Committee on Ways and Means

The American Competitiveness and Corporate Accountability Act of 2002
(Competitiveness - Inversions - Tax Shelters)
Summary of Legislation

The United States Tax Code is one of the most complex in the world. The inequities and burdens that our tax system imposes on U.S. companies, particularly those operating in international markets, are greater than those imposed by most other nations. The negative effects of our uncompetitive Tax Code are demonstrated by (1) the number, size, and frequency by which U.S. companies are acquired by foreign competitors[1] and (2) the increase in the number of companies reincorporating, in such places as Bermuda, to remain competitive and to avoid being bought by their foreign competitors. Further, the determination by the World Trade Organization (WTO) that both the Foreign Sales Corporation (FSC) and Extraterritorial Income (ETI) tax structures are illegal export subsidies, coupled with an uncompetitive tax system, indicate that our tax system needs substantial reform.

Therefore, the Committee on Ways and Means has developed a comprehensive package of tax reforms designed to improve the international competitiveness of the United States and its companies. The American Competitiveness And Corporate Accountability Act encourages existing companies to remain in the United States and new companies to incorporate in the United States. In particular, the legislation (1) imposes a 3-year moratorium on inversions, (2) removes the tax incentives for U.S. companies to invert, (3) modernizes, simplifies, and makes competitive our taxation of U.S. multinationals that compete in a global marketplace, (4) eliminates the unintended tax advantages that our tax system bestows on subsidiaries of foreign owned companies operating in the United States, (5) reduces the tax incentives for foreign acquisitions of U.S. businesses, and (6) reduces the use of abusive tax shelters.

The legislation is described below in three sections: Competitiveness, Inversions, and Tax Shelters. The three sections, when combined, produce the desired effect of keeping U.S. companies in the United States and improving the competitiveness of U.S. companies both at home and in foreign markets.

[1] During the period 1998-2000, 77% of all cross-border mergers involving a U.S. company, as measured by value, resulted in foreign companies acquiring U.S. companies. (February 27, 2002, Committee on Ways and Means Hearing.)

I. <u>COMPETITIVENESS PROVISIONS</u>

The United States taxes income on a worldwide basis. The United States taxes its corporate and individual citizens' income wherever it is earned (both inside and outside the U.S. borders).

Because the United States taxes income earned outside its borders, the U.S. tax system provides some relief from double taxation of foreign income. This relief comes in two forms, (1) limited deferral of U.S. taxation of active income earned abroad until it is paid to the U.S. parent company and (2) foreign tax credits for income tax paid to a foreign country to offset, at least partially, the U.S. tax on the same foreign income. However, these deferral and tax credit rules are extremely complex and often inadequate to prevent double taxation of the same income.

In an effort to ameliorate the burden placed on U.S. businesses competing in the global market, the United States enacted the Extraterritorial Income Act (ETI) and its predecessor the Foreign Sales Corporation (FSC). However, on January 14, 2002, the WTO Appellate Panel ruled that the United States' ETI regime was a prohibited export subsidy that violates U.S. treaty obligations. This marks the fourth time in the last 2 ½ years that the FSC-ETI tax regime has been found to be an export subsidy in violation of U.S. treaty obligations.

The FSC and ETI rules essentially result in a 5.25 percent U.S. income tax reduction on export income. The WTO rules treat direct taxes (income taxes) differently from indirect taxes (such as value added taxes). Indirect taxes, such as those used by most European countries through their VAT systems, can be rebated or reduced on exported goods. Income taxes, such as those imposed by the United States, cannot be rebated or reduced upon export. The WTO relied on this distinction to find that the FSC and ETI rules, which reduce income taxes on exports, were illegal subsidies.

Failure of the United States to comply with the WTO's decision and remove the export subsidy could result in retaliatory trade sanctions against U.S. exports. The authorized sanction amount is scheduled to be released by the WTO Arbitration Panel during the second half of July. The EU is seeking over $4 billion per year in sanctions.

In sum, the U.S. faces two issues. First, we have a complex and burdensome Tax Code that damages the competitiveness of U.S. companies. Second, the ETI-FSC attempt to reduce this burden is an impermissible export subsidy. Therefore, Ways and Means has crafted a tax reform package that is WTO compliant and enhances American competitiveness.

