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Obama's Corporate Tax Reform Proposal

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President Obama recently announced his latest budget proposal. He suggested a one-time levy of 14% as a transition tax on the earnings American firms have accumulated abroad, a recurring tax on future foreign earnings of 19%, and finally, to lower the corporate tax rate to 28%.

This proposal aims to resolve the issues of the ineffectiveness of corporate tax and to tackle its main consequence: U.S. tax avoidance and corporate inversions.

Traditionally, the U.S. employs a U.S. person (person or corporation) on their worldwide income. To mitigate potential double taxation, the U.S. employs a credit system, allowing a U.S. person to claim a credit for the foreign income taxes imposed on foreign source income. However, a major exception to this system is the deferral privilege, whereby the U.S. does not tax foreign source income earned by a U.S. person through a corporation until those profits are repatriated by the domestic shareholder through a dividend distribution.[1]

Since the U.S. corporate tax rate is one of the highest amongst the developed countries (35%), U.S. companies have managed to avoid it by structuring their business so that most of their profits are now located abroad. Hence, the figures speak for themselves: G.E. ($110 billion), Microsoft ($74 billion), Pfizer ($69 billion) and Apple ($54.4 billion).

Another consequence of this corporate tax avoidance is the phenomenon of inversions. A corporate inversion is a transaction in which a U.S. based multinational restructures, so a foreign parent replaces the U.S. parent, in order to avoid U.S. taxes. Another goal of corporations is to access cash located abroad without paying the "repatriation tax."

The one-time tax aims to incentivize companies to repatriate foreign profits. There is a precedent for this; in 2004, the United States Congress enacted such a tax holiday for U.S. multinational companies, allowing them to repatriate foreign profits to the U.S. at a 5.25% tax rate. The Internal Revenue Service ("IRS") has assessed that, in total, 843 companies brought back $312 billion.

However, there are some vocal critics of the proposal. Concerning the repatriation tax, some commentators stress the fact that the 2004 tax holiday did not prevent the same fifteen companies, which benefited the most, from later cutting at least 20,000 jobs. Concerning the suppression of the deferral privilege, one of the main concerns is that it may incentive U.S. companies to increase the likelihood of foreign companies purchasing them as targets by searching for inversion partners. Indeed, in order to access their offshore cash, companies with substantial offshore holdings should make a move now when it is easier for them to reincorporate abroad. Finally, the last criticism is a classic one, some critics advocate a territorial

[1] Misey & Schadewald, A Practical Guide to U.S. Taxation of International Transactions, published by Commerce Clearing House, Inc. ("CCH M&S"); 9th Ed. (2014).

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system under which the I.R.S. would only seek to tax those profits earned within the United States.