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Obama's Proposals to Address Offshore Tax Abuses Are a Good Start, but More Is Needed

On May 4, President Obama proposed several measures to protect the U.S. tax system from offshore tax abuses. The proposed measures, which address both tax avoidance and tax evasion, are steps in the right direction but could be stronger. The additional details made public by the Treasury Department on May 11 provide more reason to be hopeful, but also illustrate certain gaps in the administration's approach. For example, the President proposes to limit the rules allowing corporations to "defer" their U.S. taxes on foreign income. He would not repeal "deferral" altogether and he would largely exempt technology and pharmaceutical companies from even the weak limits he proposes. He proposes sensible steps to reduce abuses of the foreign tax credit and the "check-the-box" rules that allow multinational corporations to cause their subsidiaries' income to "disappear." His proposals to crack down on the use of secret accounts in offshore tax havens are also positive steps but could be much stronger.

Offshore Tax Abuses

There are two problems that the President hopes to address with his proposals. First, the tax code may create an incentive for companies to base their operation and jobs offshore rather than here in the U.S. Second, many individuals and corporations are abusing the tax system through off-shore schemes to avoid or evade their U.S. taxes on their U.S. income.

This report focuses more on the second problem, the problem of offshore tax abuses, because this is probably the greater threat and because the President's proposals are more focused on this problem.

The President's Proposals to Address Offshore Tax Abuses

Problem	Proposed Solution	Revenue Impact (in billions of dollars)
Offshore Tax Avoidance (not necessarily illegal)		
"Deferral"	Defer deductions for expenses (except R&E) related to deferred income	60.1
Foreign Tax Credit	Determine credit on "pooling basis"	24.5
Foreign Tax Credit	Prevent "splitting" foreign income and foreign taxes	18.5
"Check-the-box" rules.	Reform business entity classification rules for foreign entities	86.5
Intangible property	Limit shifting of income through transfers of intangible property	2.9
Earnings stripping	Limit earnings stripping by expatriated entities	1.2
Repatriation	Repeal rule limiting taxable gain in repatriation of earnings in cross-border reorganizations	0.3
80/20 Companies	Repeal 80/20 company rules which allow taxpayers to avoid withholding on U.S. dividends	1.2
Hedge fund "dividend loophole"	Prevent the avoidance of dividend withholding taxes	1.4
Dual-capacity taxpayers	Deny foreign tax credit for payments made in exchange for specific economic benefits	4.5
Offshore Tax Evasion (definitely illegal)		
Offshore tax havens	Combat under-reporting of income through offshore jurisdictions.	8.7
	Total Revenue Impact	**209.9**

The problem of U.S. tax abuses is straightforward. Too many American individuals and corporations are paying less than their fair share because they are taking advantage of offshore tax schemes that are not available to most ordinary Americans.

Many of these offshore tax schemes fall into two categories, which are described below.

1. Multinational Corporations Abusing U.S. Tax Rules

Some companies abuse the rules that determine if and when the U.S. will tax income they make abroad. They use complicated techniques to shift income offshore to delay or completely eliminate the U.S. tax on that income. For example, many corporations manipulate the rules related to "deferral" by making their U.S. income appear to be foreign income, so that they can "defer" U.S. taxes indefinitely.

These abuses may sometimes be illegal (meaning they constitute tax *evasion*). More often, they are practices that have never been found to violate U.S. tax laws, even though they clearly lead to results never intended by Congress (meaning they constitute tax *avoidance*). Many of these are practices that *ought to be illegal*.

Either way, these abuses usually involve sham transactions (transactions that have no real economic substance) that make a corporation's domestic income appear to be income earned abroad so that the U.S. company can enjoy the tax advantages that are available for "foreign" income.

2. Individuals Hiding Income in Tax Havens

Some Americans are simply hiding their income from the IRS, which is obviously always illegal (meaning it constitutes tax *evasion*). Most Americans have few, if any, opportunities to hide their income from the IRS, but wealthy people have many opportunities to hide their income in countries that prevent their banks from providing any information to the U.S. tax enforcement authorities.

In other words, wealthy Americans can engage in complicated transactions involving countries that we think of as "tax havens" to hide their income from the IRS. The use of tax havens for tax evasion has been estimated to cost around $100 billion a year. That's a lot of revenue that could go to education, health care or other investments we need but instead is lost because some wealthy people are willing to cheat on their taxes.

