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Global Legal Group

The International Comparative Legal Guide to: Corporate Tax 2012

A practical cross-border
insight to corporate tax work

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Gazing in the Crystal Ball: The State of Corporate Tax Reform in the United States



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I. Introduction

Over the past year, several plans that would substantially modify the current system of corporate taxation in the United States have been proposed. Political jockeying over tax reform is part of the *status quo* in United States politics. However, the increasing urgency of the nation's need to address the size of its national debt, the amount of deficit spending by the federal government and the need to spur the domestic economy to produce more jobs and GDP growth, have moved corporate tax reform proposals out of the province of economists and have made them a key factor in the political brinksmanship that has come to define 2011. With a Presidential election looming in 2012 and the House of Representatives under the control of the so-called "Tea Party" freshman representatives, the debate over tax policy has taken on ideological dimensions. Which policies will emerge as politically viable is a question that corporate taxpayers have to face as they plan their business operations for the near and long-term future. While each of the proposals described herein shares many common goals, their methods for achieving these goals differ dramatically. With respect to the current system of corporate taxation, the proposed changes range from modifications of specific provisions of the Internal Revenue Code of 1986, as amended (the "Code"), to the complete elimination of the corporate income tax.

This article will begin by analysing the current treatment of corporations under the Code. Next, this article will examine the treatment of U.S. corporations' domestic activities, as proposed in five of the more prominent plans that have recently been proposed [see Endnote 1]:

- The bipartisan proposals from the National Commission on Fiscal Responsibility, chaired by former Senator Alan Simpson and Erskine Bowles [see Endnote 2];
- The Bipartisan Tax Fairness and Simplification Act of 2011, introduced by Senators Ron Wyden, Dan Coats and Mark Begich [see Endnote 3];
- The proposals from the Bipartisan Policy Center's Debt Reduction Task Force [see Endnote 4];
- Republican Congressman and Chairman of the House Budget Committee, Paul Ryan's "Roadmap to America's Future" [see Endnote 5]; and
- President Obama's revenue proposals for the 2012 fiscal year [see Endnote 6].

Next, moving to the international tax arena, this article will review the taxation of U.S. corporations' foreign-source income, comparing proposals advocating for a territorial tax system versus the current "full-inclusion" system. Finally, this article will contain a discussion of several items that would indirectly affect the business activities of U.S. corporations.

The Current System of Taxing U.S. Corporations

General Corporate Tax Rates and Deductions

Generally, U.S. corporations are taxed at a rate of 35% on their domestic-source taxable income [see Endnote 7]. While corporations are denied certain deductions and exemptions available to individual taxpayers, corporations are not subject to many of the floors, phase-outs or other limitations on the use of itemised deductions which apply to the income taxation of individuals [see Endnote 8].

Treatment of U.S. Corporations' Foreign-Source Income

A U.S. corporation conducting foreign activities through the use of foreign subsidiaries is generally subject to U.S. tax only when the income of such subsidiaries is repatriated into the United States in the form of a dividend or other distribution to its U.S. parent or when a gain is realised on the disposition of shares of the foreign subsidiary. Special rules apply to deemed income to have been repatriated in the case of certain foreign corporations with U.S. shareholders if such foreign corporations have certain forms of passive income or other categories of specified income and meet certain other tests. The taxation of U.S. corporations' foreign income is discussed in further detail in Section V.

Rationales Driving Current Corporate Tax Reform Proposals

Increasing Tax Revenue - Reducing the Federal Debt

For much of the past two years, Congress has focused on ways to reduce the U.S. debt burden in both the short and long-term. The Congressional Budget Office ("CBO") found that, as of July 2010, federal debt held by the public stood at a higher percentage of gross domestic product than during the Great Depression, and at its highest point since the Second World War [see Endnote 9]. The CBO attributed this increase in federal debt to three predominant factors: a) the deficit between federal revenues and spending that predated the 2008 fiscal crisis and resulting recession; b) the reduction in federal revenues which occurred as a result of the 2008 fiscal crisis; and c) the costs of stimulus and bailout policies executed to respond to the 2008 recession. As a consequence of the rising national debt, the CBO noted that future private investment in productive uses may be "crowded out", since an increasing

portion of Americans' savings will have been directed to the purchase of public debt rather than to funding such investments. Conversely, as U.S. debt is increasingly held abroad, a larger portion of U.S. capital will continue to travel overseas.

To reduce the increasing level of national debt, the twin policies of decreasing government spending and increasing tax revenues have moved to the front of the national debate over fiscal policy. Liberal policy makers have argued that increased tax revenues must be part of the solution, while conservative policy makers have argued that increasing corporate taxes depresses job growth and therefore economic growth in general. Instead, they argue that decreasing the tax rate on corporate income may increase federal tax revenues due to the economic growth and job creation that reduced tax burdens will create [see Endnote 10].

Competitiveness of U.S. Businesses in the Global Economy

Cited as a cause for modifying the corporate tax in several of the proposals discussed herein [see Endnote 11] is the decreasing competitiveness, whether real or merely perceived, of U.S. businesses in the global economy. For 2008, a year in which tax revenues were down across the board, the effective corporate tax rate was 23.4% [see Endnote 12]. This effective rate increased to 32.5% for corporations with assets of between \$5 million and \$100 million, and to 31.7% for corporations with assets between \$100 million and \$500 million [see Endnote 13].

Among member nations of the Organization for Economic Cooperation and Development ("OECD"), after Japan's reforms to their corporate tax system take effect, the United States will have the highest statutory combined corporate tax rate for 2011 [see Endnote 14]. These statutorily high rates have been blamed for suppressing both domestic and foreign investment in U.S. businesses [see Endnote 15] and thereby depressing economic growth in the United States generally. Bringing down the corporate tax rate has been viewed as a key to restoring U.S. corporate competitiveness in the global economy.

