And Now for Something Completely Different: Doing a Fiscal U-Turn

By Max B. Sawicky

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Rep. Dennis J. Kucinich, D-Ohio, who is seeking the Democratic presidential nomination, along with Reps. Barbara Lee, D-Calif., and Bernie Sanders, I-Vt., last week introduced ambitious new legislation (H.R. 3655) that aims for a U-turn in tax and fiscal policy. Their Progressive Tax Act of 2003 (PTA) includes a "simplified family credit" (SFC) and a payroll tax credit, both major tax cuts for workers and their families. Coupled with these are revenue-raising provisions that would reduce deficits and improve the dim outlook for the federal budget. The guiding spirit of this legislation is audacity. Something like shock therapy is aimed at slowing the current open-ended bacchanal of regressive, budget-busting tax cuts.

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The SFC replaces the dependent exemption for children, the earned income tax credit (EITC), the child tax credit (CTC), and the additional child credit. By replacing multiple benefits with a single program and by simplifying the eligibility rules, the SFC eliminates a major source of complexity for taxpayers. The National Taxpayer Advocate has reported that the definition of "qualifying child" is one of the chief sources of tax litigation.

The SFC provides a maximum benefit of $2,000 per child. The credit phases in with the first dollar of earnings at a rate of 50 percent. In other words, the credit supplements wages at 50 cents on the dollar, up to a maximum earnings amount of $4,000 per child. There is no limit on the number of children covered, unlike the current EITC. The credit is fully refundable, unlike the CTC and the dependent exemption, so families with low income tax liability but ordinary payroll tax liability can benefit. Those families have received little or no tax relief over the past three years. The SFC phases out at high income levels in the same manner as the current CTC. Families without labor income receive the full credit, insofar as it offsets income tax liability.

Figuring the credit could not be simpler: Simply take the greater of either tax liability or one-half of earned income, subject to a limit of $2,000 per child. The credit phases out for adjusted gross income in excess of $100,000 for household heads, and $150,000 for married couples filing a joint return. (Current thresholds for the CTC are $75,000 and $110,000, respectively.)

The new payroll tax credit is also refundable. For each worker, it offsets payroll tax incurred for as much as the first $10,000 of earnings. The maximum value of the credit is $1,530 — the amount of payroll tax paid by both the employer and employee. Childless individuals and working parents are eligible for the payroll tax credit. The credit begins to phase out at $15,000 in earnings. Eligibility for the credit resides simply in payroll tax liability.

These credits alleviate some long-standing deficiencies of the tax code. For low-income families, they improve work incentives by reducing marginal tax rates. A marginal tax rate is the share of an additional increment of income taken in taxes. A benefit like the EITC that falls as income rises has the same impact as a positive marginal tax rate. The EITC currently phases out at rates of 16 or 21 percent for families with one or more than one child, respectively. Combined with marginal income tax rates and payroll tax rates, this implies total marginal tax rates that can exceed those faced by middle- and upper-income persons. For instance, a family with two children in the 15 percent tax bracket could have a combined marginal tax rate of 15 plus 15.3 (for the payroll tax) plus 21 (from the EITC), for a total of more than 50 percent. By contrast, a millionaire receiving capital gains or dividends could face a marginal tax rate below 20 percent.

By providing for a complete phase-in of benefits below earnings of $10,000, the payroll tax credit would be expected to have an impact on employers as well. To some extent, it could reduce the cost of hiring additional workers.

The new credits eliminate marriage penalties that apply under the EITC, which are the largest faced by anyone under existing tax law. Marriage penalties result from two circumstances: combining incomes of spouses for purposes of joint filing and increased family size resulting from the marriage of two persons who each had children before marriage.