President Obama's Proposals

The proposals announced by the President on May 4 (and described in more detail by the Treasury on May 11) would take some small steps to reduce the ability of individuals to hide their income in tax havens, but the bulk of his proposals are more focused on abuses by corporations.

American individuals are supposed to pay U.S. taxes on all their income, regardless of where it is earned. American taxpayers receive a credit against their U.S. taxes for foreign taxes they pay, to avoid double-taxation.

American corporations are often effectively exempt from paying U.S. taxes on their overseas profits because they can "defer" U.S. taxes on those profits indefinitely – until the profits are repatriated (brought back to the U.S.). Even when the foreign income is repatriated (typically through a dividend paid to a U.S. parent company from its foreign subsidiary), the U.S. parent company still receives a credit for any foreign tax paid in order to avoid double-taxation when the foreign government has taxed the income already.

Several of the President's proposals address abuses of deferral and the foreign tax credit. He also proposes more limited, but nonetheless important, steps to crack down on tax evasion by individuals using tax havens.

Defer Deductions for Expenses Related to Foreign Income on which Tax is Deferred (with Exception for R&E)
Projected Nine-Year Revenue Impact: $60.1 Billion

Corporations are allowed to defer paying taxes on the profits of their offshore subsidiaries until those profits are brought home (repatriated). But some of the expenses a corporation incurs to earn offshore profits are deductible against their U.S. taxable income right away. Allowing immediate deductions of these expenses is, at best, a tax subsidy for moving operations offshore. Even worse, it makes corporations even more tempted to devise schemes to make it appear that their U.S. income is being earned offshore.

The Obama administration gives the example of a U.S. corporation that borrows money to acquire stock of a foreign corporation. The U.S. corporation can often take an immediate deduction against its U.S. taxes for the interest on the debt, even though U.S. taxes on any income generated by the foreign investment can be deferred indefinitely.

In 2007, House Ways and Means Chairman Charlie Rangel (D-NY) proposed, as part of a larger tax reform bill, to require that corporations defer deductions for expenses related to earning foreign income so long as they defer U.S. taxes on that foreign income. There is an intuitive logic to this reform. Right now, companies not only have a zero U.S. tax rate on their unrepatriated profits, but a *negative* tax rate because they can deduct some of the costs of earning those profits. The Rangel reform would reduce this "tax arbitrage," and would thus reduce some of the perverse incentive to move operations offshore or to shift income offshore through sham transactions. But it would be less effective than doing away with deferral altogether.

While Congressman Rangel's proposal was weaker than the optimal reform (repealing deferral), President Obama's proposal is even weaker than Rangel's proposal. The administration would require corporations to defer deductions for expenses on foreign income insofar as they defer U.S. taxes on that income, just as Rangel proposed, but the administration would further water down this reform by exempting research and experimentation expenses from the change.

Unfortunately, this exception is a boon to the tech and pharmaceutical companies, who are among the worst abusers of deferral. Ironically, the President proposes to use much of the money saved from his reforms to make permanent the tax credit for research and experimentation, to reward these companies a second time at a cost of $74.5 billion over ten years.

Closing Loopholes in the Foreign Tax Credit
Projected Nine-Year Revenue Impact: $43 Billion

The foreign tax credit (FTC) prevents double-taxation in a situation in which a foreign government taxes the income a U.S. taxpayer earns abroad. But companies should not be able to use the FTC to reduce U.S. taxes on their U.S. income. However, there are loopholes in the FTC that allow companies to do exactly this. The President's proposal would close two of those loopholes.

One way that corporations use the FTC inappropriately is to claim foreign tax credits for foreign tax paid on profits that are not yet subject to U.S. tax. For example, a U.S. corporation that owns part of a foreign entity can characterize that entity as a partnership for purposes of claiming the FTC (which allows it to immediately claim the FTC) but also characterize the foreign entity as a corporation for purposes of deferral (meaning it can defer U.S. taxes on the income generated by the foreign entity). In other words, the U.S. company can be inconsistent, under current law, in how it characterizes an entity to manipulate whether and when it will pay U.S. taxes on the foreign income. The President proposes to prevent this "splitting" of foreign taxes from foreign income.

