

7-1-2012

Corporate International Taxation Reform: Should US move towards a Territorial Tax System

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Corporate International Taxation Reform:

Should US move towards a Territorial Tax System?

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Abstract:

One of the most current and highly debated issues facing the Obama Administration is: - the restructuring of the present corporate income tax system. More specifically, congress and the president's administration are pressed with a decision as to whether to consider plans to reform the deferral of overseas income earned by US multinational corporations and ultimately move the US from a worldwide system of international taxation towards a territorial tax system. This paper highlights a current problem upon which the US taxes multinational corporations. Many in favor of a territorial tax argue that it is a much needed change to a system that has not seen significant amendment since the Tax Reform Act of 1986 and that the US adheres to a system designed when its own economy dominated the world. Additionally, supporters claim that a shake up to international tax system is necessary if US multinational companies are to compete in a global environment. They assert that if no drastic changes are made, US companies will suffer a competitive disadvantage.

In assessing whether this new territorial tax system is plausible this paper will highlight four main issues that face US multinational corporations, those being (1) Controlled Foreign Corporations (CFC) rules, (2) foreign tax credits (3) Transfer pricing and Accounting Principles Board Opinion 23 – Accounting for Income Taxes – Special Areas (APB 23). Moreover, this paper encompasses the pros and cons of this new territorial tax system proposal. Finally, this paper draws from the writer's work experience and gives alternative considerations that can also be adopted for US multinationals.

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Section 1: Introduction

Taxes play a vital role in society. Because of this we must recognize and understand the tax policies and laws that permeate our society. There are three main factors that play a significant role in influencing and forming the US tax code, those being based on: economic, social and political justifications. Having an understanding of what the influences that make up the US tax system are illustrates how convoluted and complex the tax code is and can be. Many professional tax preparers argue that a reform is needed to simplify the code. However, no more is this truly evident and has there been such an outcry for reform than when it comes to the US corporate tax system. Many individuals support a reform and argue we should follow other industrialized nations. While others argue that a reform is not needed and that it is futile to compare the US to other nations because the US is the world's largest economy and therefore should make its own reform policy and not follow others. The debate over reforming the corporate code has become so heightened that Congress and other politicians have joined the bandwagon. While these politicians agree that reforming the entire system is not practical, they have singled out one of the most important issues facing corporate taxation today - the tax treatment of corporate international cross-border transactions. In trying to address how to go about fixing this issue, Congress is faced with two options – keep and reform the current worldwide tax system or move to a territorial tax system?

The structure of this paper is as follows. Section 2 explains the influences that shape the US tax code as well as the importance of corporate international Tax Reform. Section 3 presents cases and a debate of whether we should keep our worldwide tax

system or move to a territorial tax system. It also discusses the pros and cons of the territorial System as it relates to CFCs & FTCs, Transfer Pricing and the APB 23 provision. Section 4 draws from the author's work experience and gives other considerations that can also be adopted for US multinationals. Lastly, section 5 provides a conclusion.

Section 2: The shaping of US tax code and the importance of reform

The US tax policies, laws and provisions are shaped not only by social ideas and vested interest but also by changing economic conditions which to some degree all play a crucial role in our society. For example, in an effort to stimulate growth and to keep abreast with changing economic conditions the tax system has been used quite frequently to accomplish economic objectives. For example, the tax code allows for the use of depreciation write-offs as a way of controlling the economy. Congress passed this tax legislation with the view that shorter lives and accelerated methods should encourage additional investment in depreciable property acquired for business use. Similarly social considerations have also influenced some provisions of the tax code. For example, the tax code allows a deduction for contributions to qualified charitable organizations. One can view this deduction as a clear attempt to shift some of the financial burden of socially desirable programs from the government to the private sector. Finally, political influences have undoubtedly shaped our tax laws and policies. Since Congress has been granted the responsibility of repealing and establishing tax law there is no surprise that lobbyist considerations would make its way into our tax code. For example, in the establishment of the American Jobs Creation Act of 2004,

former Democratic Senator of Georgia, Zell Miller, sponsored a provision that called for the suspension of import duties on ceiling fans. Ironically, the nation's largest seller of ceiling fans is Home Depot, which just so happens to be based in Atlanta Georgia.

The importance of corporate taxation in today's global environment is paramount. Whether a corporation is establishing, acquiring, expanding or selling a business within or outside US, it needs to stay on top of a rapidly changing global tax system. Corporations are increasingly looking to maximize their tax benefits and to maintain a competitive advantage. Many reformers argue that the rules and regulations governing US international tax are undoubtedly complex and require knowledge and insight at the federal, state and local levels. Additionally, reformers assert that the US currently adheres to a system designed when its own economy dominated the world and that much needed change is required because the international corporate tax system has not seen significant amendment since the Tax Reform Act of 1986. For these reasons many fear that US multinationals face a competitive disadvantage and will continue to do so unless there is an overhaul of its corporate tax system.¹

Section 3: Cases and Pros and Cons

Section 3.1:- *Keep our worldwide tax system or move to a territorial tax system? – An examination of cases.*

Legislature and the Obama administration agreed that the tax treatment of corporate international cross-border transactions is in need of dire reform. One initiative currently

¹ Tax changes should look beyond America. (2009). International Tax Review, (09587594), n/a-n/a. Retrieved from <http://search.proquest.com/docview/230199380?accountid=13044>

being circulated is the proposal of a territorial tax system by the House Ways and Means Committee Republicans led by Chairman Dave Camp of Michigan. This type of tax system is beginning to draw considerable support and is currently backed by a growing number of voices ranging from the Bowles-Simpson commission, to the House Republicans, to leading contenders for the Republican presidential nomination. In assessing whether the Committee's proposal is plausible this paper will highlight four main issues that face US multinational corporations, those being (1) Controlled Foreign Corporations (CFC) rules, (2) foreign tax credits (3) Transfer pricing (4) Accounting Principles Board Opinion 23– Accounting for Income Taxes – Special Areas (APB 23). While those familiar with corporate international taxation will recognize that these factors are to some degree related and may overlap each other, however, a separate analysis into each is warranted.

