

# *US Outbound Tax Newsalert*

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*Senate Finance member Enzi  
introduces territorial tax bill  
with similarities and differences  
to Camp proposal*

## *Overview*

On February 9, 2012, Senate Finance Committee member Michael Enzi (R-WY) introduced an international tax reform bill that adopts a territorial tax system and makes significant changes to the subpart F and foreign tax credit ("FTC") regimes. Although the bill does not reduce the corporate income tax rate, Sen. Enzi anticipates future tax reform efforts will reform the taxation of individuals, flow-through businesses, and corporations. Sen. Enzi intends that the bill not increase the deficit and has requested a revenue estimate from the Joint Committee on Taxation.

The bill has some similarities to the October 26, 2011, Discussion Draft released by House Ways and Means Committee Chairman Dave Camp (R-MI). Both proposals include a 95 percent dividends received deduction ("DRD") for dividends received by a corporation that is a 10 percent shareholder in a controlled foreign corporation ("CFC") or a foreign corporation that elects to be treated as a CFC. However, the proposals differ in the treatment of foreign branches, gain on sale of a CFC shares, previously taxed income ("PTI"), FTC limits, undistributed pre-effective date earnings and profits ("E&P"), hybrid dividends, and anti-base erosion rules.



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## *Implementing a modified territorial tax system*

### **Applying the 95 percent DRD**

The Enzi bill would create a new section 245A that provides a 95 percent DRD for qualified foreign-source dividends distributed out of E&P accumulated in tax years beginning after 2012 and received by a corporate 10 percent US shareholder from a CFC. The DRD would result in a 1.75 percent tax rate (35 percent of five percent) on such dividends, which would include section 1248 amounts. The DRD would be available only if the CFC's stock has been held for at least one year by the 10 percent US shareholder receiving the dividend, as determined using section 246(c) (with modifications). No FTCs would be available to offset the taxable five percent of the dividends as the amount would be treated as income from US sources and no deduction would be available for withholding taxes.

As under the Camp Draft, subpart F or passive foreign investment company ("PFIC") inclusions would not be treated as qualified dividends, but the Enzi bill would also disqualify hybrid dividends (i.e., dividends treated as interest in the payer's country of residence). Unlike the Camp Draft, distributions out of E&P accumulated in tax years beginning before 2013 would be taxed as under present law and earnings would be deemed distributed on a first-in, first-out basis.

The Enzi bill would allow any corporate US shareholder of a 10/50 company in the top three tiers of a foreign corporate chain to elect to treat the 10/50 company as a CFC, and thereby be eligible for the DRD. A 10/50 company below the third tier would be ineligible for the election, and would be denied section 902 credits. Dividends from a 10/50 company ineligible for the DRD would generally remain subpart F income in the hands of a CFC payee. Unlike the Camp Draft, the Enzi bill would allow the election to be made for each 10/50 company separately. Also unlike the Camp Draft, the Enzi bill would not treat all first-tier foreign branches as CFCs, although it would authorize regulations to deal with branches under the territorial regime. The technical explanation of the bill anticipates that this may include guidance to prevent inappropriate loss or FTC planning, including through the use of branches.

**Observations:** Similar to the Camp Draft, the Enzi bill would apply the DRD regime only to US subchapter C corporations, but some other provisions of the Draft would apply to all taxpayers. In some instances the bill would increase the US tax burden on non C-corporation shareholders of foreign corporations. The bill proposes the 95 percent DRD to be effective starting in tax years beginning in 2013. As in the Camp Draft, the Enzi bill preserves domestic deductions that might be considered attributable to DRD-eligible income.

### **Four tax regimes for foreign earnings of US corporations**

Consistent with the Camp Draft, the earnings of US corporations received from related foreign corporations and foreign branches (PFICs) generally would be taxed under one of four regimes:

1. **Territorial regime.** As described above, dividends (gross of withholding tax) from CFCs -- and electing 10/50 companies -- derived from non-subpart F foreign income would be 95 percent exempt, with no FTCs;

2. Portfolio investment regime. Dividends (gross of withholding tax) from non-electing 10/50 companies, foreign companies in which the US shareholder owns less than a 10 percent interest, and 10 percent-owned foreign subsidiaries for which the one-year holding period is not satisfied would be fully taxable, with a direct section 901 FTC for any foreign withholding taxes. No indirect FTC would be allowed under section 902, which would be repealed with respect to post-2012 earnings.
3. Subpart F regime. Subpart F income of CFCs and electing 10/50 companies would be subject to current US tax with a section 78 gross-up and FTCs for indirect (section 960) and direct (section 901) foreign taxes, as appropriate. As under current law, distributions out of PTI would not be taxed again.
4. Branch regime. First-tier foreign branches would be taxed as under present law subject to regulations intended to prevent inappropriate loss and credit planning.

