US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

June 22, 2012

Joint Committee explanation of Obama's FY 2013 budget covers four new international tax provisions

Overview

On June 18, 2012, the staff of the Joint Committee on Taxation (JCT) released a pamphlet (JCS-2-2012), that analyzes the revenue provisions proposed in President Obama's Fiscal Year (FY) 2013 federal budget. When compared to the FY 2012 pamphlet, the FY 2013 version provides similar analysis of the international tax provisions. In fact, for five (of the seven) international tax proposals that did not change from FY 2012, the analysis is virtually identical. With respect to the proposals for pooling foreign tax credits (FTCs) and taxing "excess returns" earned by controlled foreign corporations (CFCs) in connection with outbound transfers of intangible property (IP), the FY 2013 JCT pamphlet reflects proposed legislative language issued in September 2011 that introduced substantive changes from, and clarifications to, the FY 2012 budget. In addition, the Administration added four new provisions for FY 2013. Three of these are narrowly targeted but the fourth would eliminate foreign taxes from any CFC's FTC pool corresponding to earnings and profits (E&P) that have been eliminated. Finally, following the FY 2013 budget release, the Administration proposed to disallow tax deductions for most expenses related to jobs that are moved from the United States to foreign locations.

Key Points

As in FY 2012, the FY 2013 JCT pamphlet thoroughly analyzes and comments on the Administration's proposals. However, there are a few significant departures from last year's views. In particular, on the proposals for pooling FTCs and taxing CFCs' "excess returns," the new pamphlet restructures its analysis and looks at some of the considerations raised in the Administration's September 2011 legislative language. The analysis of proposals on (i) interest expense deferral, (ii) outbound transfers of IP under sections 367(d) and 482, (iii) deductibility of reinsurance premiums, (iv) earnings-stripping by inverted companies, and (v) treatment of dual-capacity taxpayers are essentially the same as in FY 2012. The analysis of the new proposals acknowledges the Administration's policy concerns but illuminates some of the potential difficulties raised by the proposals' mechanics.

Most of the pamphlet's general points echo comments from last year:

- In general, the JCT staff questions whether the proposals carried over from the FY 2012 budget would effectively achieve the Administration's stated purpose of discouraging US companies from moving (or keeping) income and jobs offshore.
- The JCT staff recognizes that the major proposals, particularly when taken together, might discourage multinational companies (MNCs) from being resident in the United States and might discourage some US-based multinationals from repatriating foreign earnings.
- The JCT staff has repeated its comments on the global competitiveness of US MNCs, comparing their economic position with foreign MNCs as well as purely domestic US companies.
- The analysis continues to recognize the possibility that treaty partners may object to provisions such as the FTC blending and subpart F liability for "excess returns" where US IP has been transferred offshore.
- The discussions of technical and administrative issues on most of the proposals remain detailed and realistic, identifying significant unresolved issues, exploring various possible approaches, and describing some of their ramifications.

For a comparison of the revenue estimates for the international and certain other provisions from the FY 2013 JCT report, the FY 2013 budget, and the FY 2012 JCT report, please see our US Outbound Tax Newsalert of March 15, 2012.

Discussion of proposals with significant changes in the FY 2013 pamphlet

Current tax on "excess returns" associated with transfers of IP offshore

Perhaps the most interesting changes in the pamphlet relate to the Administration's September 2011 legislative language on the proposed new subpart F category for certain outbound IP transfers to low-taxed CFCs. Specifically, the JCT staff notes (i) the threshold effective tax rates (ETRs) specified (full inclusion under 10 percent and a sliding scale for 10-15 percent), (ii) the 1.5:1 ratio for returns to costs, (iii) the use of section 936(h)(3)(B) (as it would be amended under the Administration's IP "income-shifting" proposal) to define what IP would be covered, and (iv) the same-country active-business exception. Although the JCT considers certain implications of those aspects of the legislative language, the pamphlet acknowledges that the FY 2013 proposal does not include any of them.

As the FY 2013 JCT pamphlet notes,

> Despite the increased detail since [the excess return provision] was first proposed, questions remain with respect to each of the three elements required in order to include income within the proposed new category of subpart F income, i.e., (1) presence of a covered intangible, (2) excess income connected with the covered intangible and (3) a low foreign effective tax rate. Although the proposal now refers to a covered intangible, defined as an intangible transferred by a US person (directly or indirectly) from the United States to a related CFC, the focus in the definition is on the nature of the transfer and not on the nature of the property interest. The nature of the nexus between the excess returns and the covered intangible remains undefined. The addition of a sliding scale of tax rates to apply when the provision is triggered helps explain the intended operation of the proposal but does not fully explain the effective tax rate.