(1) How both systems deal with CFCs:

To first dissect the Committee's proposal we must first have an understanding of how the territorial tax system deals with CFCs. Under a territorial tax system profits of a multinational corporation are only taxed by the country where the income is earned, that is, income earned by foreign subsidiaries and branch operations e.g., a foreign owned company with a subsidiary operating in the United States is exempt from their country's domestic corporate income tax. This newly proposed tax system is contrary to the current tax system being implemented to deal with foreign source income. The current US tax system employs a worldwide system whereby companies registered as U.S. domestic companies are subject to taxation on all income regardless of where income is

earned, that is, domestically or internationally and are allowed a credit for foreign taxes paid on net foreign source income so that corporations are not taxed twice on the same income (first by a foreign tax authority and then by the Internal Revenue Service). Because US owned foreign corporation with exclusive operations overseas are not subject to US corporate income tax on their profits, the tax code stipulates that such profits will be taxed to the US shareholders only upon repatriation back to the US as dividends. However, because some corporations may continue to defer indefinitely any US tax on all their foreign profits and never divvy them back to the US, there exist a potential for abuse. To fix this exploitation Congress enacted provisions to limit the availability of deferral. Under the controlled foreign corporation (CFC) rules of subpart F, the US taxes certain types of income earned by CFCs, whether or not it is distributed to plug the loophole of indefinite deferral.

To fully comprehend the current US worldwide tax system, an understanding of what a CFC is and what are the rules governing Subpart F is essential. According to the tax code, certain types of income generated by CFC are currently included in gross income by the US shareholder without regard to actual distributions. For subpart F to apply, the foreign corporation must have been a CFC for an uninterrupted period of 30 days or more during the taxable year. When this is the case US shareholders must include in gross income their pro rata share of subpart F income and increase in earnings that the CFC has invested in US property for the tax year. This rule applies to US shareholders who own stock in the corporation on the last day of the tax year or on the last day the

foreign corporation is a CFC. The gross income inclusion must be made for their taxable year in which the taxable year of the CFC ends.²

To illustrate here are two examples:

Li Inc., a calendar year corporation, is a CFC for the entire tax year. Claudia Company, a US corporation, owns 60% of Li's one class of stock for the entire year. Subpart F income is \$100,000 and no distributions have been made during the year. Claudia, a calendar year tax payer, includes \$60,000 ($\$100,000 \times 60\%$) in gross income as a constructive dividend (an undeclared dividend by the company that involves the use of corporate assets) for the tax year.

Li Inc., is a CFC until July 1st of the tax year and earns \$100,000 of subpart F income. Dawn, a US citizen, owns 30% of its one class of stock for the entire year. She includes \$14,877 ($\$100,000 \times 30\% \times (181\text{days}/365\text{ days})$) in gross income as a constructive dividend for the tax year.

A US shareholder of a CFC does not necessarily lose the ability to defer US taxation of income earned by the CFC. Only certain income earned by the CFC triggers immediate US taxation as a constructive dividend. This tainted income is sometimes referred to subpart F income and can be characterized as income with little or no economic connection with the CFC's country of incorporation. Subpart F income includes income such as – insurance income (§ 953) – income attributed to insuring risk of loss outside the country in which the CFC is organized. Foreign based company

² Subpart F, § 951 – 964 of US Federal Tax Code

income (§954) – income transactions whereby a CFC earns income that lacks any economic connection to its country of organization, it includes foreign personal holding company income (royalties, rents and annuities), foreign based sales income, foreign based company service income and foreign base company oil-related income. Illegal bribes and Income derived from a § 901 (j) foreign country - sanctioned countries.³ These types of income are included in U.S. gross income by U.S. shareholders as they are generated, not when they are repatriated.

With regards to what a CFC is. The tax code stipulates that a CFC is any foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by US shareholders on any day during the taxable year of the foreign corporation. The foreign subsidiaries of most multinational US parent corporations qualify as a CFC. For purposes of determining if a foreign corporation is a CFC, a US shareholder is defined as a US person or another corporation who owns, or is considered to own, 10% or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly, and constructively is counted. Indirect ownership involves stock held through a foreign entity, such as a foreign corporation, foreign partnership or foreign trust. This stock is considered to be actually owned proportionately by the shareholders, partners or beneficiaries. Constructive ownership rules apply in determining if a US person or corporation is a US shareholder, and in

³ Willis, Eugene, William H. Hoffman, David M. Maloney, and William A. Raabe. "Chapter 25: Taxation of International Transactions." South-Western Federal Taxation 2010: Comprehensive Volume. Mason, OH: South-Western Cengage Learning, 2010. 25. Print.)

determining whether a foreign corporation is a CFC and for certain related party provisions of Subpart F.⁴

To illustrate here is an example:

Shareholders	Voting Power	Classification
Claudia	30%	US person
Qian	9%	US person
Wei	40%	Non US person
Radekha	20%	US person
Irfan	1%	US person

Qian is Claudia's daughter. Claudia, Qian and Radekha are US shareholders. Claudia own 39%, 30% directly and 9% constructively through Qian. Qian also owns 39%, 9% directly and 30% constructively through Claudia. Thus Qian is a US shareholder. Radekha owns 20% directly. The corporation is a CFC because US shareholders own 59% of the voting power. Irfan, a US person, owns 1% and is not related to any of the other shareholders. Thus, Irfan is not a US shareholder and would not have to include any of the Subpart F income in gross income. If Qian were not

