership for purposes of subpart F and section 1248 income inclusions. In this way, taxable U.S. partners finally would be taxed appropriately on the deferred earnings.

The principal reason less-than-10-percent shareholders do not suffer taxable constructive inclusions under the existing subpart F provisions is that Congress believed they lacked sufficient voting power to force distributions of accumulated corporate earnings.³⁵ The same rationale might suggest that those shareholders should be excused from the transition tax on accumulated corporate earnings. Perhaps more important, doing so would remove many small shareholders from the coverage of the transition tax without sacrificing much revenue.

³¹See Morse, "Taxing the 2.5 Trillion," *Tax Notes*, Jan. 9, 2017, p. 247.

³²See *supra* note 23.

³³See section 7701(a)(30) (defining U.S. person). U.S. citizens, resident aliens, domestic corporations, domestic partnerships, and domestic trusts and estates are U.S. persons under this definition. In the case of a U.S. partnership, of course, the deemed repatriation and attendant tax liability will flow through to the partnership's U.S. partners to the extent of their distributive shares of the partnership's income, because the partnership is not a taxpayer for U.S. income tax purposes. See sections 701, 702, and 703.

³⁴Section 951(b) (defining U.S. shareholder for subpart F purposes).

³⁵See Gustafson, Peroni, and Pugh, *supra* note 15, at 494-495.

A different concern arises regarding U.S. resident shareholders who qualify as U.S. shareholders of a foreign corporation because they meet the 10 percent threshold but who are outside the scope of subpart F because the foreign corporation's U.S. shareholders do not in the aggregate own more than 50 percent of the vote or value of its stock. Thus, those corporations are not section 957(a) CFCs and are not subject to the constructive inclusion mechanism of subpart F even though their equity is significantly owned by U.S. shareholders. That raises the question whether subpart F should be expanded for purposes of the transition tax so that the tax reaches the shareholders of these so-called 10/50 companies. Congress thought that these shareholders were significant enough to warrant extending a modified version of the section 904(d) CFC dividend look-through rules to them. This suggests that it would be worth Congress's time to gather data on whether imposing the transition tax on U.S. shareholders of 10/50 companies would raise enough revenue to warrant doing so. Apparently, Camp believed that this was the case, because his transition tax proposal would apply to U.S. shareholders of 10/50 companies.³⁶ We agree.

An immediate tax would encounter the reality that large amounts of the earnings accumulated in U.S.-owned foreign corporations are in forms other than cash — that is, in buildings, equipment, intangibles, and other nonliquid assets. Thus, some affected foreign corporations might be unable to distribute sufficient cash to cover their U.S. shareholders' transition tax liabilities, and a tax on the undistributed earnings of U.S.-owned foreign corporations should recognize that liquidity concern.

This may suggest limiting a U.S. tax on undistributed foreign earnings to amounts accumulated in liquid form. Doing so, however, would overlook the fact that foreign corporate earnings invested in foreign business assets have never borne a U.S. tax and therefore have enjoyed the benefit of deferral. Moreover, to confer nontaxation on those earnings because they are invested in nonliquid assets would amount to singling them out for beneficial cash flow consumption tax treatment, which allows investments to be made with pretax earnings³⁷ while the bulk of business investments must be made with after-tax earnings. In our view, a transition tax that is part of fundamental corporate tax reform should reach all accumulated earnings of foreign subsidiaries regardless of whether the accumulations are in liquid or illiquid form. The problem of possible lack

of liquidity for paying the tax can be handled by making the tax payable in annual installments spread over a suitable period, with an appropriate interest charge.³⁸

The Obama and Camp Proposals

Two proposals have been put forward that are relevant to this report. In connection with a February 2016 proposal to partially repeal deferral by prospectively imposing a minimum tax on current foreign earnings of CFCs,³⁹ the Obama administration advocated a 14 percent one-time tax on previously untaxed foreign income of those corporations.⁴⁰ The tax would presumably be levied on the corporations' U.S. shareholders, although this is not expressly stated in the proposal. Foreign income taxes borne by that income would be partially creditable⁴¹ against the one-time U.S. tax. Afterward, the affected income could be repatriated tax free.⁴² Payment of the tax would be prorated over five years. There is no express provision for an interest charge.