Nature of a covered intangible and its transfer

Although the FY 2013 budget does not define a "covered intangible", the FY 2013 JCT pamphlet assumes the definition from the 2011 proposed legislative language. The pamphlet also points out continuing issues with identifying an IP transfer that would fall under the proposed subpart F treatment. In particular, the pamphlet notes that the proposal does not limit relevant outbound IP transfers by the date of the transfer or the location where the IP was originally developed. In addition, while noting that including cost-sharing arrangements in this proposal would depart from current law, the JCT staff remarks that the proposal would probably not cover IP resulting from research and development (R&D) activities performed in the United States at a CFC's expense.

Connection required between excess return and IP transfer

The FY 2013 pamphlet continues to emphasize that the proposal, while requiring that taxpayers compute the excess income with regard to a connection or benefit from the transferred intangible, is still not drawn tightly enough to ensure that the apparent connection or benefit is actually attributable to a covered intangible transfer. As the pamphlet says, even with this requirement, the proposal does not distinguish between transfers of high-value IP and other types of IP that may be connected with the measured gross income.

As in the FY 2012 pamphlet, the new pamphlet comments that the “excess return” proposal could be criticized because its distinction between normal and excessive returns is not clearly based on a measurement of the profits associated with assigned risk. As a result, a CFC's active business profits from a transaction that is appropriately priced under the arm’s-length standard could be taxed currently in the United States. The JCT staff reiterates that this proposal could provide incentives for US companies to receive royalty payments in the United States rather than incur the subpart F inclusions, because taxpayers could deduct the royalty payments (which may be taxed at a relatively low rate under certain treaties) and potentially use them for cross-crediting with higher-tax foreign income. Moreover, the JCT staff acknowledges that taxpayers might structure their royalty payments to minimize or eliminate withholding tax on royalty payments from the CFC to the United States, minimize or eliminate income tax to a CFC recipient of a royalty from a related CFC, and avoid inclusion of a CFC-to-CFC royalty in US income (based on the CFC look-through rule).

Technical issues still unresolved

This year's JCT pamphlet again addresses certain technical issues not clarified in the budget, including the time period over which to calculate the ETR (specifically, one-year vs. multi-year); whether to use US or foreign tax principles (noting the difference in approach between the subpart F high-tax exception rules and the branch rules); and the treatment of transfers to disregarded entities and actual branches (with questions about a possible need for anti-stuffing rules to prevent artificially lowering the tax rate).

Like last year, the JCT staff notes the potential for conflicts with treaty partners, where the United States could be viewed as pre-empting source-country taxation of income attributable to the transferred IP and provides arguments both supporting and challenging the arguments that this proposal may result in a treaty override.

Finally, the JCT pamphlet again identifies a number of issues regarding the information gathering and reporting that this proposal would create.

> ***Observation:*** The JCT staff continues to highlight how the Administration has not fully addressed the potential consequences of the "excess return" proposal. The JCT staff also highlights the inconsistencies between the September 2011 legislative language and the FY 2013 budget. As in prior years, taxpayers may hope that any eventual legislation on this issue will consider the JCT staff's additional comments.

Blending section 902 foreign tax pools

The Administration's proposal to blend section 902 FTC pools has always been part of its fundamental approach to international tax reform, but the mechanics were never clearly stated until proposed legislative language was issued in September 2011. Those mechanics parallel the approach taken in the interest expense deferral proposal, making the two provisions more compatible. Nevertheless, the FY 2013 pamphlet pinpoints both technical and policy considerations that the proposed legislative language and FY 2013 budget description do not appear to address.

On the policy side, the new pamphlet revises a numerical example (first offered last year) to reflect the approach in the proposed legislative language, and then notes that the proposal does not end the present-law disincentive to repatriate earnings from low-tax foreign subsidiaries. The pamphlet also notes that the proposal does not eliminate FTC planning opportunities, because it applies only to deemed-paid taxes (creditable under section 902), and not to taxes actually paid by a domestic corporation (creditable under section 901). Accordingly, the JCT staff observes that incentives would still exist for structural planning to manage the rate of foreign tax imposed on foreign subsidiary income. In particular, the JCT staff envisions where taxpayers could remove high-taxed foreign earnings from the pooling regime by, for example, converting foreign subsidiaries in high-tax jurisdictions to branches or partnerships – or simply by operating in branch form in high-tax jurisdictions. The JCT staff believes this planning opportunity works against the policy purpose of the interest rate deferral proposal.