⁴ § 958 and 318 (a) of US Federal Tax Codes

related to Claudia or to any other US persons who were shareholders, Qian would not be a US shareholder and the corporation would not be a CFC.⁵

(2) How both systems deal with the foreign tax credits:

If we turn our attention to how the territorial tax system deals with foreign tax credits (FTCs) and compare it to how the US currently treats them we may also be able to draw a conclusion on which system may be better for adoption. Because the territorial system simply seeks to permanently exempt dividends and income earned from foreign subsidiaries and branch operations of US based multinationals entities from income of their US parent, the issue of FTCs is not applicable and will simply be eliminated, that is, FTCs would simple be unnecessary. This system is contrary to the worldwide tax system currently being implemented. Under such system, the US retains the right to tax its citizens and residents on their world-wide taxable income. This approach can result in double taxation which is a problem to US persons and corporations who invest abroad. In dealing with this problem, Congress enacted the FTC provision which allows a tax credit (a dollar for dollar reduction of US income tax liability) for foreign income taxes paid.

⁵ Willis, Eugene, William H. Hoffman, David M. Maloney, and William A. Raabe. "Chapter 25: Taxation of International Transactions." South-Western Federal Taxation 2010: Comprehensive Volume. Mason, OH: South-Western Cengage Learning, 2010. 25. Print.)

To illustrate here is an example:

Bob's Appliances, Inc., a US corporation, has a branch operations in Brazil from which it earns taxable income of \$750,000 for the current year. Bob Inc. pays income tax of \$150,000 on these earnings to the Brazilian tax authorities. Bob Inc. must also include the \$750,000 in gross income for US tax purposes. If we assume that, before calculating the FTC, Bob Inc. owes \$255,000 in US income taxes on their foreign source income, then total taxes on the \$750,000 would equal \$450,000 (\$150,000 + \$255,000), a 54% effective tax rate. But Bob Inc. takes an FTC of \$150,000 against its US tax liability on the foreign source income. Bob Inc.'s total taxes on the \$750,000 now are \$255,000 (\$150,000 + \$105,000), a 35% effective tax rate.⁶

(3) How both systems deal with transfer pricing:

Turning our attention to how the territorial tax system deals with transfer pricing and comparing it to how the US currently treats them may further our understanding and help us to draw a conclusion on which system may be better for adoption. However, this may not be possible because according to the House Ways and Means Committee Republican Chairman, Dave Camp of Michigan, the proposal is simply a discussion draft and serves as a beginning point for substantive debate about reforming the corporate tax code. As such a comparison with regards to transfer pricing is not plausible because the proposal does not incorporate how it plans to deals with transfer

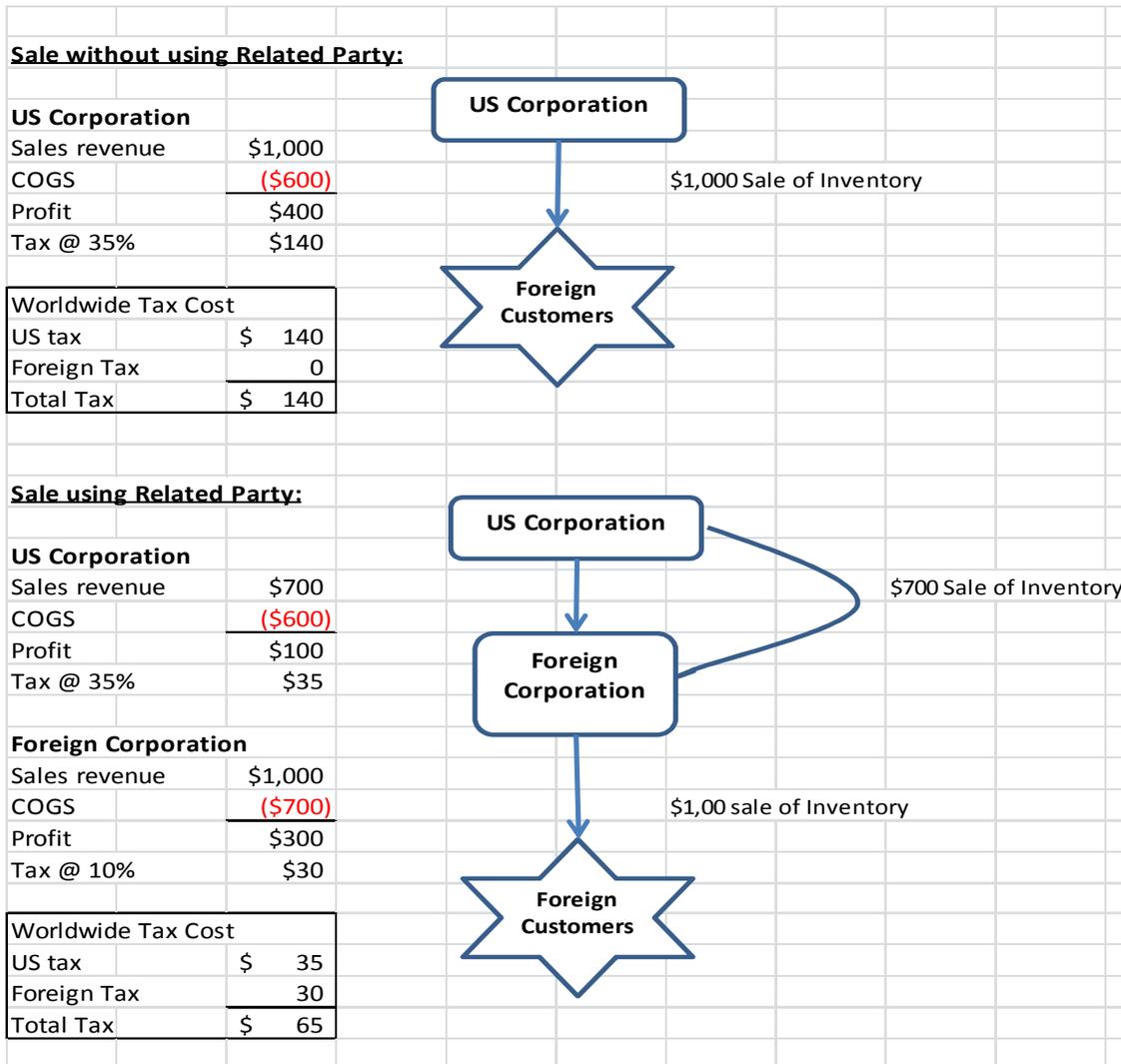
⁶ Willis, Eugene, William H. Hoffman, David M. Maloney, and William A. Raabe. "Chapter 25: Taxation of International Transactions." South-Western Federal Taxation 2010: Comprehensive Volume. Mason, OH: South-Western Cengage Learning, 2010. 25. Print.)

