CTJ Citizens for Tax Justice

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Contact: Steve Wamhoff
(202) 299-1066 x33

Key Provisions in H.R. 4213 Would Prevent Abuse of Foreign Tax Credits

A recent paper from the National Foreign Trade Council (NFTC), a lobby for multinational U.S. corporations, unfairly criticizes provisions to end abuses of the foreign tax credit[1]. These provisions, which are included in H.R. 4213, the jobs and "extenders" bill, would make our corporate tax system fairer and more rational.

The United States taxes the worldwide income of individuals and corporations that reside here. This is not particularly burdensome because the U.S. allows its taxpayers a credit against their U.S. taxes for any taxes paid to a foreign government. The purpose of the foreign tax credit is to avoid double-taxation, to ensure that the combined foreign and U.S. taxes paid on the income never exceed the U.S. taxes that would be paid on that income if it was generated in the U.S.

The provisions in H.R. 4213 related to offshore tax loopholes are estimated to raise a total of $14.5 billion over ten years. These provisions target practices that corporations use to obtain foreign tax credits that exceed what is necessary to avoid double-taxation. The following discusses the two provisions that make up over two thirds of the revenue impact.

Rules to prevent splitting of foreign tax credits from foreign income.

Some U.S. multinational corporations have found ways to "split" the foreign tax credit from the foreign income that it is supposed to shield from double-taxation. If a U.S. corporation can find a way to use the foreign tax credit for income that is not even taxable in the U.S., then the benefits of the credit exceed what is necessary to avoid double-taxation.

Here's one way they do it. A U.S. corporation can defer paying U.S. taxes on foreign income until that income is "repatriated," meaning it's brought back to the U.S. Often the foreign income is simply reinvested in the foreign subsidiary and it may never be repatriated.

Ostensibly, a U.S. company cannot use foreign tax credits for foreign taxes paid on income that is not yet subject to U.S. taxation because the U.S. taxes have been deferred. But some U.S. companies have found ways to have it both ways, so that they defer U.S. taxes on foreign income even while they take foreign tax credits for the foreign taxes paid on that income. This obviously has nothing to do with preventing double-taxation.

A U.S. corporation can defer income generated by its subsidiary only if that subsidiary is a corporation. But a U.S. corporation that owns part of a foreign entity may be able to

[1]National Foreign Trade Council, Inc., "National Foreign Trade Council Paper on Revenue Offsets in H.R. 4213, American Jobs and Closing Tax Loopholes Act of 2010," May 24, 2010. http://www.nftc.org/default/tax/NFTC%20extender%20position%20paper.pdf

characterize that entity as a corporation for purposes of deferral (meaning it can defer U.S. taxes on the income generated by the foreign entity until the earnings are repatriated). However, the U.S. company then includes the foreign taxes paid by that entity in its foreign tax credit calculation because the entity is treated as a partnership in the foreign country.

H.R. 4213 would prevent this sort of scheme by requiring that the foreign tax credit cannot be taken until the foreign income is taxable in the U.S.

The complaint put forth by the National Foreign Trade Council (NFTC) is that this amounts to a "retroactive" tax increase because the effective date of this provision includes some foreign taxes paid before the overall effective date of the bill. The reform would in fact apply to some foreign taxes paid before the May 20, 2010 effective date because they were paid (or accrued) within the U.S. multinational's taxable year that includes May 20, 2010. But the reform would apply to such income only to determine whether U.S. multinational corporations could use foreign tax credits based on taxes paid on this income in the future. This is not a retroactive change.

Perhaps more importantly, the NFTC's paper does not make any serious attempt to challenge the fairness of the reform provision other than to criticize its alleged retroactivity. It seems that even the corporate lobbyists cannot seriously dispute that these schemes have no place in a rational corporate tax system.

Denial of foreign tax credit on income not subject to U.S. taxes by reason of "covered asset acquisition."

When a corporation wants to buy an interest in another corporation, it often prefers to obtain the assets of the target entity rather than stock in the target entity. The short explanation for this preference is that the buyer can benefit from depreciation of the assets, and if the target entity is a foreign company, the buyer can manipulate the depreciation rules to increase its foreign tax credits beyond the foreign taxes it actually pays. These transactions, called "covered asset acquisitions," generate foreign tax credits on income that is not taxable in the U.S.

The corporation that wants to obtain an interest in another company can either obtain stock in the target or obtain its assets. Stocks do not "wear out" but have a value that simply goes up or down. So buyer's "basis" in stock is the price it pays pay to purchase the stock. If it sells the stock at a later date for more than what it paid to obtain it ("basis"), then the difference is a capital gain.

If the corporation buys assets, the buyer's "basis" is also the price it paid to obtain the assets, but the buyer can takes write-offs for the "depreciation" of the assets, i.e., the assumed decline in the value of the assets over time.

In some situations, the assets were already fully depreciated for tax purposes when they were held by the seller. The seller may have held onto them for several years, over which time they depreciated (for tax purposes) to zero. (The depreciation for tax purposes may not reflect economic reality, if the assets really do have value and can be sold again.) The new buyer should, in theory, carry over the seller's basis (which was zero in this example), but the tax laws allow a "step-up" in the basis to the purchase price of the assets. That means that the assets can be written off again, this time by the buyer.

There are reasons why corporations might prefer to buy stock in another corporation, rather than buying assets. Most notably, the shareholders in the "seller" corporation get a better deal on their taxes if the acquisition is a stock acquisition. In some cases, section 338 of the tax code allows buyer corporations to choose between stock and asset treatment of an acquisition, whatever the formal structure of the deal.

The problem is that corporations have figured out how to use section 338 to manipulate the foreign tax credit. U.S. corporations aren't supposed to use section 338 to obtain a "foreign corporation," so they get around that by obtaining an entity that is considered a corporation by its home country but is considered to be some other type of entity (like a partnership) in the U.S. The U.S. "buyer" corporation obtains the stock of the foreign entity whose assets have depreciated to zero or some low value, but gets the step-up in basis of the assets (in a transaction called a "covered asset acquisition.") This step-up in basis is recognized in the U.S. but usually not in the foreign country. The U.S. corporation, which is now the parent of the foreign entity, will use depreciation write-offs to lower its U.S. taxes, but the foreign government won't allow that depreciation because, under its tax rules, it considers the basis to be zero or some low value.

The end result is that depreciation for foreign tax purposes is less than it is for U.S. tax purposes. As a result, foreign taxes are paid on income that is not even taxable in the U.S. (because the greater write-offs allowed under the U.S. rules reduce taxable profits in the U.S.). The problem is that the U.S. parent company can get foreign tax credits based on foreign income that is not taxable in the U.S.

The main complaint made by the National Foreign Trade Council against this provision is that it will hurt "competitiveness," since the most of the companies that U.S. corporations compete with pay taxes on a "territorial basis," i.e., their home country taxes income generated in that country, but generally doesn't try to tax income generated by its taxpayers in other countries. In contrast, the U.S. taxes its taxpayers on their worldwide income (if repatriated back to the U.S.). The NFTC's complaint seems like an admission that the foreign tax credit is being used to do more than just prevent double-taxation. It's also being used to subsidize foreign tax systems, by helping U.S. corporations pay their foreign taxes.

The foreign tax credit was created solely to prevent double-taxation. To allow the credit to do more than that is an obvious abuse.