Technical and transition considerations

The JCT staff continues to raise technical uncertainties left unresolved by the Administration proposal, even after the issuance of proposed legislative language. In particular, the new pamphlet mentions the interplay between the proposed pooling regime and the section 904 FTC limitation rules. The pamphlet also acknowledges that the proposed legislative language clarifies that the FTC pooling regime would include foreign taxes of 10/50 companies (creating potentially significant administrative burdens for taxpayers). With respect to transition issues, the JCT staff notes that the legislative language would apply the new rules only to taxes paid or accrued in tax years after 2012, but that the section 902 pool calculation would continue to aggregate all foreign taxes paid or accrued after 1986. Thus, an additional rule would need to identify whether taxpayers were making post-2012 distributions from income associated with taxes subject to the new pooling treatment.

> ***Observation:*** While acknowledging that the proposed legislative language clarified the provision's mechanics, the JCT staff continues to highlight that this provision could have unintended consequences.

Tax on a foreign partner's gain on a look-through basis

The Administration's proposal provides that gain or loss from the sale or exchange of a partnership interest is considered effectively connected income (ECI) to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is, in turn, attributable to ECI property. The FY 2013 pamphlet expresses significant concerns about this new proposal. The pamphlet notes that the Administration's rationale for codifying Rev. Rul. 91-32, relating to foreign partners' sales of interests in partnerships that may earn US ECI, is that those partners may not be complying with the controversial position taken by the IRS in Rev. Rul. 91-32.

The JCT staff's analysis compares the proposed treatment with the source rule for dispositions of corporate stock and the treatment of tax-exempt organizations holding interests in partnerships that conduct unrelated business activity. The pamphlet also considers the potential impact of the proposal on publicly-traded or tiered partnerships. With respect to technical issues, the JCT staff notes that the proposal could lead to complex issues related to netting of gains and losses. With respect to policy issues, the pamphlet comments that this proposal could be viewed as overriding treaties that contain specific provisions with respect to withholding, although the language of the proposal does not recognize that possibility.

> ***Observation:*** The JCT staff acknowledges the Administration's policy concerns regarding the possibility that foreign persons could avoid paying US federal income tax on ECI if the income is earned through a partnership. Nevertheless, the pamphlet appears to reflect a view that this proposal's mechanics could potentially generate unintended consequences.

Prevent the use of leveraged distributions from related foreign corporations to avoid dividend treatment

This budget proposal provides that, to the extent a foreign corporation funds a second, related foreign corporation (distributing corporation) with a principal purpose of avoiding dividend treatment on distributions to a US shareholder, the US shareholder's basis in the distributing corporation's stock will not be taken into account for the purpose of determining the distribution treatment under section 301. As in its discussion of other Administration proposals, the FY 2013 pamphlet applies close technical analysis to this new provision, including an example on determining whether a distribution should be classified as a dividend.

As the pamphlet indicates, this proposal applies only if a funding transaction has a principal purpose of avoiding dividend treatment to the US shareholder. The JCT notes that, because purpose is a subjective matter, it is difficult to determine whether a taxpayer has a principal purpose of avoiding dividend treatment, particularly where a taxpayer can demonstrate that it has other important non-tax purposes in undertaking the transaction. Much of the brief analysis is devoted to whether the subjective "principal purpose" test makes this provision more effective or less, without reaching a conclusion.

In any case, the JCT does express concerns about the proposal's lack of a specified time period for determining the relationship between the funding transaction and the distribution.

> ***Observation:*** As with other FY 2013 proposals, the JCT staff acknowledges the Administration's policy concerns. In this case, the concern is that taxpayers might use intercompany funding to avoid US federal income tax on certain foreign subsidiary distributions. If the funding came from an affiliate without E&P, it could cause treatment of the distribution as a tax-free return of capital. However, the JCT pamphlet questions the provision's mechanics as presented in the FY 2013 budget.

Extend section 338(h)(16) to certain asset acquisitions

The new pamphlet presents this proposal as a straightforward effort to extend the application of the source and character rules in section 338(h)(16) to any covered asset acquisition, within the meaning of section 901(m). The analysis simply describes how that extension might work, for example in covering the purchase of a foreign disregarded entity. The JCT staff does not express any concerns about this proposal.

