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Obama Administration releases legislative language for international tax proposals

On September 12, 2011, the Obama Administration released legislative language for the American Jobs Act, including two revenue-raisers in the international tax area: the FY 2012 Budget proposal to modify the treatment of dual-capacity taxpayers and a companion provision to create a new section 904 foreign tax credit ("FTC") basket for oil and gas income. On September 19, 2011, the Obama Administration released *The President's Plan for Economic Growth and Deficit Reduction*, with legislative language for five additional revenue-raising proposals in the international tax area from its fiscal year (FY) 2012 Budget. This language includes the long-awaited articulation of five international tax provisions:

- Deferral of interest expense deductions for foreign-related expenses
- Pooling of deemed-paid FTCs
- Subpart F category for excessive returns on intangible property ("IP") transferred outbound
- Valuation methods and scope of IP under section 367(d)
- Earnings-stripping rules for inverted companies

All of these provisions would be effective for tax years beginning on or after January 1, 2013, which is generally a year later than the effective date for these provisions in the FY 2012 Budget. This memorandum summarizes and analyzes the legislative language for all seven of the provisions described above.

General Observations

Although some version of these proposals has been in the Administration's Budget for the past two or three years, observers including the Joint Committee on Taxation ("JCT") have speculated as to their technical details. This document provides the first look at the Administration's version of those details. The proposed language of these provisions is generally new, with mechanisms unlike previous versions of these concepts, including the proposals regarding deduction deferrals and FTC pooling in legislation introduced by former House Ways and Means Committee Chairman Rangel in 2007.

The proposed effective dates for these provisions look ahead to the next presidential term. Although these proposals may not be enacted in isolation, or as revenue-raisers for other legislation, in the near-term, they constitute an important window into the Administration's approach to comprehensive corporate tax reform. When the Administration unveils its tax reform package, it may offer a system based on territorial tax principles while using some of the ideas embodied in these proposals.

Subpart F Income for Excess Returns Associated with Transferred Intangibles

This proposal has generated the greatest interest and uncertainty with respect to its scope and potential impact, and the legislative language answers many of the questions observers have been asking, although some uncertainties remain. The Administration has adopted some of the language offered on this proposal by Rep. John Tierney (D-MA) earlier this year (H.R. 2495). (See US Outbound Tax Newsalert dated 07/29/11)

Proposed section 954(a)(4) would create the new Subpart F category of foreign base company excess intangible income ("FBCEII"), with specific rules under proposed section 954(f). The language clarifies such fundamental issues as the scope of covered intangibles; the rate of return that would be considered excessive, rendering income potentially subject to FBCEII treatment; the mechanism for associating a transferred intangible with an excessive return; and the level of foreign tax below which a CFC would be potentially subject to FBCEII treatment.

With respect to scope, all section 936(h)(3)(B) intangibles would be covered if they are sold, leased, licensed, or otherwise transferred (directly or indirectly) to a CFC by a U.S. related person (using the section 954(d)(3) definition). In addition, an intangible subject to any shared risk or development agreement (including any cost-sharing agreement) between the CFC and any related person(s) would be covered. The language does not require that a U.S. person be a party to the agreement, which may be a drafting error, as otherwise there would be no transfer of the intangible from a U.S. person at all.

The threshold for an excess return is a 50 percent mark-up over the CFC's directly allocable costs, specifically excluding interest and taxes. This threshold is more generous than the 15 percent margin in the Tierney bill but still may be low for some industries. However, taxpayers with significant research and development costs may appreciate that all such costs would be treated under proposed section 954(f) as properly allocable to income derived from a covered intangible. This treatment would increase the amount of costs against which the margin is measured.

As in the Tierney bill, the income subject to potential FBCEII treatment includes gross income from the sale, lease, license, or other disposition of property in which the covered intangible is used (directly or indirectly), and from services related to the covered intangible or in connection with property in which the covered intangible is used (directly or indirectly). This language attempts to associate the income received with the transferred intangible. Like the Tierney bill, proposed section 954(f) would exclude same-country income from FBCEII.