pricing issues. However, by looking at the previous treatment of how territorially deals with CFCs and FTCs we can infer that because territorial systems exempts dividends, transactions between a foreign subsidiary and its domestic parent will move taxable income into or out of the territorial exemption.⁷ This is contrary to the current US system that places great emphasis on transfer pricing rules under section 482 to ensure that corporations and taxpayers do not inappropriately shift income between domestic and foreign operations. Under section 482 of the tax code, the IRS has the power to reallocate gross income, deductions, credits, or allowances between or among organizations, trades, or businesses owned or controlled directly or indirectly by the same interests. This can be done whenever the IRS determines that reallocation is necessary to prevent evasion of taxes to reflect income more clearly. In essence what this means is that Section 482 is a “one-edged sword” available only to the IRS. The taxpayer generally cannot invoke it to reallocate income and expenses.⁸

⁷ General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals, Feb. 2011

⁸ Reg. §1. 482 – 1(a) (3) of US Federal Tax Code

To illustrate here is an example:



In looking at the above example, C&L is a U.S. corporation that manufactures and sells inventory to an unrelated foreign customer. The sales price for the inventory is \$1,000 and the related cost of goods sold (COGS) is \$600. The resulting profit is \$400 all taxed to the US corporation, resulting in a \$140 US income tax liability ($\$400 \times 35\%$). If C&L has no business presence in the foreign jurisdiction and is merely selling to a customer located there, the foreign government is unlikely to impose any local tax on the U.S. Corporation. Consequently, the total tax burden on the sale is \$140. However,

suppose instead that C&L attempts to reduce its total tax expense by channeling the inventory sale through a foreign subsidiary located in the same country as the foreign customer. In this case, because C&L controls the foreign subsidiary, it chooses an intercompany sales price (the transfer price) that moves a portion of the profits from the U.S. to the foreign country. By selling the inventory it manufactured to its 100% owned foreign subsidiary for \$700 the US Corporation reports only \$100 of profits and an associated US tax liability of \$35. The foreign subsidiary then sells the inventory to the ultimate customer for \$1,000 and, with a \$700 COGS earns a \$300 profit. In this example, the foreign country imposes only a 10% tax on corporate profits, resulting in a foreign income tax of \$30 ($\$300 \times 10\%$). By using a related foreign entity in a lower tax jurisdiction, the US Corporation has lowered its overall tax liability on the sale from \$140 (all US) to \$65 (\$35 US and \$30 foreign).⁹

The critical question is whether the IRS will view the \$700 intercompany sales price as the appropriate transfer price. Under § 482, the IRS may question why the foreign corporation deserved to earn \$300 of the total \$400 profit related to the manufacture and sale of the inventory. In general, the US Corporation must document the functions performed by the foreign corporation, the assets it owns in producing the income. Without documentation of significant functions, assets or risks of the foreign subsidiary, the IRS will not consider the \$300 profit earned by the foreign corporation to be appropriate and it will adjust the transfer price upward. If the IRS determines that the transfer price should have been, \$990, and then the US Corporation reports a \$390

⁹ Willis, Eugene, William H. Hoffman, David M. Maloney, and William A. Raabe. "Chapter 25: Taxation of International Transactions." South-Western Federal Taxation 2010: Comprehensive Volume. Mason, OH: South-Western Cengage Learning, 2010. 25. Print.)

profit (with \$136.5 US income tax) and the foreign corporation earns a \$10 profit (with \$1 in foreign income tax). With this change in transfer price the US Corporation does not succeed in transferring a meaningful portion of its profits to the lower tax jurisdiction and reduces its tax liability by only \$2.50.¹⁰

(1) How both systems deal with ABP 23 Opinion:

In furthering our understanding of which system may be better for adoption we should consider how multinationals treat special types of corporate tax preferences under both tax systems. More specifically, if we analyze how multinationals utilize the treatment of APB 23 provision under both systems we may be able to draw a conclusion as to which system is better for adoption. However, before we can continue with our comparison we must first have a conceptual understanding of what essentially is the APB 23 provision. In effect, the APB 23 provision was named after Opinion No. 23 issued by the Accounting Principles Board in 1972 (the predecessor of the Financial Accounting Standards Board – FASB). APB 23 is one of the 19 remaining opinions that are still used and in effect today. APB 23 has been adopted by FASB and is used to establish accounting guidelines for income taxes for special areas dealing with corporations and its subsidiaries. Though the FASB has amended and replaced certain sections of this guideline to correspond with the complexities of today's multifaceted corporate tax transactions, the majority of its initial ruling still retains in its originality and is followed today by many companies as a generally accepted accounting principle.