Combining the incomes of spouses for purposes of joint filing can push taxpayers into tax brackets with higher marginal rates. With tax credits, the counterpart to this effect is the phaseout of the credit with increasing income. Under the SFC, the phaseout of the child portion is limited to relatively high-income taxpayers. The payroll tax credit is structured so that combining incomes has no negative effect on total credits. This is accomplished by simply doubling the income threshold at which the credit begins to phase out, from $15,000 to $30,000. (Alternatively, one could allocate the credit separately to each worker, whether married or not, according to his or her individual payroll tax liability (employer plus employee, in this legislation).)

The other source of marriage penalties is the consequence of families with more than two children. The child benefit of the SFC is not limited to any maximum number of children, so the formation of larger families has no negative impact on the family's taxes. The payroll tax component is not linked to children at all, so there is no impact there either.

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In terms of simplicity, work incentives, and marriage penalties, the new credits are a notable improvement over current law. It must be added that for the sake of limiting negative effects on tax liability relative to 2003 tax law, the cost of these credits is significant.

To raise revenue for purposes of deficit reduction and new spending initiatives, the Kucinich-Lee-Sanders bill rescinds tax cuts over the past three years that chiefly benefit upper-income persons. The most important "clawbacks" are: (a) it restores the top two tax rates that prevailed in 2000 — 36 and 39.6 percent; and (b) it changes the treatment of capital gains and dividends to conform to taxation of so-called ordinary income. At the same time, the bill effectively preserves benefits provided under the expansion of the child tax credit to middle- and lower-income families.

Without doubt, the most controversial aspect of the Kucinich-Lee-Sanders proposal will be that it devotes a large amount of revenues to a progressive tax cut/tax credit. Although it remains to be scored by official bodies, my best guess is that annually the PTA provides $85 billion in tax cuts and recovers $115 billion in revenue, for a net deficit reduction of $30 billion.[1] Those sympathetic to the general framework but more concerned with deficit trends or spending will prefer a scaled-down tax cut and more net proceeds. Alternatively, those more committed to a progressive distribution of the tax burden might prefer the proposal as it stands. Because the SFC is simple, it is easy to scale its size and cost up or down as desired.

In net terms, the Kucinich-Lee-Sanders proposal is a plus for deficit reduction. It raises more money than it costs. For workers and families with children, it is a progressive tax cut. For the nation, it tackles a task that everyone knows is necessary: recovering money lost from excessive tax cuts enacted after 2000. Whatever the reaction to the details of this proposal, a debate over revenue recovery clearly belongs on the agenda. For some, the equity dimension is at least as important, if not more so.

This proposal will tend to strike insiders and professionals as beyond the realm of plausibility. As for econometric models, it is commonly held that the best predictor of the future is the past. This is usually true, except when it isn't. For example, the current posture of House Republicans would have been difficult to predict in the 1980s. Nor would the pros have suspected that a tax proposal from Jerry Brown could consume the public debate in 1992.

With the waters of fiscal policy debate sufficiently roiled, the Kucinich-Lee-Sanders proposal could clear the way for more pragmatic efforts in the same direction. For one, Rep. Rahm Emanuel, D-Ill., has boosted the idea of an SFC since his successful electoral campaign in 2002, though he has not proposed tax increases that would reverse any part of the cuts enacted over the past three years.

In the absence of some kind of crisis, it is hard to imagine the passage of significant tax increases, especially with the current makeup of Congress. On the other hand, for those who believe current deficit trends are unsustainable, tax increases are inevitable. Tax credits such as the SFC could help lubricate the gears of this difficult exercise, aside from merely improving the tax treatment of income for those of modest means.

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[1]I am indebted to Robert Denk of the Institute on Taxation and Economic Policy for assistance on the revenue estimate. I take responsibility for any inaccuracies.

Three Versions of Puerto Rico's CFC Repatriation Proposals

By Ralph J. Sierra Jr.

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Once the Senate Finance Committee rejected Puerto Rico's government-sponsored amendment to Internal Revenue Code section 956, one would have thought the matter was dead and buried — yet proponents of the proposal have every intention of resurrecting it at the first opportunity. (For prior coverage, see *Tax Notes*, Oct. 6, 2003, p. 7.) However, I am tempted to ask, "Which proposal?"