In February 2014, Camp released a discussion draft of an international tax reform proposal that included replacement of the current U.S. system with a territorial regime. That replacement regime would effectively exempt 95 percent of the dividends paid by a foreign corporation out of its foreign-source income to any U.S. corporation that was a U.S. shareholder (as defined in section 951(b)) of the foreign corporation⁴³ if at least 10 percent of the voting stock of the foreign corporation was owned directly or indirectly by a U.S. corporation.⁴⁴

³⁸See JCX-42-11, *supra* note 13, at 109. A strong argument can be made that liquidity relief should be limited to the portion of the transition tax allocable to noncash assets of the foreign subsidiaries, *i.e.*, previously untaxed earnings that exceed some percentage of cash and liquid investments such as marketable securities. However, there would be some practical problems in designing and implementing such a rule.

³⁹See Treasury, "General Explanations," *supra* note 13, at 13. For a critique of this proposal in an earlier form, see Shay, Fleming, and Peroni, "Designing a 21st Century Corporate Tax — An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base," 17 *Fla. Tax Rev.* 669, 708-717 (2015).

⁴⁰See Treasury, "General Explanations," *supra* note 13, at 23.

⁴¹The foreign taxes borne by the income would be multiplied by a percentage equal to 14 percent divided by the maximum U.S. corporate tax rate for 2016. The result would be the allowable FTC. *See id.* at 23.

⁴²*See id.*

⁴³See JCX-15-14, *supra* note 3, at 24. Section 957(b) defines a U.S. shareholder as a section 957(c) U.S. person who owns, directly, indirectly, or constructively, "10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation."

⁴⁴See H.R. 1, Tax Reform Act of 2014, section 4001.

³⁶See JCX-15-14, *supra* note 3, at 28.

³⁷See Joseph M. Dodge, Fleming, and Peroni, *Federal Income Tax: Doctrine, Structure & Policy* 142-143 (4th ed. 2012).

The exemption would be allowed even for dividends from prior accumulations that had not borne a U.S. or foreign tax.⁴⁵ To deal with these untaxed accumulations, the proposal included a one-time transition tax.

Generally speaking,⁴⁶ under Camp's transition tax, all U.S. shareholders (corporate and noncorporate⁴⁷) of either (1) a section 957(a) CFC or (2) a noncontrolled foreign corporation, at least 10 percent of the voting stock of which was owned by a U.S. corporation or at least 5 percent of the voting stock of which was owned by a U.S. corporation through a chain of foreign corporations connected by at least 10 percent voting stock ownership, would be taxed through subpart F on their pro rata shares of the corporation's post-1986 accumulated E&P that had not previously borne a U.S. tax.⁴⁸ Affected shareholders would be allowed to deduct 75 percent of their pro rata shares that were attributable to cash or liquid assets and 90 percent of their pro rata shares that were attributable to other assets.⁴⁹ The proposal assumed that when the transition tax would be imposed, the top U.S. corporate tax rate would be 35 percent. Thus, the maximum expected tax rate on the cash and liquid asset portion was 8.75 percent, and the maximum anticipated tax rate on the remaining portion was 3.5 percent.⁵⁰ The tax would be payable in installments over seven years,⁵¹ with no interest being charged on timely paid installments.⁵² The installments would be backloaded, so that the final two payments would account for 45 percent of the deferred tax liability.⁵³