¹⁰ Willis, Eugene, William H. Hoffman, David M. Maloney, and William A. Raabe. "Chapter 25: Taxation of International Transactions." South-Western Federal Taxation 2010: Comprehensive Volume. Mason, OH: South-Western Cengage Learning, 2010. 25. Print.)

The current tax system for an APB 23 provision stipulates that a corporation can make an assertion to treat the earnings of any CFC as being invested indefinitely offshore under APB 23. Earnings indefinitely invested in this fashion will only suffer from a local tax expense. Thus under this pronouncement, a multinational corporation can reduce its tax expense from 35%, the current US tax rate, to a 10% on a CFC paying taxes at a 10% local tax rate. Fundamentally, in creating and setting standards that deals with the issue of accounting for income taxes, the predecessor to FASB provided an exception rule to the recording of a deferred tax liability with respect to the excess of book basis over tax basis in the stock of a foreign subsidiary if there exists sufficient evidence that the foreign subsidiary has invested or will invest its undistributed earnings indefinitely, that is, if the investment is essentially permanent in nature and extent. This exception to the recording of a deferred tax liability has come to be known as the APB 23 provision.¹¹

Essentially what the APB 23 provision is saying is that a corporation's tax provision will not include an accrual of U.S. taxes that would be due on repatriation of foreign earnings if that corporation's foreign earnings from its foreign subsidiary are deemed to be permanently reinvested. However, for a corporation to take advantage of the APB 23 provision they must evaluate whether the foreign earnings qualify for the indefinite reinvestment plan. In doing so they adhere to the six factors outlined in APB 23, paragraph 8: (i) financial requirements of the U.S. shareholder, (ii) financial requirements of the controlled foreign corporation, (iii) operational and fiscal objectives of the parent company, long-term and short-term, (iv) remittance restrictions imposed by

¹¹ Id. § 31 (a), 288 (f); Accounting for Income Taxes – Special Areas, APB Opinion No. 23, supra note 100

governments, (v) remittance restrictions imposed by lease or financing agreements of the subsidiary and (vi) tax consequences of the remittance.¹² Furthermore the US Corporation must show an indefinite reinvestment plan as outlined in paragraph 31 of APB 23. The guideline asserts that a US parent company has to provide specific documentation of detailed plans for reinvestment of the undistributed earnings. Examples of such documentation include items such as past experience, planned foreign mergers and acquisitions, and overall needs for the undistributed earnings to stay offshore. This documentation must reflect a viable plan and rebut the presumption on repatriation.¹³

To illustrate how APB 23 works, here is an example:

	Consolidated Income Statement (APB 23 Used)	Consolidated Income Statement (APB 23 Not Used)
Pretax Financial Income	\$60,000,000	\$60,000,000
Current Tax Expense	\$14,000,000	\$14,000,000
Deferred Tax Expense	\$0	\$7,000,000
Net Income	\$46,000,000	\$39,000,000

The above example illustrates how the APB 23 provision works and demonstrates its financial accounting advantage. If we are to assume a US parent owns 100% of the stock of a foreign subsidiary. The U.S. parent's basis in the stock of the foreign subsidiary is \$1 million for book and tax purposes. The U.S. Parent has pretax financial income of \$40 million in 2007, and the foreign subsidiary has pretax financial income of

¹² Id. § 31 (a), 288 (f); Accounting for Income Taxes – Special Areas, APB Opinion No. 23, paragraph 8

¹³ Id. § 31 (a), 288 (f); Accounting for Income Taxes – Special Areas, APB Opinion No. 23, paragraph 31

\$20 million in 2007. Assume the U.S. parent is subject to a 35% U.S. tax rate, and the foreign subsidiary is located and operating in a no-tax jurisdiction. Under the consolidation/equity method, the U.S. parent will include the foreign subsidiary's pretax financial income in its consolidated income, thereby increasing pretax financial income to \$60 million for 2007. If the U.S. parent was required to record a deferred tax liability for the excess of its book basis over its tax basis in the stock of its foreign subsidiary, then the U.S. parent would record a \$7 million deferred tax liability (\$20 million times 35%) and an increase to deferred tax expense of \$7 million. This would reduce the consolidated net income from \$46 million (\$40 million of income less \$14 million in taxes plus \$20 million income from the foreign subsidiary) to \$39 million. In business terms, the U.S. parent takes a charge or hit to earnings of \$7 million as a result of recording the deferred tax liability. If the U.S. parent can show that the foreign subsidiary has invested or will invest the undistributed earnings indefinitely, then the U.S. parent may utilize APB 23 to avoid recording a \$7 million deferred tax liability, and thereby avoid a \$7 million increase to deferred tax expense that is, the charge to earnings. As a result, the consolidated net income will remain at \$46 million. By utilizing APB 23, the consolidated net income is \$7 million higher than it would be in the absence of APB 23. In addition, the effective tax rate is lowered as a result of utilizing APB 23. In the example, the effective tax rate utilizing APB 23 is equal to 23.33% (\$14 million income tax expense divided by \$60 million operating income). If APB 23 is not applicable, the effective tax rate is equal to 35% (\$21 million income tax expense divided by \$60 million operating income).¹⁴

¹⁴ Liguori, Albert, Bill Ling, Jennifer Jung, and Rosann Torres. "A&M Tax Advisor Weekly - Alvarez & Marsal." *Global*

Here is another less complex and straightforward example:

	Non - APB 23	APB 23
Earnings Before Tax (EBIT)	\$100	\$100
Local Tax, e.g., 20% of EBIT	\$20	\$20
US tax, 35% of EBIT	\$35	N/A
US Foreign Tax Credit	(\$20)	N/A
US tax net	\$15	\$0
Total Tax	\$35	\$20
Net Income	\$65	\$80

