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Obama Eyes Expanded Taxing Power Over Digital Economy

By **Jonathan Randles**

Law360, New York (March 05, 2014, 7:14 PM ET) -- A proposed tax change floated by President Barack Obama that would expand the government's ability to tax digital products finds some common ground with Republicans, but experts said Wednesday that it may not achieve the administration's ultimate goal: preventing U.S.-based multinationals from shifting profits overseas.

Obama's proposed budget for fiscal year 2015 would create a new category of subpart F income for transactions involving digital goods or services. The provision, which is projected to raise approximately $4.9 billion through 2019, is aimed specifically at holes in the tax code that have allowed corporations to avoid paying U.S. taxes.

The president's budget also renews the administration's call to tax excess income generated through the transfer of intangible property — patents, trademarks and copyrights — from a U.S.-based corporation to a foreign entity it controls that's based in a lower tax jurisdiction. House Republicans offered a similar plan for taxing intangible property in their tax reform proposal released last week.

Edward Kleinbard, a professor at the University of Southern California Gould School of Law, said Obama and the GOP proposals are aimed at addressing the same problem: corporations shifting into tax havens income attributed to the development and exploitation of intangible assets. That there is some measure of unity on the issue is a sign that change to the corporate tax system is possible even in a highly partisan Congress, he said.

There is consensus among Democrats and Republicans that the corporate tax rate is too high and, although the parties split on potential fixes, agree that lowering the tax rate would be good for the U.S. economy and domestic investment, Kleinbard said. Whether that is enough for tax reform to gain traction on Capitol Hill remains to be seen, he said.

“Something has to happen in the corporate arena,” Kleinbard said. “There are lots of points of commonality, and the current environment is fundamentally unstable. It should be possible to imagine a standalone corporate tax reform.”

Congress enacted subpart F rules in 1962 with the goal of preventing U.S.-based multinational corporations from moving their income abroad to low-tax jurisdictions. But changes in how the U.S. recognizes foreign subsidiaries and seismic changes in business brought about by the advancement of digital technology have allowed companies to work around the rules.

Generally, subpart F income encompasses income from foreign entities and passive income including dividends, interest, rents and royalties, according to the U.S. Department of the Treasury. However, transactions involving computer software, for instance, could be characterized by a corporation as a sale or lease — a distinction that could be used to significantly reduce a company's tax liability, the Treasury said.

“By choosing different forms for substantially similar transactions involving digital goods and services (leases, sales, or services), taxpayers may be able to avoid the application of the existing subpart F rules,” the Treasury said in a report analyzing Obama's budget proposal.

“In this regard, the subpart F rules, which are generally intended to require current U.S. taxation of passive and highly mobile income, have not kept pace with advances in technology. This shortcoming enables [controlled foreign corporations] to shift income related to digital goods and services to low-tax jurisdictions, in many cases eroding the U.S. tax base,” the government said.

But experts warned that the administration's approach may not tax corporations' income effectively and, along with the Republican's competing tax plan, would add complexity to the existing labyrinth of U.S. tax rules.

Kleinbard described Obama's proposal as a piecemeal approach and said the new rules the administration is proposing would be elaborate and difficult to express in statutory language. Kleinbard previously served as chief of staff for the Joint Committee on Taxation, a nonpartisan congressional group that helps lawmakers write tax legislation.

“The solution is to tax firms on their worldwide income at a lower rate,” Kleinbard said.

NYU School of Law Professor Daniel N. Shaviro said Obama's extended subpart F mirrors Congress' original intent for the rules but added too that the effectiveness of the proposal will depend on the legislative language, writing in an email that “as always in these matters the devil is in the details.”

Shaviro also cautioned that the proposal likely would make it more appealing for businesses to develop their digital investments through companies that are not based in the U.S.

Calls to update U.S. tax laws to accommodate the growth of digital commerce aligns with a push internationally by the European Union and the Organisation for Economic Cooperation and Development.

Growth in cross-border business and profit-shifting is one factor that has contributed to a shrinking corporate tax base globally. The OECD is in the process of creating new international guidelines to address base erosion and price-shifting.

While substantive reforms may not be on the immediate horizon, substantial changes to how companies conduct business in the U.S. and abroad likely would require corporate restructuring to conform with new rules, said Mayer Brown LLP partner Shawn O'Brien.

O'Brien, who represents clients in international tax disputes, said that despite a perception that all multinational corporations are large-scale operations, more and more small- and medium-sized companies are conducting cross-border business.

“I think what people are really after is certainty,” O'Brien said. “Unfortunately, we haven't had certainty in the tax law for a long time.”

--Editing by John Quinn and Richard McVay.

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