Section 956 provides that when a controlled foreign corporation repatriates funds back into the United States, it is typically deemed or imputed to have paid a dividend to its stateside stockholders, more often a stateside, publicly held corporation (the parent company). The proponents of the proposal hope that by routing those profits through Puerto Rico, the companies will have sufficient incentive to move operations located elsewhere to Puerto Rico. Those proponents have not looked at the dark side of the proposal.

The First Proposal

The first effort to enact the Puerto Rico proposal was H.R. 2550, The Economic Revitalization Act of 2001. That would have conferred a 90 percent exemption from the dividend imputation consequence of section 956 when the CFC makes stateside investments prescribed by that section. If the investment is made through loans or equity participation in the parent company or another corporation under common control by the parent company (an affiliate), this version would allow the investment, when in the form of a loan, to be made free of interest, or if in the form of stock, free of the need to pay dividends. When the CFC pays an actual dividend to its parent company, the full amount of the prescribed investment will qualify as previously taxed income, so that the full federal income tax falls on only 10 percent of the amount invested stateside (the equivalent of an effective tax rate of 3.5 percent under today's rates). A qualifying CFC would have been incorporated under the laws of the Commonwealth of Puerto Rico or another possession of the United States, or incorporated under the laws of a foreign country, but was engaged in the active conduct of a trade or business in the Commonwealth of Puerto Rico or another possession of the United States. Also, the law would have prohibited the Internal Revenue Service from imputing interest on the loan or dividends on the equity investment. Or the stateside taxpayer could irrevocably elect to qualify dividends it receives from a CFC for a special deduction of 85 percent (the DRD).

Assume a Puerto Rico branch of a CFC, organized under the laws of Malaysia, operates as a sales office that is to be key in generating the sales of the product manufactured in Malaysia by the Malaysia CFC. As a practical matter, under these provisions, along with other provisions of federal income tax law, this could readily skew the profit split between the Malaysia factory branch and the Puerto Rico sales and marketing branch in favor of the Puerto Rico branch, even though the Malaysia branch might have many more employees than the Puerto Rico branch. If the products were delivered directly from Malaysia to the CFC's customer outside Puerto Rico, all of the income from that sale would avoid Puerto Rico income tax jurisdiction as well. Therefore, the multinational group would be able to avoid both federal and Puerto Rico income tax on a significant portion of its income.

Why Section 956?

Why do the stateside multinationals favor amending section 956 instead of seeking to amend the section of the federal income tax law that confers a special deduction for dividends received by stateside corporate taxpayers? The reason is evident from how the multinational and its CFC interact in their trade or business.

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The Puerto Rico proposal addresses the problems that the multinational has when its CFC conducts operations in a currency exchange control foreign jurisdiction. When a CFC, for example, produces items in a jurisdiction that has currency exchange control rules, the multinational company is reluctant to remit funds into that country because it fears being unable to promptly repatriate them back to the United States. For example, if a CFC sells $10 million of product to its stateside parent or an affiliate, the multinational will not want to transfer $10 million into that country. Similar to what takes place in our neighboring Dominican Republic, the only money that the company would send into that country would be the funds necessary to pay local costs, such as payroll, rent, and tax. It would not want to transfer any of the profit element in the $10 million.

The stateside entity records the $10 million sale on its books as $10 million in inventory and $10 million in accounts payable to the CFC. The CFC books an account receivable of $10 million and sales in the same amount. Although the receivable is from a stateside entity, it is not covered by section 956 because that stateside asset of the CFC was generated in the normal course of business. However, as time goes by, with its reluctance to remit $10 million to the currency exchange control jurisdiction, the multinational and its CFC agree to convert the remaining balance into a note payable. Ultimately, it cancels the note by converting it into a dividend to avoid transferring the funds and subjecting multimillions to being locked up indefinitely under a currency exchange control regime.