<u>Competitiveness Provisions</u>

1. Repeals the Subpart F Anti-Deferral Foreign Base Company Sales and Services Rules
2. Reforms Interest Allocation Rules
3. Reduces Foreign Tax Credit Baskets to Three
4. Extends the Foreign Tax Credit Carryover Period from 5 to 10 years
5. Repeals the 90% Limitation on the Use of Foreign Tax Credits for AMT Purposes

6. Recharacterizes Overall Domestic Losses
7. Increases Section 179 Small Business Expensing from $24,000 to $40,000 and increases eligible investment limits from $200,000 to $325,000
8. Provides Look-Through Treatment for Payments Between Related Controlled Foreign Corporations
9. Provides Look-Through Treatment for Sales of Partnership Interests
10. Repeals the Primarily Duplicative Foreign Personal Holding Company and Foreign Investment Company Rules
11. Applies Look-Through Rules to Dividends from Noncontrolled section 902 companies (10/50 companies)
12. Provides Deferral for Pipeline Transportation Income
13. Provides for Attribution of Stock Ownership through Partnerships to Determine Section 902 and 960 Credits
14. Provides Deferral for Commodity Hedging Income for Materials Used in Manufacturing Operations
15. U.S. Property not to Include Certain Assets Acquired by Dealers in Ordinary Course of Business
16. Provides for Equitable Treatment of Certain Mutual Fund Dividends
17. Provides an Election not to Use Average Exchange Rate for Foreign Tax Paid other than in Functional Currency
18. Repeals Withholding Tax on Dividends from Certain Foreign Corporations
19. U.S. Parent not have to Recalculate its Foreign Subs E&P Under “Unicap” Rules
20. Repeals the ETI Rules

In addition to keeping U.S. companies in the United States and increasing the competitiveness of our companies in the world market, these provisions simplify the Tax Code, provide more equitable taxation of U.S. multinationals, and permit companies to base their decisions on business considerations and not the Tax Code.

Simplification

The U.S. Tax Code, in particular the international provisions, are extremely complex and burdensome to comply with and to administer. This bill greatly simplifies the U.S. taxation of foreign income. For example, reducing the number of “baskets” into which foreign tax credits must be categorized from nine to three will cut the number of separate calculations that a taxpayer is required to make and to track. The repeal of the 90% limitation on the use of foreign tax credits for AMT purposes also reduces complex duplicative calculations and record-keeping.

Fairness

Many of the provisions reform inequitable rules and increase the fairness of the Tax Code. For example, the interest allocation provisions are reformed so that a company is not always required to allocate its U.S. interest expenses against foreign source income, particularly when the U.S. loan proceeds are used solely to support U.S. operations. The bill also extends the period during which foreign tax credits can be carried forward and, thus, allows taxpayers to more fully utilize foreign tax credits to prevent double taxation.

Business Planning

Several of these provisions also allow multinational corporations to make decisions and arrange their operations based on real-world business considerations rather than tax factors. For example, the repeal of the foreign base company sales and services rules allows companies to streamline their overseas operations. Currently, the foreign base company sales and services rules often force companies to set up complex, duplicative and inefficient operational structures in order to "fit" the complex, duplicative and inefficient U.S. tax rules.

II. INVERSION LEGISLATION

Recently, several prominent U.S. companies changed their principal place of incorporation to a foreign jurisdiction or announced their intention to do so. Among the benefits of "inverting" are the ability to: (1) remove foreign income from the U.S. taxing jurisdiction and (2) reduce U.S. tax on income earned in the United States through interest payments to a new foreign affiliate.

In addition to the competitiveness provisions that provide companies with an incentive to incorporate in the United States, the bill removes the tax advantages of foreign corporations with U.S. operations and imposes a 3-year moratorium on inversions. This bill, while incorporating some provisions contained in other bills, goes much further and is more effective at stopping inversions. The legislation: (1) reforms the rules governing the deduction of interest payments by U.S. subsidiaries to their foreign parents, (2) ensures that companies pay a tax when they transfer assets offshore, (3) ensures that top executives pay tax on their stock options at the time of an inversion transaction, much like shareholders pay tax on their stock, and (4) imposes a 3-year moratorium on inversions.