Avoidance of U.S. Tax Through the Use of Offshore Vehicles

Related to the competitiveness concerns described above is the belief that high tax rates on corporate income cause an outflow of both capital investment and economic activity generally. This is due almost entirely to the desire to avoid the higher tax rates on corporate income imposed by the U.S., as opposed to the rates applicable in foreign jurisdictions [see Endnote 16]. Since a U.S. corporation's foreign-source income is generally not subject to U.S. taxation until it is repatriated to the United States, there is a strong incentive for U.S. and multinational corporations to avoid distributing non-U.S. source income to its U.S. corporate shareholders. Reducing the rate at which U.S. corporations are taxed has been argued to lead to a reduction in the incentive of U.S. corporations to send income-producing activities offshore.

II. Reforms Advocating for a Lower Corporate Tax Rate Applied Across a Broader Base

Many of the proposals to overhaul the Code's corporate tax provisions focus on reducing the applicable rates at which corporate income is taxed, while simultaneously broadening the base of corporate income which is subject to tax. Notably, the most publicised of these plans, described below, are based on input from

both Democrats and Republicans, but none of them have yet evidenced sufficient political support to give rise to a true front runner. While each of these plans are in many ways similar, they differ sharply in the means of broadening the effective corporate tax base.

A. The Simpson-Bowles Plan

Responding to growing concerns about the long-term fiscal health of the United States, President Obama, in early 2010, created the National Commission on Fiscal Responsibility and Reform (the "Commission") [see Endnote 17]. Chaired by former Senator Alan Simpson [see Endnote 18] and former Chief of Staff to President Clinton, Erskine Bowles [see Endnote 19], President Obama tasked the bipartisan commission with the creation of a proposal that would balance the federal budget by 2015, excluding any interest payments on the federal debt. In December 2010, the Commission released its plan, entitled "The Moment of Truth" [see Endnote 20]. In addition to a comprehensive overhaul of the Code [see Endnote 21], the Simpson-Bowles Plan recommends significant cuts to discretionary spending, containing healthcare and social security costs, and mandatory reform of the budget process, to ensure that its goals are accomplished.

Describing the corporate tax provisions of the Code as "a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment", the Simpson-Bowles Plan cites the necessity of reforming the corporate tax code to maintain the competitiveness of U.S. business, and to prevent the loss of both American jobs and the corporate tax base. Thus, the Simpson-Bowles plan would replace the current corporate tax brackets, taxing corporate income at a single rate to be set between 23% and 29% [see Endnote 22]. To offset this rate reduction, the Simpson-Bowles Plan would eliminate all business tax expenditures, including all currently available corporate tax credits and the domestic oil production deduction [see Endnote 23]. Additionally, the Plan would eliminate the Last-In, First-Out method of accounting for inventory, albeit with an "appropriate" transition period.

On an international level, the Simpson-Bowles Plan advocates the use of a territorial tax system, where income earned by foreign operations located in the U.S. would be exempt from U.S. corporate income tax, and would be taxed solely by their domiciliary countries [see Endnote 24]. However, the drafters would continue the current treatment of taxing passive foreign-source income earned by U.S. shareholders of foreign corporations.

Hoping to ensure the swift passage of its proposals, the Commission included a "failsafe" feature in its Plan. Should Congress fail to pass legislation reforming the Code by 2013, this provision would automatically impose either: a) reductions of all itemised and above-the-line deductions for both individuals and corporations, business credits, domestic production activities deduction, and exclusion from income for employer-provided health insurance; or b) a trigger reducing rates and tax expenditures to certain specified levels by 2015.

B. The Bipartisan Tax Fairness and Simplification Act of 2011

Co-Sponsored by Senators Ron Wyden [see Endnote 25], Dan Coats [see Endnote 26] and Mark Begich [see Endnote 27], the Bipartisan Tax Fairness and Simplification Act of 2011 ("BTFSA") [see Endnote 28] would also replace the current corporate tax brackets with a single rate, in this case 24% [see Endnote 29].

As with the Simpson-Bowles Plan, the BTFSA would impose this lower rate on a broader tax base. This would be accomplished, in part, by eliminating numerous narrowly tailored tax preferences. These industry specific and other niche-based tax breaks, which are not generally available to corporate taxpayers (especially focused on the oil, gas and energy industries), include the following provisions of the Code, and would be effective for tax years beginning after December 31, 2011:

- the enhanced oil recovery credit (Code Section 43);
- the domestic production activities deduction (Code Section 199);
- the bankruptcy exception to the general limitation on net-operating losses for corporations undergoing a change in control (Code Section 382(l)(5));
- the rules concerning sales or dispositions to implement the Federal Energy Regulatory Commission or State electric restructuring policies (Code Section 451(i));
- the dollar limitation (Code Section 453A(b)(1)) and the exception for personal use and farm property (Code Section 453A(b)(3)), which permit deferral of gain recognition for non-dealer instalment obligations;
- the exception from the percentage of completion method of accounting for certain construction contracts (Code Section 460(e)(1));
- the allowance for percentage depletion for certain oil and gas wells (Code Section 613A);
- the deduction for costs relating to the development of certain mines (Code Section 616); and
- the provisions concerning the exceptions to the inventory property sales source rules (Sections 861(a)(6), 862(a)(6), 863(b)(2), 863(b)(3), and 865(b)).

