



TAX PROVISIONS IN THE SO-CALLED
“EDUCATION JOBS AND MEDICAID ASSISTANCE ACT” (H.R. 1586)
(as scheduled for consideration on the House Floor on August 10, 2010)

On August 10, 2010, the House is expected to consider further Senate amendments to H.R. 1586, a bill that provides \$26.1 billion in new social spending, primarily related to education jobs funding and federal matching funds for Medicaid (FMAP).¹ While some of this new social spending would be offset by other spending reductions as well as an unobjectionable provision that would repeal the advance earned income tax credit (EITC), **H.R. 1586 also recycles a series of highly controversial international tax changes that are broadly similar to provisions that House Republicans have overwhelmingly rejected as part of two separate bills over recent months.**² The U.S. Chamber of Commerce, the National Association of Manufacturers (NAM), the Business Roundtable (BRT), and the Promote America’s Competitive Edge (PACE) Coalition have all expressed serious concerns about these anti-competitive international tax changes and are expected to issue letters of opposition to these provisions.

I. INTERNATIONAL TAX CHANGES:

H.R. 1586 contains a series of international tax changes could have far-reaching consequences on the competitiveness of worldwide American businesses. **These changes should be considered, if at all, only within the broader context of a comprehensive tax reform effort that seeks to lower the very high U.S. corporate tax rate (at 35%, the second highest among our major trading partners).** These proposals should certainly not be used to “pay for” the social spending contained in this bill. Moreover, despite hopes that, under Chairman Levin, Ways and Means would return to “regular order” when considering tax legislation, when these international tax provisions were first unveiled in May, they were simply “air dropped” into a prior bill (what was then H.R. 4213, the Democrats’ “deficit extenders” bill, which passed the House on a mostly party-line vote) with virtually no notice, no consideration by Ways and Means, and no meaningful opportunity for public comment. Since that time, these revenue offsets have still not been formally marked up by Ways and Means, even though they have been the subject of increasingly intense criticism. This is just the latest disturbing example of the Majority’s behind-closed-doors approach to legislating. The American people deserve better.

¹ H.R. 1586, as originally passed by the House of Representatives on March 19, 2009, addressed the taxation of certain bonus payments received from certain TARP recipients. Subsequently, the Senate used this shell as a vehicle for entirely unrelated legislation providing a long-term reauthorization of the Federal Aviation Administration (FAA). The House then passed an FAA-related amendment to H.R. 1586 on March 25, 2010. Now, the Senate has once again repurposed this shell as the vehicle for the \$26.1 billion education jobs / Medicaid FMAP / international tax raisers / advance EITC elimination bill that is scheduled to be considered by the House on August 10, 2010. This document discusses only the bill’s tax provisions.

² On May 28, 2010, House Democrats used very similar provisions to help offset the cost of their “deficit extenders” package (H.R. 4213, Roll Call #324, R: 1-170), and on July 30, 2010, they unsuccessfully attempted to use them again to pay for a bill (H.R. 5982, Roll Call #514, R: 2-153) that would have eliminated the onerous new 1099 reporting requirements that the Majority enacted as part of its government health care takeover.

Several of the most significant of these international tax proposals are discussed below.

Prevent “splitting” of foreign tax credits. Under current law, U.S. corporations are taxed on their worldwide income. However, income earned by U.S. companies through foreign subsidiaries is generally taxed only when those earnings are repatriated to the U.S. (although certain exceptions exist for passive and certain “mobile” income upon which the U.S. company is taxed immediately). Since income of the foreign subsidiaries is generally taxed by the respective foreign jurisdictions, in order to minimize double taxation, U.S. companies are generally allowed to offset their U.S. tax liabilities on their foreign source income by the foreign taxes paid through foreign tax credits. However, some U.S. companies have adopted certain corporate structures that permit them to separate income earned in foreign countries from the taxes paid. As a result, these companies have been able to reduce their U.S. tax liability on other foreign earnings.

- The provision would establish a “matching rule” to prevent taxpayers from using these tax structures to split foreign tax credits from the associated foreign income.
- This provision would raise \$4.25 billion over 10 years.