The foreign tax rate threshold in the Administration proposal is also much more workable than in the Tierney bill, which set a 35 percent effective tax rate as the minimum required to avoid FBCEII treatment. However, in the Administration's proposed section 954(f), the floor is ten percent and the ceiling is only 15 percent; that is, all of the relevant income would be characterized as FBCEII if a CFC's effective rate is ten percent or lower, and none of the relevant income would be characterized as FBCEII if a CFC's effective rate is fifteen percent or higher. Between ten and fifteen percent, the proposal imposes a sliding scale based on the "applicable percentage" of the five percentage points between 15 and ten percent (i.e., a 12 percent effective rate would result in a 60 percent FBCEII inclusion). The proposal allows taxpayers to calculate the effective rate of a CFC without including any losses incurred in, or carried over into, the current year. Thus, a CFC carrying start-up losses forward to early years of high profitability apparently could ignore the impact of the losses on its tax rate in those years.

In coordination with other provisions, the Administration proposes that FBCEII would constitute a separate FTC basket under section 904 and would not be treated as any other kind of foreign base company income under section 954.

Observations

Changes to this proposal for FY 2012 were apparently made in response to comments from the Joint Committee and others, requiring a closer connection between the transferred intangibles and the excess income. The relatively high 50 percent mark-up, the addition of all R&D costs to expenses directly allocable to covered intangibles, and the relatively low 15 percent effective tax rate ceiling for FBCEII all seem taxpayer favorable. However, even a number of OECD countries have statutory rates under 20 percent and Ireland currently has a 12.5 percent rate so this revised effective rate test might apply to income arising in many jurisdictions.

The proposed section 954(f) language suggests that it would apply to all covered intangible transfers (sales, licenses, cost-sharing agreements, etc.), whenever they may have occurred. The numbers for the rate of return and effective tax rate do not correspond precisely to the numbers previously stated by Treasury as used in its prior revenue estimates.

Deferral of Deductions Allocable to Unremitted Foreign Earnings

Under the Administration's proposal, deductions of "foreign-related interest expense" would be allowed only to the extent that such expenses are properly allocable or apportionable to currently taxed foreign income. Foreign-related deductions properly allocable or apportionable to foreign income not currently taxed would be deferred; those deductions could be taken in subsequent years as previously deferred foreign earnings are repatriated and subjected to U.S. taxation.

Unlike the 2007 Rangel bill, which would have created an entirely new Code section for foreign-related expense deferral, the Administration's proposed language would create a new Code section 163(n) (redesignating the current section 163(n)), consistent with the narrowing of the proposal to interest expense only. The mechanics are relatively simple, limiting the amount of foreign-related interest expense allowed as a deduction for any given tax year to an amount that bears the same ratio to the sum of (a) the current-year foreign-related interest expense and (b) the deferred foreign-related interest expense as the "current inclusion ratio."

The current inclusion ratio is a percentage reflecting (i) the sum of all current-year dividends and Subpart F inclusions (without the section 78 gross-up) by a U.S. corporation from a section 902 (basically, a ten percent-owned foreign) subsidiary, divided by (ii) the aggregate amount of the subsidiary's post-1986 undistributed earnings (that is, the U.S. shareholder's pro rata share) for the tax year. For this purpose, the amount of undistributed earnings would be determined by translating each section 902 corporation’s post-1986 undistributed earnings into dollars using the average exchange rate for the current year. The current inclusion ratio for an affiliated group (as defined in section 864(e)(5)(A)) would be determined as if all members were a single corporation, and the computations would be applied separately to each section 904 basket.

If the allowable amount of foreign-related interest expense using the ratio exceeds the actual foreign-related interest expense for the year, any deductions deferred from previous years would be allowed up to the amount of the excess (or the remaining deferred foreign-related interest expense, whichever is less). Proposed section 163(n) would define "foreign-related interest expense" on the basis of asset-based apportionment to foreign-source income that excludes foreign-source income earned directly by a U.S. company. Thus, foreign-related interest expense is the percentage of interest expense for the tax year apportioned under sections 861 and 864(e) to foreign-source income that corresponds to the proportion that (i) the value that the stock of all section 902 corporations bears to (ii) the value of all assets that produce foreign-source income. The aggregate amount of foreign-related interest expense that would not be allowed as a deduction in prior years under the current inclusion ratio formula would become the "deferred foreign-related interest expense."