### **Pre-enactment earnings**

Unlike the Camp Draft, the Enzi bill would not require that pre-enactment earnings of foreign subsidiaries be included in income at the end of the last tax year preceding the territorial system. Instead, Enzi proposes to modify section 965, under which corporate 10 percent US shareholders could elect a one-time 70 percent DRD for eligible dividend amounts received in the first post-2012 year from any CFC (but not a 10/50 company) out of pre-2013 E&P. Eligible amounts include both cash dividends and special subpart F deemed dividends, and are the lesser of (1) the shareholder's pro rata share of the CFC's pre-2013 earnings or (2) cash dividends paid out of pre-2013 earnings plus any portion of the shareholder's pro rata share of the CFC's pre-2013 earnings that the taxpayer elects to deem as subpart F income. Unlike the Camp Draft, the Enzi bill would not allow an FTC or deduction with respect to foreign taxes attributable to these amounts. Moreover, the remaining 30 percent of any dividends that is taxable (after application of the 70 percent DRD) would be treated as US-source income.

As in the Camp Draft, taxpayers could elect to pay tax on the pre-enactment earnings in up to eight equal annual installments.

**Observation:** Although the DRD for repatriating pre-enactment E&P in the Enzi bill may be less generous than in the Camp Draft (where it is bracketed at 85 percent), the elective nature of the repatriation provision would allow taxpayers to choose the most favorable combination of earnings to repatriate before the effective date, within the first post-2012 tax year, and in subsequent years.

### ***Subpart F and related provisions, including new subpart F category***

Unlike the Camp Draft, the Enzi bill would not repeal section 956 (which taxes investments in US property by CFCs) or 959 (which exempts previously taxed subpart F income from further tax on repatriation), but it would repeal section 954(d) and 954(e), governing foreign base company sales income ("FBCSI") and foreign base company services income ("FBCSvI"). Also, the Enzi bill would extend permanently the active financing exception (section 954(h)) and the CFC look-through rules (section 954(c)(6)).

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The Enzi bill would add a new category of subpart F income under which all income of a CFC is deemed taxable unless the US shareholder establishes that the CFC's effective tax rate ("ETR") exceeds one-half of the maximum rate applicable to US corporations, which would currently establish a floor of 17.5 percent, based on the 35 percent maximum rate. The ETR would be determined on a country-by-country basis for each country in which a CFC conducts any trade or business, using US principles similar to those applied in analyzing the subpart F high-tax exception.

"Qualified business income" of a CFC would not be considered subpart F income under this rule even if the CFC's ETR for a given country was below the threshold. Qualified business income is defined as a CFC's income (other than "intangible income" as defined in the bill) that arises in a foreign country, attributable to the active conduct of a trade or business by the CFC through a fixed place of business and by its employees physically located in the country.

**Observations:** While liberalizing the subpart F rules in some respects, the Enzi bill effectively would repeal deferral for intangible income earned by CFCs or 10/50 companies treated as CFCs. The retention of section 956 allows for claiming FTCs on an elective basis by making investments in US property rather than distributing CFC E&P.

### *FTC changes*

The bill would repeal the section 902 indirect FTC for post-2012 earnings but preserve the section 960 indirect credit (with some modifications). As noted above, credits would not be available for dividends subject to the 95 percent DRD.

Unlike the Camp Draft, the Enzi bill would not eliminate the allocation and apportionment of a US person's indirect expenses, but would accelerate the effective date of worldwide interest expense allocation rules to apply to taxable years beginning after December 31, 2012. Unlike the Camp Draft, the Enzi bill would not place all foreign taxes in one basket or repeal the section 909 anti-splitter rules. Rather, the Enzi bill would create a new FTC basket for foreign intangible income.

### *Deduction for foreign income derived from US-developed IP*

The Enzi bill would provide a deduction equal to 50 percent of the "qualified foreign intangible income" derived by a US corporation from the active conduct of a US trade or business with respect to intangible property ("IP") giving rise to that income. For this purpose, foreign intangible income must arise from goods and services provided to foreign customers, and it is only treated as from active conduct of a US trade or business if the US corporation developed, created, produced, or added substantial value to the IP in the United States through the active conduct of a US trade or business.

**Observation:** Unlike the anti-base erosion Option C in the Camp Draft, the Enzi bill would fully tax the IP income of CFCs with no deduction. It is unclear whether Camp Option C or the Enzi bill is compliant with the World Trade Organization rules that limit export-contingent tax incentives.

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## *Repeal of export source rules*

The Enzi bill would eliminate the inventory property sales sourcing rules for FTC purposes.

**Observation:** Under present law, the export sales source rule is beneficial to companies that otherwise would not have enough foreign source income to fully utilize FTCs. Due to the adoption of a territorial tax system, the export sales source rules are likely to be less important than under current law.

## *Gain or loss on sales of foreign corporation stock*

The Enzi bill would make any section 1248 deemed dividend amount eligible for the 95 percent DRD, but capital gain in excess of that amount would be taxed under present law. The Enzi bill also treats as a dividend, eligible for the DRD, the subpart F income arising from any gain on a sale of stock by an upper-tier CFC in a lower-tier CFC (or electing 10/50 company), to the extent that it is recharacterized as a dividend.

No deduction would be allowed for any loss recognized from a sale or exchange of foreign corporation stock where a US corporation owned at least 10 percent of the vote at any time when the foreign corporation was a CFC during the five years preceding the sale. A similar rule would apply to disallow E&P deductions for sales of stock of lower-tier CFCs by upper-tier CFCs.

## *No proposals on partnerships or thin capitalization*

Unlike the Camp Draft, the Enzi bill does not specifically grant the Treasury Department authority to issue regulations governing the treatment of partnerships. Nor does it provide rules limiting deductions for the net interest expense of US corporations.

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