1. Related Party Interest Payments - Current Law

A major component, or as the Department of Treasury stated "the juice," of an inversion is the immediate tax benefit of "earnings stripping" through interest payments by the U.S. company to the new foreign parent. The interest payments are deductible in the U.S. (thus reducing the company's U.S. tax liability on income earned in the U.S.) and often subject to low tax in the foreign country to which the payments are made. This earnings stripping technique is not unique to inverted companies, but, is also employed by other foreign owned companies operating in the United States. Foreign companies currently use earnings stripping to substantially reduce their U.S. tax liability on income earned within the United States. U.S. companies cannot use this tax reduction technique to reduce their U.S. tax liabilities and, thus, are at a competitive disadvantage in their home country.

Under Tax Code section 163(j), a U.S. subsidiary of a foreign company currently can deduct all interest paid to a related foreign party so long as the U.S. subsidiary's debt to asset ratio is less than 1.5 to 1. If the U.S. subsidiary's debt to asset ratio is greater than 1.5 to 1, the interest deduction is limited to 50% of the subsidiary's adjusted taxable income (taxable income plus net interest expense, depreciation, amortization, depletion, and net operating losses.) Under current law, interest expense in excess of the 50% threshold is carried forward indefinitely and can be used in a subsequent year.

Changes to Related Party Interest Payments

1. **The 1.5 to 1 debt-to-asset safe harbor is eliminated.** Eliminating this safe harbor helps ensure that foreign companies are not eliminating their U.S. tax on income earned in the United States through interest payments to a foreign related party. In some circumstances, companies with a large amount of equity in

the United States can stay under the 1.5 to 1 safe harbor and still wipe out their entire U.S. tax liability.

2. **Related party interest expense is disallowed to the extent that the U.S. subsidiary of a foreign owned company's debt to asset ratio exceeds the foreign company's worldwide debt to asset ratio.** This provision helps prevent foreign owned U.S. subsidiaries from reducing their U.S. tax obligations by concentrating debt in their U.S. subsidiaries. In order to alleviate unintended consequences that these rules could impose on companies with significant financial operations, the provision provides a separate comparison of U.S. financial operations to worldwide financial operations.

3. **Reduces allowable interest expense from 50% to 35% of adjusted taxable income.** Current law allows foreign owned U.S. subsidiaries to reduce their U.S. tax liability by over 50% by making interest payments to a related foreign company. Decreasing the allowable interest percentage from 50% to 35% will reduce abusive tax reduction techniques while still allowing foreign companies to use related party debt for legitimate business investment. This provision does not limit a company's interest payments to unrelated entities.

4. **Reduces disallowed interest expense carryforward from infinite to 5 years.** Allowing a company to carryforward disallowed interest expense infinitely exceeds the purpose of the carryforward provision which is to allow flexibility to deal with fluctuations in income. A five year rule is consistent with other provisions in the Code and satisfies the intended purpose.

5. **Delayed effective date for non-inverted companies.** The effective date of these provisions will be delayed until taxable years after December 31, 2003 for
non-inverted foreign owned companies. This delay allows companies to adjust their debt structures to reflect the new law.

2. Corporate Costs of Inverting - Current Law

If a U.S. company transfers assets (such as stock in a foreign subsidiary) to a foreign parent company, gain in the assets is taxed at 35%. However, under current law, this corporate tax can be reduced or eliminated by foreign tax credits and net operating losses (NOLs).

Changes to Cost of Inverting Rules

This proposal imposes the full tax on the transfer of assets to a foreign entity. Inverted companies no longer will be able to utilize foreign tax credits, net operating losses, or other tax attributes to reduce or eliminate the tax on the transfer of assets. This proposal is intended to reduce the incentive to transfer U.S. owned assets to a foreign jurisdiction.

3. Taxation of Stock Options in Inversion Transactions - Current Law

Under current law, shareholders typically pay a capital gains "toll charge" on their stock when a company inverts. However, stock options and other types of stock based compensation held by top executives and directors are not taxed in the inversion.

Change to Stock Option Rules on Stock Inversions

This proposal imposes a 20% excise tax on the value of all stock options and stock based compensation held by insiders, top executives and directors when a company inverts. The provision will equalize the tax treatment of shareholders and corporate insiders. It also will give company executives a financial stake in the decision to invert, thereby aligning management's interests with shareholder interests. No other bill imposes a tax on stock options.