> ***Observation:*** This proposal could be viewed as overriding the decision in the *Dover* case, involving the characterization of the proceeds from the sale of a disregarded entity. The *Dover* case involved a "check and sell" transaction, in which a US company's foreign subsidiary "checked the box" and elected to be treated as a disregarded entity before the parent company sold it. As a result, the parties treated the transaction as an asset sale, not a stock sale. The IRS challenged that treatment, but the Tax Court upheld it in 2004. Since then, many US companies have used this "check and sell" approach.

Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated

As the FY 2013 JCT pamphlet explains, this proposal would reduce the amount of foreign taxes in a foreign subsidiary's post-1986 pool to the extent that a transaction results in the reduction of the subsidiary's E&P. The proposal focuses particularly on the potential impact of certain redemptions and section 355 distributions; it would not apply to distributions treated as dividends or deemed dividends, restructuring under non-recognition provisions, or E&P inherited under section 381.

The JCT staff states that the proposal is intended to prevent transactions from violating the section 902 "matching principle," under which each dollar of a section 902 foreign corporation's post-1986 earnings has associated with it a ratable amount of the corporation's post-1986 foreign income taxes. After providing a numerical example of this matching principle and the potential violations of such principle where E&P is reduced by a redemption, the pamphlet analyzes the extent to which the proposal changes current law, commenting that existing Treasury regulations provide rules for the removal of a section 902 corporation's taxes from the post-1986 foreign income tax pool when earnings are removed from the post-1986 undistributed earnings pool. The JCT staff argues that the history of the regulations supports the view that present law already requires removal of foreign taxes associated with earnings that have been removed by non-dividend transactions such as a redemption. The pamphlet notes that the proposal applies not just to redemptions, however, but also to "other non-dividend transactions in which a section 902 corporation's earnings pool is reduced."

Although apparently supportive of the Administration's purposes underlying this proposal, the FY 2013 JCT pamphlet does identify some technical issues that it raises, including (i) how the proposal interacts with the section 904 FTC limitation baskets, (ii) how to treat foreign taxes when there is already an E&P deficit in one or more baskets, and (iii) whether (and how) this proposal would apply to pre-1987 E&P, which is not subject to the pooling of post-1986 E&P.

> ***Observation:*** The FY 2013 JCT pamphlet suggests that this proposal may codify current law, which is surprising given arguably contradictory language in the FY 2013 proposal that appears to suggest that current law does allow E&P reductions without corresponding foreign tax pool decreases in section 312(n)(7) situations. Notwithstanding the FY 2013 JCT pamphlet's assertions, there remain strong arguments that E&P reductions in certain non-dividend transactions do not give rise to corresponding decreases of the post-1986 foreign tax pool.

Remove tax deductions for shipping jobs overseas

The Administration's proposal for disallowing tax deductions with respect to expenses incurred in connection with moving jobs outside the United States is half of a proposal that would provide tax credits for bringing jobs back into the United States. The FY 2013 JCT pamphlet spends several pages on economic arguments for and against this policy-driven limitation on tax deductions. It also analyzes technical considerations raised by the proposal, noting that the scope of costs included in the proposal is limited to relocation expenses. Therefore, companies may not have a significant incentive to alter their decisions regarding insourcing or outsourcing their business activities. In addition, the JCT staff comments that the expenses disallowed as a deduction depend on the definitions of "trade or business" and "line of business," and do not take into account the possibility that a certain line of business may lose its US market but grow in favor elsewhere in the world. In addition, the pamphlet discusses issues related to the measurement of workforce levels. Finally, the JCT staff questions the mechanics of disallowing deductions related to a CFC's expenses, which would ordinarily be relevant to the US tax return only where the CFC earns subpart F income.

> ***Observation:*** The new pamphlet does not express strong views on the practicability or advisability of this proposal, which is generally understood to be a political position of the Administration more than an expression of tax policy to be implemented.

Conclusion

The FY 2013 JCT pamphlet generally maintains a thorough, balanced, and realistic approach with respect to issues raised by the Administration's budget proposals. Particularly in a highly partisan Congress, it seems clear that key members of the tax-writing committees and Congressional staff are still listening to the concerns of both corporate taxpayers and tax abuse prevention advocates.

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