The second loophole involves a U.S. corporation manipulating dividends. A U.S. corporation that controls several foreign corporations can manipulate which of the foreign corporations pays it dividends. In some circumstances, the U.S. company receiving these dividends is "deemed" to have paid a share of the foreign taxes paid by the foreign corporation. The U.S. corporation simply chooses to have a dividend paid by a foreign corporation with a lot of income that has not yet been repatriated and which resides in a high-tax jurisdiction. The resulting FTC is greater than the U.S. tax would have been on that income if it was generated in the U.S. The President's proposal would require that the deemed paid foreign tax credit is calculated on a consolidated basis, or "pooling basis," including all of the foreign subsidiaries' income repatriated to the U.S.

Eliminating Loopholes that Allow "Disappearing" Offshore Subsidiaries
(Reform "Check-the-Box" Regulations)
Projected Nine-Year Revenue Impact: $86.5 Billion

One exception to the general rule allowing U.S. corporations to "defer" U.S. taxes on their foreign income applies when certain types of payments, like interest payments, are made to offshore subsidiaries of U.S. companies. Congress made a decision many years ago that it would be simply too easy to concoct tax avoidance schemes with this sort of income if deferral

was not limited. Unfortunately, this limit was severely weakened in the mid-1990s with the adoption of the "check-the-box" rules, which the President proposes to reform.

In the mid-1990s, the Treasury mistakenly thought it would be a good idea to eliminate litigation over what legal form a business takes (e.g., corporation, partnership, limited liability company) for tax purposes by allowing businesses to decide the matter on their own by simply checking a box on a form.

Of course, simplification did result, in the sense that litigation always declines when the IRS simply stops pursuing a type of tax avoidance.

The check-the-box rules have been a particular disaster for offshore tax enforcement. The Obama administration gives an example of a U.S. company that owns a holding company in the Cayman Islands, which itself has a subsidiary in Germany that makes cars and another in the Cayman Islands that lends money to the carmaker in Germany. The loan has no real economic purpose whatsoever. The German carmaker makes interest payments to the other subsidiary in the Cayman Islands. The German carmaker thus can take deductions against the taxes it would otherwise pay the German government, perhaps enough to eliminate those taxes altogether. The subsidiary in the Cayman Islands has income (the interest payments from the German carmaker) but the Cayman Islands doesn't tax it.

But both the German carmaker and the Cayman Islands subsidiary are ultimately owned by the U.S. company, so their income is taxed by the U.S. As explained above, the U.S. company cannot defer taxes on the interest payments received by its subsidiary in the Cayman Islands. So you would think that the U.S. will tax this income.

Thanks to the check-the-box rules, however, the U.S. government is simply told that the subsidiary in the Cayman Islands is not a separate corporation from the German carmaker at all, so the interest payments are not income. They tell the German government the opposite, that the Cayman Islands entity is a separate corporation, so that the German subsidiary can take deductions for the interest payments, effectively eliminating its tax liability to the German government. In many, if not the vast majority of cases, the profits that are shifted to the Cayman Islands were initially U.S. earnings that were artificially shifted to Germany.

To project the U.S. tax base on U.S. profits (and, to a much lesser degree, to curb tax subsidies for actual foreign investments), the Obama administration would change the rules so that U.S. companies that establish certain offshore subsidiaries must treat them as corporations for U.S. tax purposes, to eliminate this type of scheme.

Limit the Ability to Shift Income Offshore through Transfer of Intangible Property
Projected Nine-Year Revenue Impact: $2.9 Billion

As already explained, a U.S. multinational corporation that has offshore subsidiaries does not have to pay U.S. taxes on the income generated abroad until that income is brought back to the U.S. (until that income is "repatriated"). So, figuring out how much of the income is

generated in the U.S. and how much is generated abroad is critical. If a multinational company can characterize most of its income as "foreign" it can reduce or even eliminate the U.S. taxes on that income.

Multinational corporations can often use intangible assets to make their U.S. income appear to be "foreign" income. For example, a U.S. corporation might transfer a patent for some product it produces to its subsidiary in another country, say the Cayman Islands, that does not tax the income generated from this sort of asset. The U.S. parent corporation will then "pay" large fees to its subsidiary in the Cayman Islands for the use of this patent.