The four inversion provisions: (1) stop "mailbox" inversions, (2) reduce the use of related party interest payments to move U.S. profits out of the United States, (3) impose a full tax when foreign corporations transfer assets from a U.S. subsidiary to a foreign jurisdiction, and (4) better align the interests of corporate management and corporate shareholders. These provisions, when combined with the competitiveness provisions, level the playing field for U.S. companies and, thus, remove the ability and the incentives to move offshore.

4. 3-Year Moratorium on "Mailbox" Inversions

The most widely reported type of inversion is one commonly referred to as the "mailbox" inversion. This type of inversion occurs when a U.S. company switches only its place of incorporation to a low tax foreign jurisdiction (such as Bermuda) but does not change its overall corporate structure, its operations, or the location of its employees. For all purposes, other than tax, the company continues to be and act like a U.S. company.

Our legislation imposes a 3-year moratorium for transactions completed after March 20, 2002. These transactions are disregarded. The inverted company remains subject to U.S. tax and is treated as if it were incorporated in the United States. This moratorium will stop inversions while the other provisions of the bill enter into force. The moratorium also gives Congress and Treasury time to carefully and thoughtfully examine the effects of the bill on corporate behavior.

III. <u>TAX SHELTER LEGISLATION</u>

"A tax shelter is a deal done by very smart people that, absent tax considerations, would be very stupid."

– Michael J. Graetz
Professor of Law, Yale University

Part of American competitiveness is a clearly defined and effectively enforced "rule of law." Tax evasion undermines this principle and reduces the economic efficiency of the U.S. economy. This anti-tax shelter legislation is designed to ensure that taxpayers undertake transactions for legitimate economic reasons and not to illegitimately reduce their tax liabilities.

The provisions also promote increased disclosure and tax compliance by imposing increased penalties on taxpayers and promoters that fail to disclose transactions. Further, once the IRS discovers one improper transaction, it can require the promoters to disclose all taxpayers to whom the transaction was offered. Finally, these provisions close existing loopholes.

<u>Taxpayer Provisions</u>

- **Codifies the economic substance doctrine.** Requires that transactions (1) have a substantial non-tax business purpose **and** (2) involve a meaningful change (apart from Federal income tax effects) in the taxpayer's economic position. This change will eliminate the courts' inconsistent application of the economic substance doctrine and ensure that taxpayer's enter into transactions for legitimate economic and business reasons and not for tax avoidance.

- **Imposes taxpayer penalty for failure to report a "listed" transaction.** A listed transaction is a transaction that Treasury has specifically identified as an abusive transaction. (Penalty: $100,000 for individuals; $200,000 for all others)

- **Imposes taxpayer penalty for failure to disclose a "reportable" transaction.** A reportable transaction is a transaction that may or may not be abusive, but Treasury requires its disclosure based on objective factors such as differences in tax and book amounts. (Penalty: $10,000 for individuals; $50,000 for all others)

- **Imposes Strict liability penalties for transactions that lack economic substance.** (Penalty: 40% of understatement for non-disclosed "listed" or "reportable" transactions; 20% of understatement for disclosed transactions.) These strict penalties will discourage taxpayers from entering into tax avoidance transactions and encourage taxpayers to report transactions that may be close to the line.

- **Increases frivolous return penalty from $500 to $5,000.**

- **Imposes a $5,000 penalty for failure to report an interest in a foreign financial account.**

- **Provides that written tax shelter communications between taxpayer and accountant are not privileged.**

<u>Promoter Provisions</u>

- **Failure to file penalties.** Promoters and those materially involved with "reportable" or "listed" transactions must file transactions with IRS. Failure to file results in the following penalties: ("reportable" transaction $50,000; "listed" transaction greater of $200,000 or 50% of fees.)

- **Failure to provide list penalties.** Promoters and those materially involved with "reportable" or "listed" transactions must maintain a list of investors to whom the transactions were offered. Failure to provide a list to the IRS within 20 business days of request results in $10,000 per day fine until list is provided to IRS.

<u>Loophole Closers</u>

- Closes a loophole under current law that allows executives to defer taxation on executive compensation and requires executives to stand in line with other general creditors and employees if the company becomes insolvent.

- Prevents taxpayers from improperly (1) generating foreign tax credits, (2) creating immediate tax losses, and (3) converting ordinary income into deferred capital gain.

- Closes the loopholes that permit the same partnership losses from being deducted more than once.