The BTFSA also attacks the usual suspects from a political perspective. Thus, Section 202 of the BTFSA limits deductions taken with respect to taxpayer-owned aircraft to the amounts included as income by that taxpayer from the use or operation of the aircraft. Further, Section 207 of the BTFSA would limit the application of the foreign tax credit for certain large integrated oil companies [see Endnote 30] that are not subject to a generally applicable income tax in the jurisdiction for which the credit is claimed. Corporate interest deductions would be indexed to inflation and the portion of interest expense deductions that is attributable to inflation would be disallowed. In one of its few provisions that would reduce the tax base, the BTFSA would allow small businesses (with gross annual receipts of up to \$1 million) to expense purchases of equipment and inventory in a single year [see Endnote 31]. The alternative minimum tax would also be eliminated.

Finally, the BTFSA would require studies to be completed, which would determine whether additional reporting should be required for pass-through entities to reduce possible “tax avoidance” by such entities, and how to reduce the federal government’s direct and indirect spending on businesses by at least \$230 billion over a ten-year period.

C. The Rivlin-Domenici Plan

In November 2010, the Debt Reduction Tax Force of the Bipartisan Policy Centre (the “Task Force”) released a comprehensive plan aimed at boosting the U.S. economy while simultaneously reducing the national debt. Chaired by former Senator Pete Domenici [see Endnote 32] and former Director of the Clinton White House Office of Management and Budget, Dr. Alice M. Rivlin, the Task Force proposes across-the-board reforms of the Code [see Endnote 33].

As with the Simpson-Bowles Plan, the Task Force cites the competitiveness of U.S. businesses in the global economy as the driving force supporting its proposed corporate tax reforms. Additionally, the Rivlin-Domenici Plan notes that the Code diverts the investment and production decisions of U.S. corporations, causing these corporations to invest in less-productive but more tax-friendly operations. In order to eliminate the financial distortion created by corporate tax policy, the Rivlin-Domenici Plan would eliminate most all corporate deductions and tax credits.

Much like the Simpson-Bowles Plan and the BTFSA, the Rivlin-Domenici Plan would lower the corporate tax rate to a single rate of 27%. To broaden the applicable tax base, the Rivlin-Domenici Plan would eliminate “tax expenditures”, loosely defined as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction ... or which provide a special credit, a preferential rate of tax, or a deferral of liability” [see Endnote 34]. Although the Task Force found some tax expenditures to be beneficial, it believes that the use of such expenditures is an inefficient means of promoting the activities benefitted by a given expenditure.

III. The Republican “Roadmap”: Representative Ryan’s Plan

Entitled “Roadmap to America’s Future Act of 2010”, the Ryan Plan cites similar concerns regarding the ability of American businesses to compete in the global economy as justification for its reforms of the Code. However, unlike the bipartisan proposals described above, Representative Paul Ryan [see Endnote 35] has proposed eliminating the corporate income tax entirely. In its place, the Ryan Plan would impose a “simple and effective” 8.5% business consumption tax (“BCT”).

Essentially a value-added tax, [see Endnote 36], the BCT would be imposed by way of a “subtraction method”, which would calculate a given business’ tax base by subtracting its total purchases from its total sales. A business would then be required to pay to the Federal government 8.5% of this figure each quarter. Significantly, the Ryan Plan rejects the use of a “credit-invoice method” to determine the applicable tax base. Such a method would require a business to calculate its BCT on each individual transaction it entered into, thus requiring a new regime to determine the effective purchase and sale price for every transaction. Because the BCT would be imposed on the gross profits of a “business entity”, defined to include both corporations and unincorporated businesses such as partnerships and limited liability companies, the current tax distinction between these entities would be largely eliminated under the Ryan Plan [see Endnote 37].

The focus of the Ryan Plan on consumption instead of income would completely change the current system of taxing mergers and acquisitions by business entities. Notably, mergers between two business entities, and split-offs and similar transactions dividing a single business entity into one or more entities, would not result in any direct tax consequences [see Endnote 38]. Likewise, a stock acquisition by a business entity would not, of itself, cause any direct tax consequences.

The treatment of asset acquisitions differs from the treatment of corporate reorganisations under the Ryan plan. In an asset acquisition, the consideration paid for the assets of an acquired business would be allocated to those assets as under the current method of Section 1060 of the Code [see Endnote 39]. Where the acquisition is of substantially all of the assets of a business, the acquiring taxpayer could elect to treat the asset acquisition as a stock acquisition, thus avoiding any direct tax consequences [see Endnote 40].

The Ryan Plan would also impose an 8.5% tax on any goods or services imported into the United States [see Endnote 41]. For goods initially exported from the U.S. that subsequently return to the U.S. as imports, this tax would be imposed on the value added from the time that the goods were initially exported to the time of their return to the U.S.

IV. The Obama Administration's Proposed Reforms

Rather than attempting wholesale reforms of the corporate provisions of the Code as the preceding reform proposals would do, the Administration Plan for the 2012 fiscal year would leave the fundamental structure of the corporate tax system intact and would selectively amend Code provisions affecting corporate taxpayers. These proposals can broadly be grouped into: the imposition of new taxes; reforming or eliminating several so-called "loopholes" targeted toward specific industries; eliminating the myriad tax preferences enjoyed by the fossil fuel energy industries; changes to international taxation provisions [see Endnote 42]; and tightening up compliance and reporting rules. The Treasury estimates that the Administration Plan would result in an increase of federal income tax revenues, totaling just under \$443 billion from 2012 through 2021, while also increasing outlays by approximately \$115.3 billion over that same period.

