US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

July 29, 2011

Rep. Tierney introduces bill with "excess return" Subpart F provision

On July 11, 2011, Rep. John Tierney (D-MA) introduced the Tax Equity and Middle Class Fairness Act of 2011 (H.R. 2495), (the "Tierney bill"), which purports to contribute to deficit reduction by ending many so-called "tax expenditures." This bill is significant primarily because it introduces the first draft statutory language for the Obama Administration's budget proposal on "excess returns" earned by CFCs on outbound transfers of intangible property ("IP"). It also introduces the first draft statutory language for the Obama Administration's budget proposals on income-shifting via IP transfers and the treatment of dual-capacity taxpayers, as well as legislative language on interest expense deferral and foreign tax credit ("FTC") blending provisions.

Observation: Congressman Tierney is not a member of the House Ways & Means Committee, and it is not known who was responsible for drafting the language of the bill, or whether any Ways & Means Committee members or the Administration support the specific language. In any case, this legislation is unlikely to be considered during this year's legislative session.

Subpart F Treatment for "Excess Returns" on Outbound IP Transfers

The Tierney bill would add new section 954(f) to the Code, describing the treatment of Foreign Base Company Excess Intangible Income ("FBCEII"). FBCEII is defined as (with respect to any covered intangible), the excess of gross income from the sale, lease, license, or other disposition of property in which the covered intangible is used (directly or indirectly), plus any gross income from the provision of services related to such covered intangible (or in connection with property in which such covered intangible is used), over 115 percent of the costs that are directly (and properly) allocable to the gross income (thus, not counting, among other expenses, interest and taxes). The bill contains a same-country exception for FBCEII.

The provision defines a "covered intangible" as a section 936(h)(3)(B) intangible that is sold, leased, licensed, or otherwise transferred (directly or indirectly) to the tested CFC by a related person (under the usual Subpart F definition in section 954(d)(3)), or that is covered by a cost-sharing agreement to which the CFC is a party. The Subpart F inclusion operates on a sliding scale, based on the foreign effective tax rate to which the CFC's tested income is subject. The scale ranges from full inclusion at a ten percent effective rate to full exclusion at 35 percent; technically, the exclusion is calculated as a percentage of income based on the ratio of the number of percentage points by which the effective rate of income tax exceeds 10 percentage points, over 25 percentage points. The effective tax rate is determined without regard to the impact of any tax losses.

As proposed by the Obama Administration, a separate FTC basket would be created for FBCEII under section 904(d). Conforming amendments would ensure that FBCEII would not be treated as any other kind of foreign base company income, and that items of income could be aggregated for purposes of FBCEII treatment. The provision would be effective prospectively, for tax years starting after enactment.

Observation: This proposal appears to be very harsh with respect to the rate of return and foreign tax rates that would trigger its application. It would only allow a 15 percent return on directly allocable expenses, which would mean that all CFCs in industries with higher routine profit margins might be subject to scrutiny under this provision. Moreover, the sliding scale of 10-35 percent for foreign tax rates means that this new Subpart F treatment would likely apply to CFCs in almost all OECD countries, as the corporate income tax rates in those countries have generally been reduced in recent years. (The range of tax rates and the rate of return that have been mentioned informally by Obama Administration officials with respect to this proposal are less draconian than the numbers in the Tierney bill.) Note also that the language of the bill does not distinguish between a U.S. "related person" and a foreign "related person," meaning that IP developed and owned outside the United States could be subject to this Subpart F treatment if it is transferred to a CFC that generates an "excess return." Finally, note that the definition of "covered intangible" would presumably be expanded by the Obama Administration's proposal to limit income-shifting through outbound IP transfers. The Tierney bill also provides legislative language for this provision; see below.

Interest Expense Deferral and FTC Blending

The Tierney bill adapts the structure and language of Rep. Charles Rangel's 2007 tax reform bill (the "Rangel bill") to implement the Obama Administration's proposal on interest expense deferral. The proposed section 975 language in the Tierney bill appears to be identical to the Rangel bill's language except where it narrows the deferred deductions to interest expense only.

With respect to the FTC blending provision, the proposed section 976 language in the Tierney bill is identical to the Rangel bill's language, with no exceptions.

Observation: It appears that the Tierney bill was drafted without fully considering the ramifications of its statutory language. The interest expense deferral proposal would apply the mechanics of the Rangel bill's expense deferral proposal to the Obama Administration's narrower interest expense deferral proposal, which could raise implementation issues. In addition, because the Tierney bill adopts the Rangel approach to FTC blending without change, it would apparently include both section 901 and 902 credits, unlike the narrower Obama Administration proposal which is limited to section 902 credits.

Limiting Perceived Income-Shifting from IP Transfers

The Tierney bill addresses perceived abuses involving outbound transfers of IP characterized as goodwill, workforce-in-place or going-concern value by adding those types of intangibles (as listed under section 197(d)) to the list of intangibles in section 936(h)(3)(B)(vi) that is used as the basis for applying section 367(d) to outbound IP transfers.

The Tierney bill implements the aspect of the Obama Administration's proposal dealing with valuation methods for outbound IP transfers by granting regulatory authority under both sections 367(d) and 482 to value such transfers either on an aggregate basis, or on the basis of the "realistic alternatives" to such a transfer.

The provision would be effective prospectively, for tax years starting after December 31, 2011. However it is explicit that no inference is intended as to the treatment of transfers made before the effective date.

Modifying FTC Treatment for Dual-Capacity Taxpayers

The Tierney bill creates a new section 901(n) to implement the Obama Administration's proposal with respect to dual-capacity taxpayers. The provision specifies that any FTC amount paid or accrued by a dual-capacity taxpayer with respect to combined foreign oil and gas income (as defined in section 907(b)(1)) would not be creditable to the extent it exceeds the amount that would have applied if the taxpayer were not a dual-capacity taxpayer. For this purpose, "dual-capacity taxpayer" is defined as a person that is subject to a levy of a foreign country or U.S. possession, and would receive (directly or indirectly) a specific economic benefit from that country or possession." The provision would rely on regulations to clarify the application.

The provision would be effective prospectively, for tax years starting after December 31, 2011, but it explicitly would not override any U.S. tax treaty.

General Observation: The Tierney bill introduces the first draft statutory language for some of the Obama Administration's budget proposals. The draft language does not seem to consider the administrability of the provisions, or that they would implement effectively the policy purposes of the Administration's proposals. As noted, it is not known whether any Ways & Means Committee members or the Administration support the specific language, or whether future bills embodying these proposals may take a different approach.

For more information, please do not hesitate to contact:

Tim Anson	*(202) 414-1664*	*tim.anson@us.pwc.com*
Alan Fischl	*(202) 414-1030*	*alan.l.fischl@us.pwc.com*
Mike Urse	*(216) 875-3358*	*michael.urse@us.pwc.com*
Mike DiFronzo	*(202) 312-7613*	*michael.a.difronzo@us.pwc.com*
Chip Harter	*(202) 414-1308*	*chip.harter@us.pwc.com*
Carl Dubert	*(202) 414-1873*	*carl.dubert@us.pwc.com*
Marty Collins	*(202) 414-1571*	*marty.collins@us.pwc.com*
Greg Lubkin	*(213) 356-6984*	*greg.lubkin@us.pwc.com*