The legislative language includes five specific regulatory delegations to deal with circumstances that could potentially complicate the relatively simple mechanics of this proposal:

1. Changes in ownership of a section 902 corporation.
2. Treatment of certain corporations that otherwise would not be members of the affiliated group as members of the affiliated group.
3. A section 902 corporation with a deficit in earnings and profits.
4. Impact of effectively connected income on (i) stock value determinations for section 902 corporations and (ii) foreign-related interest expense.
5. Interest expense that is directly allocable to income.

Observation

The release of the legislative language answers many outstanding questions about the interest expense deferral proposal, but the regulatory delegations suggest that the mechanics still require clarification. As noted in a previous communication (See US Outbound Tax Newsalert dated 02/17/11), the interest deferral proposal has conceptual similarities to the 2007 Rangel bill but it is narrower in scope and would not repeal worldwide interest expense apportionment ("WWIA"). Legislation enacted in 2009 and 2010 postpones the effective date of WWIA until 2021, but the JCT has commented that, without WWIA, this interest expense deferral proposal would be an "overcorrection" of any perceived issue involving the deduction of U.S. expenses allocable to foreign income.

Blending Section 902 Foreign Tax Pools

The administration's proposal to blend section 902 FTC pools has been coordinated with the interest expense deferral proposal to a significant degree, removing some of the existing questions about the interaction of these two proposals.

The proposed mechanics of the two provisions would be similar, based to some extent on shared computations. The legislative language would create a new section 910 specifying that the aggregate amount of deemed-paid (under section 902 or 960) post-1986 foreign income taxes creditable in a given tax year would be limited to the current inclusion ratio for the sum of the current-year foreign income taxes and the "suspended post-1986 foreign income taxes." For this purpose, the current inclusion ratio would be the same as for the interest expense deferral proposal. Foreign tax credits would be suspended (and subsequently allowable) under proposed section 910 in a similar manner to the deferral of interest expense deduction under proposed section 163(n). Consistent with the interest expense deferral proposal, currency translations would use the average exchange rate for the current year, and the computations would be applied separately to each section 904 basket. Note that any suspended foreign tax credited in a subsequent year would be treated as paid by a U.S. corporation in the year in which the credit is allowed.

The FTC blending proposal has four specific regulatory delegations, most of them similar to those for the interest expense deferral proposal, relating to:

1. Changes in ownership of a section 902 corporation.
2. Treatment of certain corporations that otherwise would not be members of the affiliated group as members of the affiliated group.
3. A section 902 corporation with a deficit in earnings and profits.
4. Amounts taken into account under section 960.

Observation

The release of the legislative language resolves many of the questions about the FTC blending proposal, but the mechanics still require clarification. As noted in a previous communication (See US Outbound Tax Newsalert dated 02/17/11), a key question raised in the JCT's 2011 analysis has been whether existing, pre-effective date earnings and tax pools of all CFCs would be combined into a single earnings pool and a single tax pool for purposes of calculating the deemed paid tax credit with respect to post-effective date distributions. It does not appear that proposed section 910 makes any distinction between pre-effective date earnings and post-effective date earnings, which could have a significant impact on post-enactment financial accounting positions.

In addition, it is unclear how the Administration envisions that this provision would interact with recently enacted section 909. This provision goes further than section 909 because it addresses what may be the Administration's concerns with cross-crediting of foreign taxes, but it also creates overlaps in the area of separating credits from earnings which is covered by section 909. Finally, the proposal carries with it serious questions of administrability for both taxpayer and the government.

Valuation and Definition of Intangible Property

The Administration's efforts to limit perceived income-shifting through outbound transfers of IP have culminated in simple amendments to sections 367, 936, and 482.

Proposed section 936(h)(3)(B)(v) would add workforce in place, goodwill, and going concern value to the list of IP relevant for all purposes for which the section 936(h)(3)(B) definition is used, such as the proposed section 954(f) excess return provision.