The Camp transition tax obviously would not reach untaxed earnings accumulated before 1987. That design decision apparently sprang from judgments that a tax on pre-1987 accumulations would

yield little revenue⁵⁴ and that because corporations are unlikely to have readily accessible information regarding pre-1987 accumulations,⁵⁵ computing those amounts would be difficult.⁵⁶ If the first judgment is correct, we are comfortable with limiting the transition tax base to post-1986 accumulations. If that judgment is incorrect, however, there should be a careful examination of this issue that balances the potential revenue gain from including pre-1987 accumulations in the tax base against the taxpayer costs of calculating those amounts and the IRS's administrative costs of policing the taxpayer computations.⁵⁷

We disagree with Camp's rate differential between accumulations in liquid and nonliquid form. The seven-year installment payment period would be adequate to address concerns regarding shareholders who have liquidity problems. Moreover, the rate differential between distributions from liquid and nonliquid accumulations would create the potential for characterization controversies and an incentive for taxpayers who anticipate tax reform to convert liquid assets into nonliquid properties, even when the conversion lacks a sound business rationale. Thus, we see no justification for the disparate rates of transition tax imposed by the Camp proposal and, as previously explained, those rates would confer an unjustified windfall on the affected shareholders.

The Rate and Liquidity

More broadly, we see no need to apply any special preferential rates under a transition tax.⁵⁸ Professors Morse⁵⁹ and Daniel Shaviro⁶⁰ have suggested that the transition tax rate be discounted from the normal rate to compensate for their proposals to disallow foreign tax credits against the transition tax. Professor Morse has proposed a further discount on the theory that about half of the transition tax base accumulations would never have

⁴⁵See JCX-15-14, *supra* note 3, at 24.

⁴⁶For a full description of the Camp transition tax, see JCX-15-14, *supra* note 3, at 29-33.

⁴⁷See JCX-96-15, *supra* note 20, at 9.

⁴⁸See TRA 2014, *supra* note 44, at section 4003.

⁴⁹See JCX-15-14, *supra* note 3, at 29-30; and JCX-96-15, *supra* note 20, at 9.

⁵⁰See Andrew Velarde and Marie Sapirie, "Camp Plan Offers Dividend Exemption for Foreign Earnings," *Tax Notes*, Mar. 3, 2014, p. 891.

⁵¹The Camp proposal is sometimes described as providing for payment of the transition tax over an eight-year period. See JCX-15-14, *supra* note 3, at 29. This is basically true but somewhat misleading because the proposal actually states that payment is to be made in eight installments, with the first installment being due at the time of the tax return for the year in which the transition tax is imposed. See JCX-15-14, *supra* note 3, at 31. Thus, there are only seven deferred installments, and the deferral period is only seven years long.

⁵²See JCX-15-14, *supra* note 3, at 31.

⁵³See JCX-96-15, *supra* note 20, at 10.

⁵⁴See *id.* at 19; and Velarde and Sapirie, *supra* note 50, at 892.

⁵⁵See Morse, "Transition Tax," *supra* note 13, at 590-591.

⁵⁶See JCX-96-15, *supra* note 20, at 30; and Velarde and Sapirie, *supra* note 50, at 892.

⁵⁷Professor Morse has suggested the possibility of addressing any information difficulties regarding pre-1987 accumulated E&P by using financial accounting income as the measure of those accumulations. See Morse, "Transition Tax," *supra* note 13, at 594-599.

⁵⁸For a contrary view, see Senate Finance Committee, "International Tax Reform Working Group: Final Report," at 78 (July 7, 2015) (stating that the Senate working group was working to ensure that the transition tax have an "appropriate discounted rate").

⁵⁹See Morse, "Taxing," *supra* note 31, at 248.

