Insight

Elsewhere in Tax Reform

GORDON GRAY | JULY 17, 2017

While major health and tax reform legislation remains bogged down on Capitol Hill, the Trump Administration continues to pursue meaningful policy reforms through the regulatory process. In April, President Trump issued Executive Order 13789, which charged the Treasury Department with identifying burdensome tax-related regulation issued since the beginning of 2016, and providing recommendations for mitigating the burdens identified. In an interim report issued on July 7th, the administration identified eight burdensome tax regulations in need of reform, and invited public comment on whether the regulations specified by Treasury should be repealed or reformed. The Executive Order requires that Treasury submit to the president its recommendations for repealing or reforming these regulations by September 18.

The regulations identified for repeal or reform affect many areas of tax policy and vary in cost burden, but one regulation relating to transactions between foreign and domestic firms, the “385” rule, is sure to draw particular attention from observers and regulators turned reformers. The 385 rule – named for the section of the U.S. tax code from which it is derived – is an Obama-era regulation that sought to limit “earnings-stripping,” a tax avoidance strategy that reduces multinational firms’ U.S. tax bill.

Earnings stripping is characterized by using tax-preferred transactions (such as intercompany loans) to shift profits from high-tax jurisdictions to low-tax jurisdictions. The prototypical example involves a multinational firm headquartered in a tax haven with a subsidiary in a high-tax jurisdiction such as the U.S. To avoid paying tax on its U.S. subsidiary’s profits, the foreign parent loans its U.S. subsidiary funds on which the subsidiary must make interest payments. Interest payments are tax deductible in the United States, therefore shrinking the company’s tax bill, while directing income in the form of interest to the parent company (or conversely, “stripping” the earnings from the U.S. tax base).

Reducing artificial income shifting, and the corresponding reduction in the U.S. tax base, is a laudable policy objective. The 385 rules, in the words of Obama-era Treasury officials, were “a blunt instrument,” were fraught with problems, and drew wide criticism during the comment period. The final rules were responsive to some of the concerns raised at the time, but remained burdensome nonetheless.

Many of the Obama-era tax regulations, including the 385 rule, were symptomatic of a broad failure to modernize the antiquated U.S. tax code. Indeed, the 385 rules were initially bundled with other rules that were attempts to limit corporate “inversions.” The 385 rules were marketed as reducing tax advantages to firms once they move offshore. Like other separate but related rules, these regulations failed to address the root causes of corporate flight from the U.S. tax system, and instead imposed needless regulatory burdens on U.S. employers.