A benefit is created as income is not subject to current US taxation

If we are to look at the two above examples and compare the current treatment of the APB 23 provision with the proposed treatment of the territorial tax system we will see stark differences. In the territorial tax system the treatment of the APB 23 provision is similar to that of transfer pricing, in that, the proposal fails to make any specific mention or outline any guidelines with regard to the issue of APB 23. Thus, such a comparison between the current treatment of APB 23 and the territorial tax system is not feasible. However, once again if we can take what we already know about the territorial tax system and apply it to the APB 23 provision we may be able to draw some conclusions. What we do know about that the territorial tax system is that it proposes to permanently exempt dividends and income earned from foreign subsidiaries and branch operations of US based multinationals entities from income of their US parent. This in effect is an elimination of deferrals and ultimately an elimination of the APB 23

provision. Thus the tax benefits and advantages that multinational corporations currently utilize will be foregone. Henceforth, if Congress moves towards a territorial exemption system, then APB 23's significance will be greatly reduced because no US income tax expense would be recorded for income of foreign subsidiaries, whether permanently reinvested or not.

Section 3.2:- *Territorial System - Pros VS Cons, CFCs & FTCs, Transfer Pricing and APB 23 provision*

To draw a final conclusion as to whether the territorial system is a better replacement for the worldwide tax system with regards to the CFC we should look at the pros and cons of this new tax scheme. **Pros:** - The leading proposal of the territorial tax system seeks to permanently exempt dividends and income earned from foreign subsidiaries and branch operations of US based multinationals entities from income of their US parent. If this type of system is adopted it will no doubt alleviate the trapped income problem that many politicians complain about. US based multinational corporations have a significant amount of foreign source income, as much as \$1trillion, based on financial statements¹⁵. These amounts are not being repatriated because it is earned in low tax jurisdictions and will therefore trigger a US tax without foreign tax credits under current rules. **Cons:** - Although improving the issue of the trapped income problem, the territorial tax system however, fails to address the issue of subpart F. Nowhere in the proposal of the territorial tax system does it address Subpart F. If we adapt territoriality without reforming Subpart F, the result will be a significant erosion of

¹⁵ Testimony of Professor Reuvebs S. Avi-Yonah, Hearing on how other countries have used tax reform to help their companies in the global market." U.S. House Committee on Ways and Means, May 24, 2011

the US domestic corporate tax base. Henceforth, those in favor of territoriality for the US but who would leave today's holes in subpart F are seeking a back-door exemption from the US income tax that would cause US multinationals to be taxed at much lower rates than the multinationals of other countries.

If we analyze the pros and cons of the territorial tax system with regards to FTCs we see a similar issue as above. **Pros:** - by exempting dividends and income earned from foreign subsidiaries and branch operations of US based multinationals entities from income of their US parent it makes the tax system simple, straightforward and less complicated. **Cons:** - The downside to this is that with a full dividend exemption it makes FTCs unnecessary, but FTCs would still be needed to prevent double taxation of certain nonexempt income items; an issue which the territorial system fails to address.

With the issue of transfer pricing, however, there can be no comparison of the advantages and disadvantages because quite simply the territorial tax system offers no solution in dealing with the issue of transfer pricing. **Cons:** - Given what we do know about territoriality and its favoring of dividend exemption, transactions between a foreign subsidiary and its domestic parent will move taxable income into or out of the territorial exemption. This presents a problem because in implementing this type of system it will significantly increase the incentives to shift income to low-tax jurisdictions. If there is no tax on dividends and foreign source income is exempt, the pressure on transfer pricing will increase exponentially and will require stronger transfer pricing rules. The territorial tax system would worsen the transfer pricing problem because it would encourage companies to shift the reported locations of activity from the US to low tax countries.

Thus creating an “income or profit shifting” heaven for US multinationals corporations to abuse.

Lastly, if we turn our analysis to the pros and cons of the territorial tax system with regards to the APB 23 provision we can see the advantages and disadvantages clearly. **Pros:** by exempting dividends and income earned from foreign subsidiaries and branch operations of US based multinationals entities from income of their US parent it makes the tax system simple, straightforward and less complicated. Furthermore, by doing so it is in effect eliminating the APB 23 provision completely by getting rid of deferrals. This may seem as a good thing for some because APB 23 has been referred to as a “rich company’s benefit,” that is, well-to-do companies can keep money offshore utilizing APB 23.¹⁶ **Cons:** If Congress moves towards a territorial exemption system, then APB 23’s significance will be greatly reduced because no US income tax expense would be recorded for income of foreign subsidiaries, whether permanently reinvested or not. This plays an important role when it comes to corporate America because the deferral of income coupled with APB 23 produces a significant financial statement benefit for American multinational companies. In fact, for many if not most public companies in the US, the deferral of income and APB 23 may be the largest and most important permanent difference. As such, a territorial system will see much resistance since it plans to eliminate deferrals. Corporate America will fight hard to retain deferrals and APB 23 because it creates a permanent difference.¹⁷ Consequently, adopting a

¹⁶ Nick Wingfield & Romy Varghese, Wall St. J., May 12, 2009, at B1.

¹⁷ Corporate Tax Reform: Listening to Corporate America, Christopher H. Hanna, Altshuler Distinguished Teaching Professor and Professor of Law, Southern Methodist University Dallas, Texas

territorial system with regards to APB 23 will be counterintuitive because the rules governing deferrals and APB 23 enable US. companies to be more competitive. Without these rules, a US based company would incur incremental US. tax expense in its books when operating in lower-tax jurisdictions. By deferring the tax expense in its financials, the rule favorably allows US companies to report effective tax rates that are comparable with its non US competitors.¹⁸ Subsequently, if deferral is repealed this could give rise to a host of other problems in calculation of the deferred tax liability and deferred tax asset for the excess of the US parent's book basis in the stock of the foreign subsidiary.¹⁹ Moreover if Congress does adopt a territorial system a question arises as to what will happen to all the permanently reinvested income that is sitting offshore. Will they be repatriated back? And if so how much of it will be included in a corporation's tax provision since an accrual of U.S. taxes on its repatriations of foreign earnings will now have to be made. Moreover, will the repatriations be brought up all at once or proportionately?