A. R&D and Energy Policy Based Changes

The Administration Plan would permanently extend the research and experimentation credit currently found in Section 41 of the Code. Currently, this credit is set to expire after December 31, 2011 [see Endnote 43]. Further, the Administration Plan would add an additional \$5 billion to the current \$2.3 billion limit on the total credits that may be claimed under Section 48C of the Code. This section provides credits for certain "qualified advanced energy projects", defined to include projects used to produce renewable sources of energy, capture and sequester carbon dioxide emissions, and design and produce electric motor vehicles [see Endnote 44]. In the same vein, the current deduction in Section 179D for certain "energy efficient" properties placed in service during the taxable year would be treated as a credit under the Administration Plan.

The outlays that these R&D and "new clean energy" based proposals would cost can be contrasted with the elimination of decades of tax incentives that target the oil, gas and mining industries. Most all of the special tax breaks enjoyed by the fossil fuel extraction markets would be repealed outright. The repeals include: the expensing of intangible drilling costs; the use of percentage depletion for oil and gas wells and coal mining; the expensing of exploration and development costs; capital gains treatment for sales of royalty interests and a host of other fossil fuel based "tax incentives".

B. Financial Crisis Responsibility Fee

Attempting to raise additional revenue for the federal government, the Administration has proposed a "Financial Crisis Responsibility Fee", which would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers and companies controlling such broker-dealers, and insured depository institutions. U.S. companies that own or control such entities would also be subject to the fee. The fee would be imposed on U.S. companies with worldwide consolidated assets of at least \$50 billion, as well as on U.S. subsidiaries of foreign firms which meet these

requirements. In general, the fee would be imposed at a rate of 7.5 basis points on the difference between the firm's consolidated risk-weighted assets, minus its capital, insured deposits and specified small business loans. Any fees paid under this proposal would be deductible for purposes of calculating such firm's taxable income.

C. General Corporate Tax Changes

Under the Administration Plan, corporations that are currently required to file a Schedule M-3 with the IRS would be required to file all of their tax returns electronically. Corporations that file at least 250 returns (including income tax returns, employment returns, excise tax returns, and information returns, among others) in a taxable year are currently required to file such returns electronically. The Administration Plan would lower this 250-return threshold to an unstated number. The Plan would also require all corporations, without exception, to comply with the quarterly estimated tax payments required by Section 6655 of the Code [see Endnote 45].

The Administration Plan contains several proposals that would affect various provisions of the Code applicable to corporations. For example, the proposal would require a corporation to recognize interest income on a portion of the payment it receives when it enters into a forward sale of its own stock, which is currently not a taxable transaction. Additionally, the Administration Plan would amend the definition of "control" in Section 249(b)(2) of the Code to account for certain indirect control relationships described in Section 1563(a)(1). Finally, the proposals would make permanent the elimination capital gains taxation on investments by non corporate holders of small business stock, in an effort to drive additional capital into the small business markets.

V. International Issues

Overview

The United States bases its jurisdiction to tax foreign source income on the residence of the taxpayer. For purposes of U.S. tax law, a corporation is treated as a domestic corporation if it is incorporated under the laws of the United States [see Endnote 46]. No consideration is given to other factors, such as the location of management activities, employees, business assets, operations, revenue sources, exchanges on which the corporation's stock is traded or the residence of shareholders. Domestic corporations are subject to U.S. tax on their worldwide income. Foreign corporations are taxed only on income that has a sufficient nexus to the United States.

Income earned by a domestic U.S. corporation from foreign activities conducted by its foreign corporate subsidiaries generally is subject to U.S. tax only when such foreign subsidiary earnings are distributed as a dividend or otherwise to the domestic shareholder. Thus, until the income is repatriated, a domestic corporation can defer the U.S. tax liability of the growth in earnings of its foreign subsidiaries unless certain anti-deferral rules apply. When foreign earnings are repatriated, the U.S. corporate shareholder can then claim foreign tax credits for foreign taxes paid by its foreign subsidiaries on the earnings used to pay the repatriated dividends. The principal anti-deferral regimes, which change this general rule of deferring taxation until repatriation, are the rules with respect to controlled foreign corporations ("CFC"s) [see Endnote 47] and foreign passive investment companies ("PFIC"s) [see Endnote 48].

Under the CFC and PFIC rules, a domestic corporate shareholder may be taxed on a current basis in the United States on certain categories of passive (and other) income earned by its foreign corporate subsidiaries, even if such foreign earnings have not been distributed to the U.S. parent corporate shareholder. This ability to defer U.S. taxation thus creates an effectively different tax rate on active foreign business income of a CFC than the rate that applies to the CFC's passive income or the U.S. shareholder's own domestic income.

The deferral aspect of the United States' current system of worldwide taxation has been viewed by many as inefficient. Critics contend that it has caused many domestic corporations to move their operations offshore and to sometimes reincorporate offshore (referred to as corporate inversion transactions) to a low tax jurisdiction. Currently, there are two main alternatives to international tax reform being discussed in the United States, and these proposals take diametrically opposed approaches to taxing foreign source income. The first approach is to adopt a territorial system of taxation in which all foreign business income is exempt from U.S. taxation. The second is to move toward a full inclusion system in which all foreign-source income is currently taxed (no deferral) without regard to whether the income is from business or investment, or whether such income is repatriated. The Joint Committee on Taxation ("JCT") recently issued a report detailing these two leading proposals to reshape the way the U.S. taxes foreign source income [see Endnote 49].

Territorial System

A territorial system of taxation generally provides that foreign income earned by a domestic corporation from foreign subsidiaries will be categorised as either: (1) active foreign income earned by a foreign branch or repatriated as a dividend from a foreign subsidiary, which would be exempt from U.S. tax; or (2) passive foreign-source income, which would generally continue to be included in income and taxed under the current anti-deferral tax regimes. The Simpson-Bowles Plan advocates a territorial taxation system for active foreign-source income.

