# *Senate Finance Committee discussion draft includes certain proposals impacting US inbound investment*

*November 27, 2013*

## *In brief*

On November 19, 2013, Senate Finance Committee Chairman Max Baucus (D-MT) released a comprehensive international tax reform discussion draft. Although the primary emphasis of the discussion draft is the modification of rules applicable to outbound investments by US multinationals, the discussion draft also includes certain proposals that may impact foreign multinationals with US operations. The US inbound-specific provisions of the discussion draft are summarized below. See our *US Outbound Newsalert* for a more detailed discussion of these provisions as well as other provisions of the discussion draft.

## *In detail*

The proposed international tax reform includes several proposals appearing under the heading, *Provisions to Prevent Base Erosion*.

**Base erosion arrangements:** The discussion draft includes a broad and sweeping proposal that would deny deductions for related party payments arising in a 'base erosion arrangement' involving a hybrid transaction, instrument, or entity, or an exemption or conduit financing arrangement, that reduces the amount of foreign income tax paid or accrued. The proposal would apply to tax years beginning after 2014.

***Observation:*** The base erosion arrangement proposal appears aimed primarily at US inbound companies, and has potentially far reaching and significant implications for various related party arrangements that involve a deduction for US tax purposes and that have the effect of reducing foreign income taxes. The proposal is broadly drafted in a number of respects and may have significant unintended consequences for US subsidiaries claiming US deductions. In requesting comments on the proposal, Chairman Baucus stated that "foreign multinational corporations have substantial opportunities to avoid taxation through financing and licensing arrangements involving their US subsidiaries. For example, foreign multinationals can take advantage of differences between US and foreign tax laws to qualify for income tax treaty benefits while paying little or no US or foreign tax on income earned in the United States. Comments are requested regarding appropriate rules to limit such opportunities beyond the limitations imposed by current law or proposed in the staff discussion draft. For example, the Chairman's staff is considering whether deductions for payments to related foreign companies should be disallowed if the payment is taxed at a low rate in the foreign jurisdiction or whether to provide rules subjecting to US tax income generated by customer-based intangibles related to sales in the United States by foreign multinationals." The proposal raises serious concerns of unilateral action in an area that is now subject to multilateral consideration. The OECD base erosion and profits shifting (BEPS) action plan and report discusses the problems inherent with such types of unilateral action as likely to lead to increased uncertainty and lack of uniformly accepted standards.

**Reinsurance:** The discussion draft would disallow insurance companies a deduction for non-taxed reinsurance premiums paid to their foreign affiliates with respect to risks other than life insurance risks, but it would also exclude from such companies' taxable income that income properly allocable to the non-taxed premiums paid, such as ceding commissions and return premiums. The proposal would be effective for tax years beginning after 2013. This reinsurance proposal is identical to recent proposals from the Administration and Representative Neal (D-MA) for limiting deductible reinsurance payments to foreign affiliates.

**Repeal of portfolio interest exemption**: The proposal would repeal the exemption from US tax for portfolio interest of US corporate debt issued to foreign holders. The repeal is not intended to override US treaty obligations that reduce the rate of US tax on interest received by foreign investors. The proposal would apply to obligations issued more than one year after date of enactment.

***Observation:*** This proposal could significantly impact the amount of foreign capital available to US companies and the US economy generally. If enacted, certain capital exporting areas of the world may no longer find US corporate debt competitive with foreign issuers' debt, given that many countries have the equivalent of a portfolio interest exception. Foreign multinationals lending to their US affiliates where the loans can be linked to public debt issuances that no longer qualify for the portfolio interest exemption may also be impacted by this proposal.

**Investments in US real property**: The discussion draft would modify the rules relating to investments in US real property. The proposal would favorably increase the foreign investor exemption threshold for sales of interests in US regulated investment companies (e.g., mutual funds) and real estate investment trusts. The discussion draft would also provide a favorable exemption from tax for gains on the disposition of US real property interests owned by foreign pension funds. The proposal would generally apply to dispositions of US real property interests after date of enactment.

***Observation:*** While the proposal provides targeted relief for foreign investors in regulated investment companies and real estate investment trusts, as well as for foreign pension funds, these rules continue to remain overbroad.

**Foreign persons' sales of partnership interests**: The discussion draft would codify the IRS' ruling position by taxing foreign investors' gain from sales or exchanges of interests in partnerships conducting a US trade or business. The proposal would also include a new enforcement provision to require the tax to be withheld by the purchaser of the partnership interest and, where the purchaser fails to do so, by the partnership itself on distributions to the purchaser. The proposal would apply to sales and exchanges after 2014.

***Observation:*** The proposal is similar to a recent Administration proposal. The IRS is also currently litigating its ruling position which has been questioned by many practitioners.

**Thin capitalization rules**: The discussion draft contains thin capitalization proposals that limit interest deductibility allocable to exempt income of a controlled foreign corporation. In requesting comments on the proposal, Chairman Baucus stated that his "staff is considering whether the present-law 'thin capitalization' rules (addressing domestic companies that have excessive debt owed to foreign affiliates) should be tightened and expanded to apply to interest on all debt owed by a domestic corporation." Such a broad approach could have significant implications for US inbound companies.

## *The takeaway*

The Senate Finance Committee discussion draft contains a number of new international tax proposals that, if enacted, would have substantial implications for US inbound investment. The broad and far reaching implications of some of these US inbound related proposals may need to be further reconsidered.

## Let's talk

For a deeper discussion of how this might affect your business, please contact:

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