Session 4: *Drawing from work experience: - Considerations that are plausible*

In working with a corporation that extends its resources to an international level, I will undoubtedly be affected if any changes are made to the corporate income tax system. Because a reform of the tax treatment of corporate international cross-border transactions is one of the most highly debated issues facing Congress today, my organization, in an attempt to stay ahead of any future legislature that might impact our

¹⁸ Liguori, Albert, Bill Ling, Jennifer Jung, and Rosann Torres. "A&M Tax Advisor Weekly - Alvarez & Marsal." *Global Professional Services - Alvarez & Marsal*. Alvarez & Marsal Taxand, LLC, 2007. Web. 17 Dec. 2011.

¹⁹ Accounting for Income Taxes No. 109, supra note 25, § 173

international as well as domestic business operations, has begun taking measures in preparing for any such changes. Whatsoever changes and reforms to the tax code results, companies will have to revise their projections and earnings and update financial statement. In our research and tax planning we have come up with other considerations that are also plausible and that might be adopted to address the tax treatment of foreign source income. However, it should be noted that these proposals are limited to the scope of our business model and may not be applicable on a general level. Nonetheless we have seen that other financial and banking service industries who have a similar organizational structure and core competence have also proposed similar suggestions. Thus our propositions would in fact benefit some but not all companies.

If a territorial system is to be adopted we feel that in dealing with dividend exemption, the US should adopt a system that exempts a set percentage of dividends and should not exempt all income as proposed by the territorial system. For example, when a foreign subsidiary pays a dividend representing active business income to the domestic parent or shareholder, the dividend should be partially exempted from tax. Adopting a 95% exemption like France, Germany and Japan does is possible and open to debate. The 5% of dividend that is subject to tax would be an offset to expenses deducted in the domestic return that are attributable to the dividend income. Furthermore, not every dividend should qualify for the exemption because of ownership thresholds qualifications. For example, the UK who just recently switched to a territorial tax system currently requires ownership of at least 10% in the foreign subsidiary, whereas Japan who also recently switched to territoriality requires 25%. Which percentage is suitable for the US is also open for debate.

With regards to taxing foreign source income, the US current worldwide tax system of collecting corporate taxes based on where the corporations profits are earned may be in need of a reform. However, the territorial system of again exempting all foreign source income, while simplistic and far less complicated may be too drastic and radical at most. The problem with today's multinational corporations is that because of the process of globalization, these corporation's businesses and investments are increasingly changing and as a result their profits are hard to pin point to a particular place. To combat this problem, the corporate tax would be assessed based on where a corporation's products are used rather than where the corporation is located or where the goods are produced. This type of corporate tax system based on usage is supported by Alan J. Auerbach, a professor of economics and law at University of California, Berkeley who was cited by saying, "assessing the tax base on where a firm's products are used eliminates the issue of where to locate a business and incentives for US domiciled business to shift profits abroad to reduce taxes." Furthermore, according to another supporters of this type of tax system, the Center for American Progress, a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all, "if this type of tax system is implemented it would deliver a host of economic advantages to US businesses and American workers. It would promote domestic corporation activity and encourage investment that would boost productivity, the key driver of increases in wages, employment and living standards."

In addressing the dilemma which so many policy makers are faced with - subpart F and APB 23 provision and its related problem of trapped earnings, a simple resolution

would be to repeal some or a percentage of deferrals. In doing so foreign earnings would be subject to current US tax and there would be no tax on repatriations. However this may have some draw backs because the question will still remain - what will happen to all the permanently reinvested income that is sitting offshore? Will they be repatriated back? And if so how much of it will be included in a corporation's tax provision since an accrual of U.S. taxes on its repatriations of foreign earnings will now have to be made. The answer to this is not simple but we should consider that repatriations be brought proportionately. By doing so a company's financial statements will have to be presented prospectively to reflect the change in its tax provision since an accrual of U.S. taxes on its repatriations of foreign earnings will now have to be made. Furthermore, for those who are worried about competitiveness, we could also reduce the corporate tax rate as suggested by Senators Wyden and Coats in their tax reform proposal. Moreover if we somehow also try to convince other industrialized nations to adopt CFC legislation that the US currently has then all major multinational entities would be subject to a single low tax on their worldwide earnings without incentives to shift income to tax heavens.

If a territorial system is to be considered, the issue of transfer pricing is to be remedied. More specifically, there exists a huge problem when it comes to transfer pricing rules in the treatment of royalties and other intellectual property transactions between related parties. This is a topic of great debate because these transactions are often the most contested issues between tax authorities and taxpayers. One way we see to resolve this issue is to exempt all or some royalty payments between foreign subsidiaries and the domestic parent. Currently, Japan, Canada and Australia adopt this

approach. Another way to go would be to adopt what the UK intends to do come 2013. Essentially the UK plans to implement a “patent box” system. This system is elective and is seen as a way of encouraging domestic high-tech industry or research and development. It would apply an effective tax rate of 10% for income that can be sourced to certain UK patented intellectual property.