The JCT in a prior report detailed various proposals to exempt foreign business income (the "Exemption Proposals") as part of a territorial system of taxation [see Endnote 50]. Under the Exemption Proposals, a domestic corporate shareholder that owns 10% or more of the stock of a CFC would exclude from income all dividends received from the CFC. Deductions for interest and other expenses of the domestic corporation would be disallowed to the extent allocable to exempt CFC earnings. The symmetrical treatment of income and expenses would be consistent with the Code's general approach of disallowing expenses associated with the earning of exempt income. Further, allocation of expenses between foreign-sources of income may curtail the perceived negative effective tax rates for overseas investments by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deduction in the United States [see Endnote 51]. This approach would be different than what is followed by most foreign jurisdictions. Many foreign jurisdictions allow a deduction for expenses that generate exempt foreign income and instead provide that a small percentage of foreign dividends is taxable.

Moreover, under a territorial system, any gain from a domestic corporation's sale of CFC stock would be excluded from income to the extent of undistributed exempt earnings. Any excess of gain over this amount would be taxable. Deduction for losses on the sale of CFC stock would be disallowed. Rules would be implemented so that all income earned by foreign branches of domestic

corporations would be treated in the same manner as income earned by CFCs.

Under the JCT's Exemption Proposals, most foreign business income would no longer be subject to U.S. taxation; regardless of the residence of the parent corporation and regardless of whether such income was repatriated. This is expected to eliminate a key perceived inefficiency in the present system, the incentive that exists now for domestic corporations to "park" and reinvest the earnings of foreign subsidiaries permanently offshore in order to defer the taxation of repatriated earnings.

There is no consensus on the scope of a territorial taxation system or whether it should apply to individuals as well as corporate shareholders. None of the leading proposals have addressed how foreign partnerships would be addressed under a territorial approach. One approach could be to continue to treat foreign partnerships as flow-through entities for purposes of determining the treatment of the partners, including each partner's share of exempt and non-exempt income [see Endnote 52]. Other options include treating an investment in a foreign partnership in the same manner as an interest in a CFC or as a portfolio investment.

There are also transition rule issues that would need to be addressed if the United States were to move to a territorial taxation system. Such issues include the treatment of foreign subsidiaries' existing untaxed earnings, existing tax attributes (e.g., foreign tax credits and net-operating loss carryovers) and the U.S. government's obligations under existing income tax treaties. A reduced tax rate on repatriated earnings may be a good transition step toward the territorial system - one with a permanent zero or very low tax on repatriation. The BTFSA would allow a one-year repatriation tax holiday [see Endnote 53]. It is certain that an implementation of a territorial taxation system would require significant time and resources to ensure that the system would be economically efficient.

Full Inclusion System

The other primary option which has been discussed for fundamental international tax reform is the adoption of a full inclusion taxation system in the United States. There is no prevailing view regarding the mechanisms that should be implemented for such a system, however, it is generally agreed that such a system would have two basic features: (1) U.S. shareholders of a foreign corporation (at least those owning a certain ownership threshold) would be taxed currently on their shares of the foreign corporation's income without regard to the repatriation of such earnings and (2) the foreign tax credit would be retained in some form to mitigate double taxation of foreign source income [see Endnote 54].

The JCT Report analyses three options for implementing a full-inclusion system: (1) treatment of CFCs as pass-through entities, such that each U.S. shareholder is required to include in income currently its share of the CFC's items of income, gain, deduction and loss without regard to the nature of such income as active or passive; (2) expansion of rules relating to the filing of consolidated tax returns to include in an affiliated group a corporation's foreign subsidiaries; and (3) expansion of the existing CFC regime to expand the nature of tax items deemed repatriated.

There are significant differences between these options. Under the consolidation approach, losses of foreign subsidiaries would be included on the U.S. tax return without any basis limitation. Additionally, the consolidation regime would apply only to U.S. corporate shareholders of foreign subsidiaries. For a consolidation regime to work, it is likely that the required ownership threshold for consolidation would be revisited, to perhaps as low as 10%. A U.S. shareholder to which the consolidation rule did not apply (i.e.,

individuals, minority corporate shareholders, etc.) generally would not be subject to tax on their share of the earnings of the foreign subsidiary until such shareholder received an actual distribution. The PFIC rules could be retained for these shareholders [see Endnote 55].

The foreign tax credit system would likely need to be restructured to accommodate a full inclusion taxation system. Under present law, in very general terms, the foreign tax credit is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The JCT Report notes that there is agreement that this limitation should be retained in concept but suggests that modifications to the limitation should be considered. For example, a move to minimise excess foreign tax credits could be through the elimination of deductions for various overhead expenses (including interest expense) incurred by a U.S. parent corporation and attributable to foreign source income. The elimination of the current situation where many taxpayers have excess foreign tax credits is considered important to the goal of eliminating incentives to avoid repatriating foreign earnings. For example, to taxpayers which have excess foreign tax credits, the imposition of foreign withholding taxes on dividend payments may disincentivise the repatriation of foreign earnings, undermining one of the principal benefits of moving a full inclusion system.

In implementing a full inclusion taxation system, it would be necessary to determine how to treat losses of a foreign subsidiary that do not flow through to U.S. shareholders. Allowing losses to flow through would simplify entity choice decisions by removing tax incentives to structure loss operations in branch or partnership form. However, it is likely that permitting the utilisation of foreign losses against domestic source income would significantly reduce U.S. tax revenue [see Endnote 56].

There are also important transition rule issues to address if the United States were to move to a full inclusion taxation system. Although no other major trade partner utilises a full inclusion tax regime, it could be an easier to transition to such a system than to a territorial regime. Current treaties reflect the existing foreign tax credit system, which would continue under the full inclusion system for mitigating international double taxation [see Endnote 57].