When it comes time to pay U.S. taxes, the U.S. parent company will claim that it's subsidiary made huge profits by charging for the use of the patent it holds, and that because those profits were allegedly earned in the Cayman Islands, U.S. taxes on those profits are deferrable (not due). Meanwhile, the parent company says that it made little or no profit because of the huge fees it had to pay to the subsidiary in the Cayman Islands (i.e., to itself).

Rules related to these types of transfers of intangible assets are supposed to limit this sort of scheme, but there are plenty of loopholes for corporations to exploit. One problem relates to "residual" intangibles like goodwill and going concern value (the value of a company that is not connected to tangible property or separately-identifiable intangibles like patents). The regulations generally don't provide rules for valuing these assets, leaving it to taxpayers to manipulate the pricing and allocation.

There are additional ways that taxpayers can manipulate these rules. For example, suppose a U.S. company has 50 patents that, valued individually, aren't worth all that much. So when the foreign subsidiary "buys" these assets from its U.S. parent corporation, it "pays" a very low price and the U.S. parent corporation has little income to report from the tranaction. But when taken together, the patents have a very high value and the transfer price should have been many, many times more than the one computed for the purposes of this transfer.

The President's proposal would include workforce in place, goodwill, and going-concern value in the definition of intangible property for the purposes of these transfers. In addition, it would give the IRS the ability to value intangible properties on an aggregate basis. The proposal also would require that intangible property must be valued at its "highest and best use."

Limit the Ability of Foreign Companies to Strip Earnings from U.S. Subsidiaries
Projected Nine-Year Revenue Impact: $1.2 Billion

Any company operating in the U.S. is supposed to pay U.S. corporate taxes on its profits. This is true even if the company is a subsidiary of a foreign parent company. Unfortunately, foreign parent companies can engage in schemes to "strip" earnings from their U.S. subsidiaries to avoid U.S. corporate taxes.

For example, the foreign parent company could charge wildly inflated fees to its U.S. subsidiary so that the latter reports no income to the U.S. These "fees" will not be taxed by the U.S. so long as the foreign country involved has a treaty with the U.S. requiring that the home country taxes the income. But the home country could be one with a very low tax rate, which makes "earnings stripping" very attractive for some foreign companies with U.S. operations.

The tax law limits the ways corporations can avoid U.S. tax through earnings-stripping transactions. The President proposes to tighten these rules.

Close the "Dividend Loophole" for Offshore Hedge Funds
Projected Nine-Year Revenue Impact: $1.4 Billion

The United States generally does not tax U.S. income received by foreigners. An exception is made for certain types of income, like dividends, because Congress decided decades ago that it would be too easy to create tax avoidance schemes involving these forms of income if the U.S. didn't tax it. (This income is often called "passive" income.)

So U.S. companies paying dividends (or other types of passive income) to foreigners must collect a 30 percent withholding tax, unless the recipient's home country has a treaty with the U.S. ensuring the income will be taxed by the home country.

Naturally, some foreign investors (or U.S. investors posing as foreigners) like to disguise dividends as some other type of income ("active" income) which the U.S. never taxes when it is received by a foreigner. Offshore hedge funds sometimes receive dividends from U.S. companies but work with U.S. financial institutions to disguise those dividends as a different type of income.

In one such scheme known as an "equity swap," a U.S. institution holds stock in a literal sense but for all practical purposes, the party bearing all the risks and rewards that usually go with owning stock is an offshore hedge fund. The hedge fund receives payments from the U.S. institution equal to the dividends paid on the stock. (The U.S. institution will also pay the hedge fund an amount equal to any appreciation in the price of the stock, and the hedge fund will pay the U.S. institution an amount equal to any drop in the price of the stock.)

In other words, the situation is exactly as if the hedge fund owned the stock directly and received dividends on it, but since the payments made to the hedge fund are not technically dividends, they do not fall into the category of income to foreigners that the U.S. government taxes. Of course, the offshore hedge fund saves so much by avoiding U.S. taxes that it is willing to pay a fee to the U.S. institution for its help.

The President's proposal would tax all dividend-based income the same, meaning a payment that is not technically a dividend but is a dividend equivalent will be taxed just like a dividend.

