US Outbound Tax Newsalert

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Obama FY 2013 budget renews prior proposals with four additions; extends CFC look-through

The Treasury Department's "Green Book," released February 13, 2012, outlines the Obama Administration's budget proposals for fiscal year 2013, with few changes to the international tax proposals carried forward from the previous year's budget. However, the budget does include four new proposals. In addition, the Administration has announced that it plans to release a "framework" for corporate tax reform later this month. This framework is expected to contain significant international tax proposals, including a proposal for a minimum tax on overseas profits. Comments from President Obama indicate that he continues to have an interest in a lower corporate tax rate, a broader tax base, and permanent enactment of some key provisions that currently are subject to annual extensions.

For US multinationals, the focus in the Administration's FY 2013 budget remains on outbound intangible property ("IP") transfers and base erosion. The key items continue to be the "excess return" proposal for IP transferred outside the United States and proposed limitations on shifting income through IP transfers. Other major items in the international tax area include the familiar proposals for deferral of foreign-related interest expense, pooling for section 902 foreign tax credits ("FTCs"), and the extension of "controlled foreign corporation ("CFC") look-through" until the end of 2013. The Administration also continues to propose to limit deductions by US insurance companies for reinsurance premiums paid to affiliated foreign reinsurance companies and earnings stripping by expatriated entities.

The four new international tax proposals are relatively modest, with each estimated to raise $3.3 billion or less over the 10-year budget window. The Administration proposes:

- Taxing gain from the sale of a partnership interest on a look-through basis (i.e., legislation meant to shore up Rev. Rul. 91-32);
- Preventing the use of leveraged distributions from related foreign corporations to avoid dividend treatment;
- Extending section 338(h)(16) to certain asset acquisitions; and
- Removing foreign taxes from a section 902 corporation's pool when the related earnings are eliminated.

All the international tax proposals in the budget would be effective for tax years beginning after December 31, 2012 except for the section 338(h)(16) provision, which would apply to transactions after that date. However, note that effective dates can, and often do, move during the legislative process.

The budget includes a proposal to "provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas." Although the substance of this proposal primarily involves incentives for "insourcing" jobs into the United States that previously had been located elsewhere in the world, part of the package involves denial of deductions for expenses in connection with "outsourcing a US trade or business."

In addition, the Administration continues to seek repeal of section 351(g), eliminating the concept of nonqualified preferred stock. The Administration has expressed a concern that section 351(g), a provision meant as an anti-abuse provision, is being used affirmatively by taxpayers in loss recognition planning or to avoid deemed dividend treatment in certain related-party stock transfers. The Administration also claims that it adds unnecessary complexity to the Code. In addition, the Administration continues to pursue repeal of the boot-within-gain limitation for reorganization transactions if the exchange has the effect of a dividend distribution (e.g., a "Cash D" reorganization). Furthermore, for FY 2013, the Administration introduced a new proposal intended to limit loss importations under section 267(d).

The 11 international tax reform provisions in the FY 2013 budget are scored by Treasury as increasing revenues by a total of $147.5 billion, a 15% increase over the FY 2012 budget total of $129 billion. The proposals to repeal section 351(g) and the boot-within-gain limitation are estimated to raise about $0.4 billion and $0.9 billion, respectively. The section 267(d) loss importation proposal is estimated to raise about $0.8 billion. The staff of the Congressional Joint Committee on Taxation ("JCT") is expected to release its revenue estimates for all Fiscal 2013 budget provisions, which will serve as the official scoring for purposes of legislative action by Congress. Also, the JCT staff customarily authors a lengthy description and analysis of the budget provisions, which may add more details and perspectives to the briefer write-ups in the Treasury Green Book.

The legislative prospects for these proposals are uncertain. It seems unlikely that any major tax legislation will be enacted before the November 2012 elections, but Congress will need to address a variety of high-profile tax issues by year-end, including the scheduled expiration of the Bush 2001/2003 individual tax cuts and the status of tax extenders such as CFC look-through.