Session 5: Conclusion

The current US federal tax code is riddled with a montage of policies, provisions, pronouncements and court rulings. Having an understanding of what the influences that make up the US tax system are illustrates how convoluted and complex the tax code is and can be. There are three main factors that play a significant role in influencing and forming the US tax code, those being based on: economic, social and political justifications. Many expert tax preparers, professionals and regulators all agree that a reform is needed to the system. One prominent area of the tax code that has garnered much attention as of late is a call for a reform of the corporate international tax system. Congress and the Obama administration are currently pursuing measures to rectify this issue. One initiative currently being circulated is the proposal of a territorial tax system by the House Ways and Means Committee Republicans led by Chairman Dave Camp of Michigan. Under this new proposal profits of a multinational corporation are only taxed by the country where the income is earned, that is, income earned by foreign subsidiaries and branch operations e.g., a foreign owned company with a subsidiary operating in the United States is exempt from their country’s domestic corporate income tax. This type of tax system is seeing much attention and is drawing considerable

support. Currently it is backed by a growing number of voices ranging from the Bowles-Simpson commission, to the House Republicans, to leading contenders for the Republican presidential nomination. This new proposed tax system is in vast contrast to the current tax code. Presently, the US employs a worldwide system for international taxation of multinational corporations, that is, US registered based entities are taxed on their income regardless of where the income is earned and are allowed a credit for foreign taxes paid on net foreign source income. Multinationals are allowed to defer US tax on overseas active business income until the income is transferred to the US.

Many supporters of a reform to the corporate international tax system argue that this worldwide tax system has been in effect since the Tax Reform Act of 1986 and has seen little to no amendments since then. Supporters fear that if there is no reform to this type of system then US multinational companies will have a hard time competing on the global platform and will thus suffer a competitive disadvantage. Proponents for change propose that the US move swiftly in adopting the territorial tax system since many other industrialized and developed countries have already done so.

In evaluating whether the Committee's proposal is plausible we have analyzed cases studies and given a breakdown of the pros and cons of the territorial tax system as it relates to four main issues that face US multinational corporations, those being (1) Controlled Foreign Corporations (CFC) rules, (2) foreign tax credits (3) Transfer pricing and (4) the APB 23 provision– Accounting for Income Taxes – Special Areas.

In assessing the territorial tax system as it relates to CFC we concluded that although it will improve the issue of the trapped income problem, it however, fails to address the issue of subpart F. Henceforth, those in favor of territoriality for the US but who would leave today's holes in subpart F are seeking a back-door exemption from the US income tax that would cause US multinationals to be taxed at much lower rates than the multinationals of other countries. When we evaluated territoriality regarding FTC's we saw that the downside to the territorial tax system is that because it proposes a full dividend exemption, it makes FTCs unnecessary. This is a problem because FTCs would still be needed to prevent double taxation of certain nonexempt income items. This as we saw is an issue which the territorial system fails to address. Reviewing the territorial proposal in relation to transfer pricing we found that the territorial tax system would worsen the transfer pricing problem because it would encourage companies to shift the reported locations of activity from the US to low tax countries. In doing so it creates an "income or profit shifting" heaven for US multinationals corporations to abuse. Lastly, in our analysis we saw that the APB 23 provision was yet another cause of concern if congress moves towards a territorial exemption system because no US income tax expense would be recorded for income of foreign subsidiaries, whether permanently reinvested or not. This plays an important role when it comes to corporate America because the deferral of income coupled with APB 23 produces a significant financial statement benefit for American multinational companies. Thus we surmised that corporate America will lobby and fight hard to keep the APB 23 provision and deferral rules.

How the US plans to deal with the issue of foreign source income is yet to be seen. As Congress struggles over which system is right for the US, many multinationals corporations are currently mapping out effective tax planning strategies in anticipation of a final decision. In drawing from work experience we provide other considerations that are plausible in addressing the four main criteria facing multinational corporations addressed above. For example, if a territorial system is to be adopted we feel that in dealing with dividend exemption, the US should adopt a system that exempts a set percentage of dividends and should not exempt all income as proposed by the territorial system. With regards to taxing foreign source income, the best possible way to combat this problem, would be to assess the corporate tax based on where a corporation's products are used rather than where the corporation is located or where the goods are produced. Moreover, in addressing Subpart F, the APB 23 provision and its related problem of trapped earnings, a simple resolution would be to repeal some or a percentage of deferrals. In doing so foreign earnings would be subject to current US tax and there would be no tax on repatriations. Finally in dealing with transfer pricing rules in the treatment of royalties and other intellectual property transactions between related parties, we proposed two options: 1) to exempt all or some royalty payments between foreign subsidiaries and the domestic parent. 2) To adopt a "patent box" system that would apply an effective tax rate of 10% for income that can be sourced to certain patented intellectual property.

If the US does make a decision to reform the present international corporate tax system by adopting a territorial tax system or any other tax system, they undoubtedly face a huge challenge in transitioning from an old system that has not seen much

change since the Tax Reform Act of 1986 to a new system. Once issue they will have to confront is costs. Legislators will have to ask themselves how much the new tax system costs to implement and how can they mitigate unnecessary costs? Other implications tax change can generate is its impact whether directly or indirectly on the economy. Tax reform may affect the availability of demand for specific goods and services.

As legislators battle over which international corporate taxation system would be best suited for the US, multinational corporations will have to engage in tax planning strategies now more than ever. For many corporations, planning in an environment where uncertainty is the only know variable will be a true test and challenge because potential reforms means increase risk but at the same time increased opportunities. Additionally, smart tax planners will realize that they need to act upon and take advantage of current tax policies that may become unavailable after a reform is made, thereby being “grandfathered in.” Also they need to take advantage of the transitioning period and identifying competitors who are doing the same and look for others who are lagging behind. Furthermore, in its planning many corporations might consider paying attention to income and deductions because if rates decreases, corporate tax payers may be looking towards loss carry backs to higher rate years so as to preserve credit carry forwards for use in lower rate years.

It is often said that before anything else, preparation is the key to success. Henceforth, multinationals corporations that effectively plan for these forth coming international tax reforms will undoubtedly be successful in the end.

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