This course of events has several federal income tax implications that the taxpayer typically considers adverse. First, regarding the conversion of the account payable into a note payable, the IRS can impute interest on the note, subjecting it to a 30 percent tax. Second, the IRS can say there was never any intent to pay the note once it was created, therefore treating it as the payment of a dividend at that time and exposing it to a 35 percent tax. Third — the worst scenario — the IRS also could say that when the stateside entity received the $10 million of goods, there was never an intention to pay for them, thereby treating it as a dividend and likewise exposing it to a 35 percent tax.

The first proposed section 956 amendment would have allowed the multinational not only to avoid both federal and Puerto Rico income tax, but also to elect when the corresponding income would be subject to federal income tax. The companies could continue to have their factories elsewhere, not in Puerto Rico. The DRD alternative was not viable to multinationals operating in currency exchange control jurisdictions because they lost the flexibility of deferring the dividend recognition from the receipt of the goods, or the conversion of the account payable into a non-interest-bearing note. Puerto Rico would not replace investment overseas. It would accommodate the removal of the risk of locked U.S. dollars for companies in foreign jurisdictions with currency exchange controls — controls that Puerto Rico lacks.

The Second Proposal

After public debate with government representatives (published by *Tax Notes International*), the Puerto Rico government realized H.R. 2550 was a Trojan horse. (For prior coverage, see *Tax Notes Int'l*, June 18, 2001, p. 3167; *Tax Notes Int'l*, Aug. 13, 2001, p. 847; *Tax Notes Int'l*, Aug. 13, 2001, p. 849; *Tax Notes Int'l*, Aug. 13, 2001, p. 852; *Tax Notes Int'l*, Aug. 20, 2001, p. 973; and *Tax Notes Int'l*, Aug. 27, 2001, p. 1067.) The Puerto Rico proposal was modified in the Senate under S. 1475. Under the Senate version, the qualifying CFC had to be organized under the laws of the Commonwealth of Puerto Rico (or another territory or possession of the United States where that CFC principally carried out the conduct of its trade or business). As a result, Puerto Rico became more able to trap and tax a larger portion of the income generated by the Malaysian factory production that was sold into the international and stateside market. Although the Puerto Rico loophole was narrowed, the federal loophole remained the same.

The Third Proposal

Once it became apparent that the Senate Finance Committee was not going to allow a tax-free open road on profits derived initially from offshore manufacturing operations into the United States by routing them through Puerto Rico, a third proposal arose. "OK," the companies said (and Puerto Rico acquiesced), "we'll allow these profits to be taxed, but not now." Which reminds me of St. Augustine's pleading to God. "Dear God," he is reported as saying during his youth, "please give me the grace of Chastity . . . but not yet."

The third proposal that Puerto Rico put forth and defended was a rehashing of S. 1475, except that the 90 percent not subject to federal income tax would be taxed when the dividend was paid. That is, the CFC must be incorporated under the laws of the Commonwealth of Puerto Rico (or the corresponding territory or possession), only 10 percent of the imputed dividend would be subject to federal income tax, and the remaining 90 percent would no longer escape federal income tax but would be subject to federal income tax when the dividend was paid. In the scenario of the transactions above, that would be when the CFC forgives the note payable of the stateside entity and treats it as a dividend. In the interval, no interest could be imputed on the note. When companies explored Puerto Rico's tax advantages from the federal income tax perspective during the years when there was full income tax exemption, in comparison with other countries in which federal income tax was deferred but not eliminated, they concluded that 10 years of deferral is equal to full exemption.

Conclusion

From the corporate perspective, the section 956 proposals have provided diminishing solutions to a complicated situation. How much benefit Puerto Rico could derive by playing into the hands of the multinationals depends on how much the companies develop their Puerto Rico operations. However, Puerto Rico's expectation that multinationals would move factories located offshore to Puerto Rico is unlikely, based on the practical alternatives available to the companies after any of the three section 956 proposals are approved.