Modify Foreign Tax Credit for Dual Capacity Taxpayers
Projected Nine-Year Revenue Impact: $4.5 Billion

When a foreign government imposes a levy that entitles the payer to a specific economic benefit, that levy is generally not a tax for purposes of the foreign tax credit. If part of the levy is tax and part is for the benefit, the regulations provide a method for the taxpayer (known as a "dual capacity taxpayer") to compute the creditable part of the tax. For example, suppose the foreign country imposes a 20 percent corporate income tax. Oil and gas companies are not subject to the corporate tax, but pay a "petroleum profit tax" of 75 percent which allows them to extract oil from government-owned land. The regulations will treat part of the petroleum profit tax as creditable foreign taxes and part as deductible royalty payments.

When the foreign country does not generally impose an income tax, the computation under the regulations will still result in some creditable foreign taxes. The President's proposal would eliminate this break and treat the levy as a creditable tax only if the foreign country generally imposes an income tax.

Improving the Rules Requiring Financial Institutions to Share Information
Projected Nine-Year Revenue Impact: $9 Billion

The United States generally does not tax U.S. income received by foreigners. As already explained, an exception is made for certain types of income, like dividends, because Congress decided decades ago that it would be too easy to create tax avoidance schemes involving these forms of income if the U.S. didn't bother to tax it.

So U.S. companies paying dividends (and certain other types of income) to foreigners must collect a 30 percent withholding tax unless the recipient's home country has a treaty with the U.S. ensuring the income will be taxed by the home country. The company making such payments forwards any withholding taxes it collects, along with information about the recipients of the income, to the IRS, which passes on the information to the foreign investors' home countries.

Foreign investors are not happy about the IRS telling their home countries about their U.S. investment income. To placate foreign investors, a program has been established in recent years in which foreign financial institutions (and foreign branches of U.S. financial institutions) can become "qualified intermediaries" (QIs) by agreeing to take on the responsibility of withholding the U.S. taxes on this income when it's received by non-U.S. persons — without revealing the identity of each individual. Foreign investors find this appealing, as do the banks who want them as customers. QIs also agree to provide information to the IRS about their U.S. customers.

Unfortunately, there are weaknesses in the QI system, which facilitate tax evasion. The administration aims to fix several of these weaknesses, including the following:

- It's easy for a U.S. person to pretend to be a foreigner holding an account in a non-QI.
- QIs can have affiliates that are non-QIs, and they can simply direct their customers to their non-QI affiliates to conduct any business that could constitute tax evasion.
- QIs have no obligation to report the foreign income of their customers to the U.S.

The combination of these weakness (and there are several others targeted by the administration) can lead to egregious tax evasion schemes.

Here is an example. American citizen Joe Moneybags opens an account in a non-qualified intermediary (non-QI) in the Cayman Islands and tells the non-QI that he is a foreigner. The non-QI forwards that false information on to a broker or company in the U.S. that makes a payment of some sort into his account at the non-QI. The payment is not the type of income that requires withholding when made to foreigners, but of course it is taxable when received by Americans. But since no one knows Joe is an American, the income leaves the U.S. without being taxed.

Then Joe has the money transferred from his account in the Cayman Islands non-QI to his account in a reputable QI in another country. Since the QI is under no obligation to report to U.S. tax authorities income that its American customers receive from *outside* the U.S., the IRS may never find out that Joe has received this income in his QI account. To make matters worse, the non-QI in this example could actually be an affiliate of the QI, which invites abuses by QIs who want to facilitate tax evasion but cannot do so directly because of their agreement with U.S. tax authorities.

The administration proposes several changes to the QI program including, among others:

1. A requirement for tax withholdings from all payments of U.S. income from U.S. financial institutions to foreign financial institutions that are non-QIs, unless investors disclose their identity and demonstrate that they are following the law.
2. An presumption that every account held by a U.S. person at a non-QI has enough money in it to require filing of a Foreign Bank and Financial Account Report (FBAR), which would make it easier for the IRS to see what transactions are being made by an account holder.
3. A requirement that QIs' not have any affiliates that are non-QIs.
4. A requirement that QIs file a Form 1099 for each U.S. customer, just as U.S. banks are required to do.