The Administration Plan's International Reform Proposals

The Administration Plan addresses international taxation reform on a more piecemeal basis than would occur under a move to either a territorial or a full inclusion system. Addressed below are some of the major reforms in this area proposed by the Administration Plan.

Defer Deductions of Interest Expense Related to Deferred Income

As discussed above, U.S. taxpayers are currently permitted to deduct certain expenses attributable to foreign investments, while deferring U.S. tax on the income from such investments. The Administration believes that this may incentivise U.S. businesses to shift their investments – and jobs – overseas, harming the U.S. economy [see Endnote 58]. The proposal defers the deduction of interest expense that is attributable to exempt foreign-source income, but continues to allow a current deduction for interest expense properly allocated to foreign-source income which is currently subject to U.S. tax [see Endnote 59]. Deferred interest expense would be deductible in a subsequent year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during such subsequent year.

Under this plan, the amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income would generally be determined under current Treasury Regulations. The Treasury Department, however, would revise such regulations as necessary to prevent inappropriate decreases in the allocation of interest expense to foreign-source income [see Endnote 60].

Pool Foreign Tax Credits [see Endnote 61]

Under current U.S. tax law, a taxpayer may claim a credit against its U.S. income tax liability for income and certain other taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. A domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). However, the deemed paid foreign tax credit must be applied separately with respect to income that falls within the passive category and income that falls within the general category.

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis by aggregating the foreign taxes, earnings and profits of all of its foreign subsidiaries. The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.

Eliminate Deferral of Excess Returns Associated with Transfers of Intangibles Offshore [see Endnote 62]

The Administration also proposes expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates. Under current law relating to transfer pricing, the IRS can reallocate gross income, deductions, credits, and other allowances between or among two or more commonly owned or controlled organisations or trades or businesses as necessary to prevent evasion of taxes or to clearly reflect income, using an arm's length standard of pricing [see Endnote 63]. Special rules relate to the pricing of transfers of intangible assets between related taxpayers in order to ensure that the transferor realises income from the transfer that is commensurate with the income earning potential of the transferred intangibles. The Administration is concerned that income shifting is taking place through transfers of intangibles to low-taxed affiliates which has resulted in erosion of the U.S. tax base and the Administration wants to reduce the incentive for such non-economic base-erosion [see Endnote 64].

Under the proposal, if a U.S. person transfers an intangible from the United States to a related CFC, then the CFC would be charged with having realised certain excess income from the intangible. The excess income would be computed with respect to the earnings of the transferee from its exploitation of the intangible asset. The transferee would be entitled to earn an "appropriate" percentage mark-up on the sale, lease, licence or other manner of commercialising the intangible asset but income earned beyond that mark-up would become subpart F income that would give rise to current U.S. tax liability of the transferor of the intangible asset.

VI. Other Issues

Altering the Treatment of Capital Gains and Dividend Income

Although not affecting the taxation of corporate income directly,

several of the proposals would amend the means for taxing individuals' capital gains and dividend income. These changes could affect individuals' incentive to invest in U.S. corporations, thereby increasing or decreasing U.S. corporations' available capital.

For example, the Rivlin-Domenici Plan would eliminate all preferential tax rates for capital gains and dividend income, taxing these sources of income at the plan's reduced rate of 27% for individuals' ordinary income [see Endnote 65]. Likewise, the Simpson-Bowles Plan would tax capital gains and dividend income as ordinary income, at reduced rates for individuals ranging from 12% to 28% [see Endnote 66].

The BTFSA would follow a similar scheme, nominally taxing capital gains and dividend income as ordinary income at a common rate of 35%. However, the BTFSA would exclude 35% of the taxpayer's long-term capital gains (using a modified six-month holding period) and qualified dividend income from the tax base, with the result that such gains and income would only be subject to an effective 22.75% rate [see Endnote 67].

For individuals in the top two tax rate brackets, the Administration Plan would apply a 20% tax rate on long-term capital gains and qualified dividend income. The Administration Plan notes that this would be the same rate at which such income would be taxed for such taxpayers under current law, as applicable after 2012.

Reducing the Tax Preference for Corporate Debt versus Equity

Though not addressed by the proposals highlighted by this article, several authors have advocated for amending the U.S. system of corporate taxation to eliminate corporations' preference for debt over equity [see Endnote 68]. Currently, U.S. corporations may borrow funds without any direct tax consequences, while deducting interest payments made on their debt. However, a corporation's shareholders are subject to a "double tax" on their equity in the corporation, due to entity-level tax on the corporation's income and the subsequent tax on dividends received or capital gains realised by the shareholder. Thus, the difference between the effective tax rate applicable to corporate debt versus the effective tax rate applicable to corporate equity is approximately 70% in favour of equity, which is the highest in the OECD [see Endnote 69].

To offset this distortion, at least one author has advocated for a corporate "cash-flow" tax, under which all depreciation deductions would be replaced by immediate expensing for all tangible investments and net financial investments [see Endnote 70]. Thus, under this system, businesses would be able to take an immediate deduction for tangible investments undertaken in excess in the funds borrowed for such investment (i.e., a net deduction for investments funded by equity), while investments funded by debt would be treated as under current law. The availability of a full deduction for equity investments is thought to help offset corporations' bias for debt.

Conclusion

As described above, the proposed plans to rewrite the U.S. system of taxing corporations vary from a group of disparate additions to and repeals from the Code, to the complete elimination of the corporate income tax as we know it. Importantly, these proposals do not exist in a vacuum, and are often merely a portion of a much broader plan for increasing U.S. domestic economic activity or reducing the federal debt, or both. Further, the likelihood of any of the plans described above being enacted wholesale is slim and any

legislative action is likely to include elements from many of the plans.