⁶⁰See Shaviro, *Fixing U.S. International Taxation* 194 (2014).

been repatriated and subjected to U.S. taxation and therefore should be spared from the transition tax.⁶¹

As explained below, we do not regard the disallowance of FTCs as justifying a rate discount. Our reasons include the likelihood that taxpayers would avoid the disallowance by making strategic, pre-effective-date repatriations. Further, we do not believe the fact that a substantial portion of the offshore accumulations of U.S. multinationals are indefinitely reinvested overseas supports a rate discount. Doing so would mean that those investments were allowed to be made with what would effectively be partially pretax earnings⁶² when most business investments must be made out of post-tax earnings. Moreover, the income in question was earned when it was potentially subject to a nonpreferential rate. We see no reason in the case of this tax expenditure to waive the normal tax rate simply because future income would receive lenient treatment. We recognize that taxpayers may have bet that they might never have to pay U.S. tax or that Congress could be persuaded to apply a lower concessionary rate to those earnings. However, the regular tax rate was always a factor that these taxpayers were aware eventually could apply, and they assumed that risk. There is no sound tax policy reason to bail this small group of taxpayers out when others cannot so benefit.⁶³

Moreover, to the extent that a one-time transition tax is used to pay for reduced future rates under a reformed system, as would likely be the case, efficiency considerations argue in favor of taxing previously untaxed accumulations at the tax rate that regularly applied up to the time of transition. As stated by the staff of the Joint Committee on Taxation:

Efficiency considerations may suggest that the one-time tax should be set at the maximum corporate rate of 35 percent if . . . revenue from the one-time tax is used to lower the tax burden on future earnings.⁶⁴

The five-year installment payment system in the Obama proposal and the seven-year regime in the Camp proposal would be adequate to address not

only liquidity issues that might arise from the nonliquid holdings of foreign subsidiaries but also liquidity issues that might arise from imposing a lump sum tax on foreign earnings that have accumulated over many years. Thus, we disagree with proposals for low transition tax rates as measures to mitigate liquidity concerns. In our view, the rates applicable the day before the reformed U.S. international income tax regime becomes effective should generally apply.

We recognize that requiring shareholders of foreign subsidiaries to include their shares of historic foreign accumulations in a single year might produce an income spike. For almost all U.S. shareholders, this would not be a problem because they are C corporations that pay U.S. income tax at a flat 35 percent rate. If it were believed necessary to assist other U.S. shareholders, it would be sufficient to solve the spike problem by providing that the transition tax rate not exceed their marginal rate calculated without the required income inclusion.

Also, we disagree with the failure of both the Camp and Obama proposals to impose a market-rate interest charge on the deferred tax. As explained, the installment payment features of those two proposals, particularly the back-loading aspect of the Camp proposal, would address the liquidity issue. There is no reason for Treasury to assume the role of an interest-free or bargain-rate lender.⁶⁵

The limited literature seems to generally favor the Obama and Camp approaches of using the accumulated E&P of the foreign subsidiaries as the base of the transition tax.⁶⁶ We agree with that approach because it matches the understanding of shareholders that they were exposed to the risk of a tax on that E&P at some future time. Moreover, E&P does not include unrealized gains.⁶⁷ Thus, the E&P base prevents shareholders of foreign subsidiaries from bearing tax on unrealized earnings that would not be imposed on domestic investments.⁶⁸

A Deduction or Credit for Foreign Taxes?

A strong case can be made that creditable foreign income taxes attributable to E&P bearing the transition tax should be credited against that tax. This is consistent with our recommendation to impose the transition tax through the subpart F structure,⁶⁹ and both the Obama and Camp proposals would allow

⁶¹See Morse, "Taxing," *supra* note 31, at 248.

⁶²For example, taxing offshore accumulations at half the regular rate would be equivalent to exempting half of the accumulations from U.S. income tax and taxing the remaining half at the full pretax reform, regular rate.

⁶³See JCX-96-15, *supra* note 20, at 20; Calvin H. Johnson, "Transition to Territoriality Without Plunder: A \$725 Billion Tax," *Tax Notes*, Feb. 27, 2017, p. 1135; and Miller, *supra* note 4, at 73-74. By analogy, would taxpayers with taxation deferred because of depreciation deductions receive such beneficial tax rate reductions?