Denial of foreign tax credit with respect to foreign income not subject to U.S. taxation by reason of covered asset acquisitions. Under current law, certain rules allow U.S. taxpayers to elect to treat an acquisition of a corporation as an asset acquisition under U.S. tax law. This election is longstanding tax policy that has been supported on a bipartisan basis. In the foreign context, U.S. companies generally choose to make this election for their foreign acquired subsidiaries because a foreign subsidiary can get a “step up” in basis for its assets for U.S. tax purposes, thereby increasing its amortization and depreciation expense deductions. This is important because the step up in basis may allow the acquired foreign subsidiary to reduce or eliminate U.S. tax on distributions back to the United States. For some transactions, the ability to make this election determines whether or not the U.S. company can afford to make the acquisition. While the provision would continue to allow companies to make this election, it would prevent a U.S. taxpayer from claiming a portion of the foreign tax credits to the extent those credits are associated with the benefits of the increased amortization and depreciation.

- The proposal could reduce the ability of U.S. companies to expand through acquisitions.
- This proposal would apply both to related-party and unrelated-party transactions.
- The proposal would raise \$3.645 billion over 10 years.

Limitation on the use of section 956 for foreign tax credit planning. Worldwide American businesses generally own foreign subsidiaries through multiple tiers. In some circumstances, lower tier foreign corporations may have a higher effective tax rate than foreign companies higher in the chain. If the lower-tier foreign corporation makes a distribution up through the chain of companies, the effective tax rate will be diluted and the U.S. parent corporation would owe U.S. tax on the dividend. However, if the lower-tier corporation loans the money directly up to the U.S. corporation, that loan is treated as a dividend from the lower-tier subsidiary directly to the U.S. corporation. Since the lower-tier foreign corporation’s effective tax rate is comparatively high, the U.S. parent corporation may owe little or no U.S. tax on the dividend. The proposal would force companies to “split” the income from the taxes and to treat the income as if it were paid directly up to the U.S. parent, while treating the taxes as if they were paid up the chain of foreign corporations.

- U.S. companies have been using this common planning technique for many years to distribute cash to the U.S. parent, and this technique has been blessed by the IRS.
- Democrats' proposals in this area seem geared more toward raising revenue than to effectuating clear, consistent, rational tax policy. While another section of the bill would prevent worldwide American companies from splitting taxes from income in order to raise federal revenues, this proposal would effectively force companies to split taxes from income in order to raise federal revenues.
- This provision would raise \$704 million over 10 years.

Repeal of the "80/20" rules. Under current law, interest or dividends paid from a U.S. corporation to a foreign person are generally subject to a 30% withholding tax (subject to reduction by treaty). However, if a U.S. corporation satisfies an 80% active foreign business income requirement, all or a portion of any interest or dividend paid by that corporation (the "80/20" company) is exempt from U.S. withholding tax. The provision would repeal these "80/20" rules and apply the 30% withholding tax on such payments. However, the provision would provide relief for existing 80/20 companies that meet specific requirements.

- This provision mirrors a proposal in the President's FY '11 budget request and has been scaled back from the version that was contained in H.R. 4849.
- This provision would raise \$153 million over 10 years.

II. REPEAL OF ADVANCE EARNED INCOME TAX CREDIT (EITC):

H.R. 1586 also contains an unobjectionable provision that would repeal the advance EITC. This provision is based on legislation (H.R. 5885) introduced by Rep. John Linder (R-GA), which House Democrats overwhelmingly opposed when it was the subject of a "You Cut" previous question vote on July 29, 2010.³

The EITC is a refundable tax credit that provides a wage subsidy to low-income taxpayers with earned income. It is "refundable" because it is paid to taxpayers whether they have positive income tax liability or not. A little-used provision in the tax code allows low-income workers to claim the EITC on an "advance" basis – i.e., in their paychecks over the course of the year rather than waiting to file their tax returns at the end of the year. An August 10, 2007 report by the Government Accountability Office (GAO) revealed significant non-compliance and fraud with the advance EITC (including 20% of claimants who did not have a valid Social Security Number), even though only 3% of EITC-eligible individuals use the "advance" option.

Sec. 219 of H.R. 1586 – like Rep. Linder's H.R. 5885 – would repeal the "advance" option for the EITC. It would not affect the ability of workers to claim their full EITC; rather, they would have to wait until they file their tax returns to do so, just as 97% of EITC recipients currently do. The Joint Committee on Taxation estimates that this provision would reduce outlays and increase revenues by \$1.13 billion over 10 years.

³ This was a vote to order the previous question on H.R. 5850 (making appropriations for the Departments of Transportation, and Housing and Urban Development, and related agencies for the fiscal year ending September 30, 2011, and for other purposes), Roll Call #484, D: 236-12, R: 0-167. By voting "yes" on this motion to order the previous question, Democrats effectively prevented consideration of Rep. Linder's legislation.