It is, of course, impossible to predict which, if any, of these proposals for corporate tax reform, or individual elements thereof, have potential for being enacted. The United States is facing an extremely divisive electoral season, rife with ideological disputes between those who view any increase to tax burdens as inherently damaging to the economy and those who view tax increases as a necessary element to reducing the federal deficit. The only conclusion one can draw concerning the outcome of U.S. corporate tax reform is that the last proposal has not been written and that all sides to the debate agree that maintenance of the *status quo ante* is an unacceptable approach. Absent a breakthrough of political *détente* or a crisis that unifies political rivals, corporate tax reform is likely to continue to be debated – but not legislated – until after the 2012 election season has concluded. Nonetheless, being forewarned is being forearmed, and knowledge of which proposals are being debated will help taxpayers to anticipate and to follow along with the coming changes to the Code.

Endnotes

- Not all of the recent tax reform proposals are described herein. For example due to its perceived lack of viability there is no discussion of Republican presidential candidate Herman Cain's 9-9-9 plan, which would create "flat" taxes of 9% each, imposed on corporate income (gross income reduced only by amounts spent purchasing goods from U.S. businesses and on capital expenditures and excluding export income), personal income (gross income less charitable contributions) and on retail sales. For details on the 9-9-9 plan, see: <http://www.hermancain.com/999plan>. Perhaps more important an omission is the fact that the recommendations of the United States Congress Joint Select Committee on Deficit Reduction are not scheduled to be released until after the editorial deadline for this chapter. The Joint Select Committee, known as the "supercommittee", was created by The Budget Control Act of 2011 (Pub. L. No. 112-25, S. 365, 125 Stat. 239, enacted August 2, 2011), as a means to stave off a sovereign debt default which was threatened by the inability of Congress to agree to an increase in the nation's debt ceiling. The supercommittee is made up of six members of the House of Representatives and six Senators, evenly divided between Democrat and the Republican members. The supercommittee is charged with issuing a recommendation by November 23, 2011 for at least \$1.5 trillion in newly enacted deficit reduction steps to be undertaken over a ten-year period. Undoubtedly, corporate tax reform will figure prominently in the debates and proposals to emerge from the supercommittee's work.
- http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf (the "Simpson-Bowles Plan").
- <http://www.gpo.gov/fdsys/pkg/BILLS-112s727is/pdf/BILLS-112s727is.pdf> (the "BTFSA").
- <http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> (the "Rivlin-Domenici Plan").
- <http://www.roadmap.republicans.budget.house.gov/plan/> (the "Ryan Plan").
- <http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf> (the "Administration Plan").
- For the first \$50,000 of taxable income, U.S. corporations are taxed at a marginal rate of 15%. This rate rises to 25% for the next \$25,000 of taxable income recognised by the corporation, to 34% for a corporation's taxable income in excess of \$75,000 and up to \$10,000,000 and to 35% for taxable income in excess of \$10 million. In addition, the alternative minimum tax provides