⁶⁴See JCX-96-15, *supra* note 20, at 20.

⁶⁵See Shaviro, "Tax-Selectivity," *supra* note 13, at 426.

⁶⁶See Morse, "Transition Tax," *supra* note 13, at 590-598; and Shaviro, "Tax-Selectivity," *supra* note 13, at 426.

⁶⁷See section 312(f)(1).

⁶⁸See Peroni, Fleming, and Shay, "Getting Serious," *supra* note 11, at 521.

⁶⁹See section 960 (allowing an indirect FTC for section 951(a) constructive inclusions).

the credit. If this approach were taken, it should be recognized that those foreign taxes were already deducted in calculating the base of the transition tax — the foreign corporation's E&P.⁷⁰ Thus, they should be added back to E&P to prevent the FTC from giving rise to a windfall because of an inappropriate double dip.

Allowing an FTC against the transition tax would, however, increase complexity. Although we do not regard international tax complexity as a critical concern, we acknowledge the argument by some commentators for simplifying this matter by forgoing the credit and leaving U.S. shareholders with the foreign tax deduction that is already built into the computation of E&P.⁷¹ After all, the primary purpose of the FTC is to prevent double taxation from prospectively chilling international business and investment. But the activities that produced the E&P in question have already occurred and cannot be affected by disincentives. Moreover, because fundamental corporate tax reform, which is what necessitates the transition tax, would likely be a one-time event, the denial of FTCs for historic E&P should not have a forward-reaching disincentive.⁷² Thus, there is a plausible case for disallowing FTCs and not making a commensurate reduction in the repatriation tax rate.

However, in spite of the theoretical possibility of denying FTCs, we see no principled way around the obligation in U.S. tax treaties to allow those

⁷⁰See generally reg. section 1.902-1(a)(9)(iii) (in determining "post-1986 undistributed earnings" for indirect credit purposes, E&P is reduced by foreign income taxes paid or accrued, regardless of whether they are creditable).

⁷¹See generally *id.* (for U.S. income tax purposes, a foreign corporation's E&P already reflects a deduction for foreign income taxes paid or accrued).

⁷²See generally Shaviro, "Tax-Electivity," *supra* note 13, at 421-423.

credits.⁷³ Also, as a practical matter, this issue may be rendered moot in many cases by the reality that if international tax reform gets close to being an accomplished fact, U.S. multinational corporations with significant unused FTCs will take action to trigger the payment of a sufficient amount of dividends from their foreign affiliates to absorb the credits before the effective date of the reform. In any event, given our view that the FTC is a central component of a properly designed international tax system and that international double taxation should be avoided as much as is administratively feasible,⁷⁴ we would favor allowing an FTC for creditable foreign taxes that are attributable to E&P giving rise to the transition tax.

Conclusion

For the reasons given, we advocate treating corporate foreign earnings accumulations that have not previously borne a U.S. tax as a subpart F inclusion for the U.S. shareholders (as defined in section 951(b)) of all CFCs and 10/50 corporations in the year before the effective date of transition to a reformed U.S. international income tax regime. This would impose a shareholder-level transition tax on all 10 percent-or-greater U.S. shareholders. The tax rates that apply should be the normal pre-reform rates, regardless of whether the accumulations are held in liquid or illiquid form and regardless of whether the accumulations are indefinitely reinvested abroad. Liquidity problems can be handled by allowing the tax to be paid in installments that bear market-rate interest. U.S. treaty obligations and longstanding international tax policy principles will require that FTCs be allowed against the transition tax. ■

⁷³See 2016 U.S. model income tax convention, art. 23.2; and 2006 U.S. model income tax convention, art. 23.2.

⁷⁴See, e.g., Fleming, Peroni, and Shay, "Two Cheers for the Foreign Tax Credit, Even in the BEPS Era," 91 *Tul. L. Rev.* 1 (2016).