The proposal would add virtually identical language to the end of sections 367(d) and 482 regarding valuation of IP, providing that the IRS could (i) aggregate transfers of IP property where that achieves a "more reliable" result, and (ii) take into consideration what a controlled taxpayer could have realized by choosing a "realistic alternative" to the transaction.

Observation

This language implements a proposal that the Administration has maintained for three budget cycles, attempting to combat perceived abuses in outbound transfers of foreign businesses with significant enterprise IP that have not been valued in a manner that the IRS has considered reliable or realistic. The provision contains no surprises.

Limiting Earnings-Stripping by Inverted Companies

The Administration's proposal to further limit earnings-stripping by inverted companies through interest deduction limitations has given rise to a proposed new section 163(j)(9).

The legislative language implements what the Administration's Budget proposed: tightening the limitation on the deductibility of interest paid by an "expatriated entity" to related persons by (i) eliminating the section 163(j) debt-to-equity safe harbor; (ii) reducing the 50 percent adjusted taxable income threshold for the limitation to 25 percent, and (iii) limiting the carryforward for disallowed interest to ten years and eliminating the carryforward of excess limitation. In addition, the language implements the expansion of the definition of an expatriated entity by applying the rules under section 7874 as if they governed inversions occurring after July 10, 1989 rather than those occurring after March 4, 2003.

The legislative language only governs expatriated entities as such, but it adds a regulatory delegation for application of the provision to interest accrued by surrogate foreign corporations (as defined in section 7874) and successor persons. Presumably, those regulations would implement that Budget proposal's statement that this tightening of the interest expense deduction limitation would not apply if the surrogate foreign corporation is treated as a domestic corporation under section 7874.

Observation

Here, too, the language implements a proposal that the Administration has maintained with little change. It seeks to develop a rule that defines boundaries that differ amongst taxpayers. The proposal also retains the draconian treatment of companies that have inverted since 1989, long before any anti-inversion rules were contemplated. The provision's retroactive reach becomes more unreasonable by the continuing expansion of the expatriated entity definition through regulatory guidance.

Foreign Tax Credit Rule Changes for Dual-Capacity Taxpayers and Oil and Gas Income

The Administration's proposal to modify the FTC rules applicable to dual-capacity taxpayers has been articulated in section 441 of the American Jobs Act as proposed new section 901(n). This new rule would limit the amount of foreign tax that can be credited by a dual-capacity taxpayer (or any member of its worldwide affiliated group) to the amount that the taxpayer would have been required to pay if it were not a dual-capacity taxpayer. The mechanism used to limit creditability would be to treat any amount paid to a foreign government in excess of that amount as not being a tax. The proposed language defines a dual-capacity taxpayer as a person that is subject to a levy in a foreign jurisdiction and also receives (directly or indirectly) a specific economic benefit from that jurisdiction. The American Jobs Act language specifies that proposed section 901(n) would not override any contrary U.S. tax treaty, and it provides a general regulatory delegation for this provision.

Section 442 of the American Jobs Act would create a separate section 904(d) FTC basket for combined foreign oil and gas income (as defined in section 907(b)(1)), in the process repealing sections 907(a), (c)(4), and (f). The language includes transition rules for carryovers and losses. The carryover rule would permit any unused foreign oil and gas taxes that would have been allowable as a carryover under repealed section 907(f) to be used as carryovers under section 904(c) with respect to foreign oil and gas extraction income. The loss rule states that the repeal of section 907(c)(4) would not apply to foreign oil and gas extraction losses from tax years beginning on or before enactment.

Observation

Again, the language of these provisions implements a proposal that the Administration has maintained with little change, although the single proposal regarding dual-capacity taxpayers is broken out into two proposed Code sections in the legislative language. These provisions would affect primarily taxpayers in the oil and gas industry, and several other provisions of the American Jobs Act would eliminate oil and gas subsidies. Note, however, that proposed section 901(n) would also affect dual-capacity taxpayers in other industries, such as mining.

Conclusion

The legislative language of these proposals reveals the Administration's thinking, which seems similar to the Administration's positions in earlier budget proposals. This insight will help in understanding the Administration's intentions during any debate on comprehensive tax reform.

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