- for a “shadow” tax regime which limits or eliminates a substantial number of deductions and credits or limits the extent to which they may be used to reduce regular corporate taxable income and applies a 20% flat rate to the resulting “alternative minimum taxable income”.
8. For a more thorough discussion of deductions allowed to corporations, see Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (Thomson Reuters/WG&L, 7th ed. 2006 & Supp. 2011-2), ¶ 5.03.
 9. Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis*, Fig. 1, July 27, 2010.
 10. See generally, e.g., Chris Edwards, *Corporate Tax Laffer Curve*, Cato Institute Tax & Budget Bulletin No. 49 (Nov. 2007).
 11. See, e.g., Simpson-Bowles, Recommendation 2.2 (“Without [corporate tax] reform, it is likely that U.S. competitiveness will continue to suffer. The results of inaction are undesirable: the loss of American jobs, the movement of business operations overseas, reduced investment by foreign businesses in the U.S., reduced innovation and creation of intellectual property in the U.S., the sale of U.S. companies to foreign multinationals, and a general erosion of the corporate tax base.”); The Bipartisan Tax Fairness and Simplification Act of 2011, Two-Pager, available at <http://wyden.senate.gov/issues/legislation/details/?id=fb5b603aed94-48a8-8ff1-c220c1052b3f> (“Currently, the United States’ corporate income tax rate is the second highest in the industrialized world, putting American corporations at a competitive disadvantage in the international marketplace.”); Representative Paul D. Ryan, *A Roadmap for America’s Future Version 2.0, A Plan to Solve America’s Long-Term Economic and Fiscal Crisis*, p. 59 (“[T]he corporate income tax . . . discourages investment and job creation, distorts business activity, and puts American businesses at a competitive disadvantage against foreign competitors.”).
 12. Tax Foundation, *Beyond the Headlines: What Do Corporations Pay in Income Tax?* p. 3 (Sept. 2011).
 13. *Id.*
 14. *Taxation of Corporate and Capital Income* (2011), Table II.1. Corporate Income Tax Rate, available at <http://www.oecd.org/dataoecd/26/56/33717459.xls>. As of 2010, Japan’s highest combined corporate income tax rate was 39.54%, while the United States’ highest combined corporate income tax rate was 39.21%. Due to changes in Japan’s system of taxing corporations, their top rate fell to 34.54% in 2011. Tax Foundation, *National and State Corporate Income Tax Rates, U.S. States and OECD Countries, 2011*, available at <http://www.taxfoundation.org/taxdata/show/23034.html>.
 15. Duanjie Chen & Jack Mintz, *New Estimates of Effective Corporate Tax Rates on Business Investment*, Cato Institute Tax & Budget Bulletin No. 64 (Feb. 2011), p. 3.
 16. See, e.g., Chuck Marr & Brian Highsmith, *Centre on Budget and Policy Priorities, Six Tests for Corporate Tax Reform*, Feb. 28, 2011, p. 1.
 17. <http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform>.
 18. Republican, Wyoming.
 19. Democrat, North Carolina.
 20. *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.
 21. In addition to comprehensive proposals to reform the corporate tax system, the Simpson-Bowles Plan would reduce tax brackets for individuals, eliminate all but a few “tax expenditures”, and tax capital gains and dividend income as ordinary income. Section II of the Plan.
 22. In its illustrative proposal, the Simpson-Bowles Plan uses a rate of 28%.
 23. Simpson-Bowles Plan, Fig. 9.
 24. See Section V, *infra*.
 25. Democrat, Oregon.
 26. Republican, Indiana.
 27. Democrat, Alaska.
 28. S. 727, 122 Cong. 1st Session (April 5, 2011).
 29. Section 201(a) of the BTFSA, amending I.R.C. § 11(b). In addition to corporate tax reforms, the BTFSA would tax individuals at one of three rates (15%, 25%, or 35%), increase the standard deduction for individuals, repeal all individual miscellaneous itemised deductions, and change the treatment of capital gains and dividend income.
 30. The term “large integrated oil company” is defined to include an integrated oil company, as defined in Code Section 291(b)(4), which has gross receipts exceeding \$1 billion for the taxable year and which averages a daily crude oil production of at least 500,000 barrels worldwide.
 31. The determination of which small businesses are eligible would refer to the gross receipts test of Code Section 448(c) of the Code, adjusting the \$5 million figure downward to \$1 million.
 32. Republican, New Mexico.
 33. In addition to corporate tax reforms, the Rivlin-Domenici Plan would create two tax rate brackets of 15% and 27% for individuals, eliminate the Alternative Minimum Tax, eliminate all itemised deductions and the standard deduction (though it would allow taxpayers to claim a 15% credit for certain home mortgage interest expenses), tax capital gains and dividends as ordinary income (at the amended rates proposed by the plan), and introduce a Debt Reduction Sales Tax of 6.5%, among other changes.
 34. Citing the Congressional Budget Act of 1974.
 35. Republican, Wisconsin.
 36. The idea of a national value-added tax is not exclusive to the Ryan Plan; the Rivlin-Domenici Plan would impose a similar, albeit temporary, national Debt Reduction Sales Tax of 6.5%.
 37. See HR 4529, Section 602 (proposed Section 206(a)).
 38. Ryan Plan, proposed Section 213(a).
 39. Ryan Plan, proposed Section 212(a).
 40. Ryan Plan, proposed Section 212(c).
 41. Ryan Plan, proposed sections 281-282.
 42. The Administration Plan’s international provisions are discussed at section V(b), *infra*.
 43. This proposal is not necessarily a drastic change to the Code. Although the research and experimentation credit is scheduled to expire, the credit has been effectively permanent since its inception, having been extended by legislation on no less than eleven occasions.
 44. I.R.C. § 48C(c)(1).
 45. The Administration appears to be less concerned with increasing revenues or ensuring compliance with this proposal than it is with ensuring the certainty of the Code’s provisions.
 46. § 7701(a)(4).
 47. See, Subpart F of the Code, Section 951 through 965. A CFC is a foreign corporation that has U.S. shareholders that own (directly, indirectly, or constructively, within the meaning of sections 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50% of: (1) the total combined voting power of all classes of its voting stock or (ii) the total value of the stock of the corporation.
 48. See, Code Sections 1291 through 1298. A PFIC is a foreign corporation that has either 75% or more of its gross income in a year from passive income sources or that owns assets which generate passive income where such passive assets are at least 50% of the corporation’s assets. The rules for determining PFIC status are complex and contain a myriad of exceptions.

49. Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011 (the “JCT Report”).
50. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005 (the “JCT Options Report”) at 186-97.
51. JCT Report, p. 94.
52. JCT Report, p. 92.
53. BTFSFA, p. 112.
54. JCT Report, p. 99.
55. JCT Report, p. 101.
56. JCT Report, p. 109.
57. JCT Report, p. 110.
58. Administration Plan, page 40.
59. *Id.*
60. *Id.*
61. Administration Plan, p. 41.
62. Administration Plan, p. 43.
63. Code § 482.
64. Administration Plan, p. 43.
65. The Rivlin-Domenici Task Force noted that “[e]liminating the differential between the tax on capital gains and on ordinary income will establish equal treatment among taxpayers with different sources of income and eliminate the incentive to use tax shelters to convert ordinary income into capital gains”. Rivlin-Domenici Plan, p. 38.
66. Simpson-Bowles Plan, p. 31, Fig. 7.
67. BTFSFA, Secs. 109, 110. The Simpson-Bowles Plan states that a similar exemption for a portion of capital gains and dividend income may be used as an alternative to the treatment of all capital gains and dividend income as ordinary income. Simpson-Bowles Plan, p. 31, Fig. 7, n.5. However, that plan would require a corresponding increase in the ordinary income rate to offset any revenue lost as a result of such an exclusion.
68. See, e.g., Center on Budget and Policy Priorities, *Six Tests for Corporate Tax Reform*, Feb. 28, 2011; Alan J. Auerbach, *A Modern Corporate Tax*, Center for American Progress, December 2010.
69. Marr & Highsmith, *supra* note 16 at 4. See also Auerbach, at 5, fig. 3.
70. Auerbach, at 8.

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