President's budget: international tax proposals - FY 2013 & FY 2012 comparison of revenue estimates		
	FY 2013 budget	**FY 2012 budget**
International tax proposals		
Defer deduction of interest expense related to deferred income	*$37,253*	*$37,665*
Determine the foreign tax credit on a pooling basis	*$60,835*	*$51,444*
Tax currently excess returns associated with transfers of intangibles offshore	*$22,973*	*$20,831*
Limit shifting of income through intangible property transfers	*$1,623*	*$1,668*
Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates	*$2,449*	*$2,614*
Limit earnings stripping by expatriated entities	*$4,432*	*$4,222*
Modify tax rules for dual-capacity taxpayers	*$10,724*	*$10,758*
Tax gain from the sale of a partnership interest on look-through basis	*$2,561*	*N/A*
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment	*$3,323*	*N/A*
Extend section 338(h)(16) to certain asset acquisitions	*$960*	*N/A*
Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated	*$389*	*N/A*
Total	***$147,522***	***$129,202***

Summary of proposals

Key international business tax changes proposed by the Obama Administration in its FY 2013 budget would:

- Treat as subpart F income (in a separate section 904(d) basket) "certain excess income" from transactions connected with or benefiting from intangibles transferred from US to related CFCs if the income is subject to a low foreign effective tax rate ("ETR").
- Limit income-shifting through outbound transfers of IP by "clarifying" that (1) the definition of IP includes goodwill, workforce in place, and going concern value for purposes of sections 367(d) and 482, and (2) the IRS has authority to value transfers of IP on an aggregate basis, taking into account other hypothetical versions of the taxpayer's transaction that could yield different results.
- Require US-based multinationals generally to defer deductions for US interest expense properly allocated and apportioned to investments in foreign subsidiaries until the earnings of those subsidiaries are subjected to US taxation.
- Limit a multinational group's deemed-paid US FTCs under section 902 to the average foreign ETR paid on the combined earnings of all foreign subsidiaries, effectively creating a further limitation on the amount of foreign tax that can be credited.
- Modify FTC rules for dual-capacity taxpayers (relevant mainly for the oil and gas industry).
- Tax any gain from the sale of a partnership interest on a look-through basis, specifically with respect to income effectively connected with a US trade or business ("ECI").
- Prevent the use of leveraged distributions from related foreign corporations to avoid dividend treatment.
- Extend section 338(h)(16) to certain asset acquisitions.
- Remove foreign taxes from a section 902 corporation's tax pool when earnings associated with those taxes are eliminated.
- Extend the "CFC look-through" rule in section 954(c)(6) and the active financing exception to subpart F under section 954(h) for an additional year, ending on December 31, 2013 for calendar-year taxpayers.

The following provides an overview of the proposals that are particularly relevant to US multinationals. Given that the proposals generally would become effective for tax years beginning after December 31, 2012, US multinationals may wish to examine how these proposals could affect their US federal income tax liabilities and the extent to which they can manage that impact.

Although (as was the case with the Green Books from the previous three years) the descriptions of Administration proposals in this year's Green Book are sparse, the Administration did offer draft legislative language last year for the existing proposals, either in the American Jobs Act or the *President's Plan for Economic Growth and Deficit Reduction*. The descriptions below reflect that language, to the extent that proposals have been carried over without change from FY 2012.

Discussion

There are few changes in the FY 2013 budget proposals that carried over from the FY 2012 budget. Note that the CFC look-through rule expired December 31, 2011; the Administration proposes extending that provision through 2013.

Subpart F income for excess returns on transactions associated with transferred intangibles

Current law

Section 482 authorizes the allocation of income among two or more organizations or businesses under common ownership or control whenever necessary to prevent evasion of taxes or clearly to reflect income, applying the standard of unrelated persons dealing at arm's length. In the case of intangible asset transfers, section 482 provides that the income with respect to the transaction must be commensurate with the income attributable to the transferred intangible assets.

In general, the subpart F rules (sections 951-964) require US shareholders with a 10% or greater interest in a CFC to include currently in income for US tax purposes their pro rata share of certain income of the CFC ("subpart F income"), without regard to whether the income is actually distributed to the shareholders. Subpart F income currently includes passive income such as dividends, interest, rents, and royalties, and other categories of mobile income from business operations.

The Administration views the potential tax savings from transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates, as putting significant pressure on the enforcement and effective application of section 482 transfer pricing rules.

Proposal

To reduce the incentive for taxpayers to engage in certain tax-saving related-party transactions, the Administration proposes expanding subpart F income to include a new category of "excess income" attributable to intangibles transferred from the United States to low-taxed CFCs. In the FY 2013 budget, the Administration generally retains the previous year's version of this proposal but specifies that the ETR thresholds in the legislative language from last September would apply.

This proposal has generated the greatest interest and uncertainty with respect to its scope and potential impact. The legislative language offered in *The President's Plan for Economic Growth and Deficit Reduction* answered many questions observers had been asking, although some uncertainties remain.

According to the legislative language, 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). 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 US 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 threshold for an "excess return" is a 50% mark-up over the CFC's directly allocable costs, specifically excluding interest and taxes. This threshold is more generous than the 15% margin in a bill introduced in 2011 by Rep. John Tierney (D-MA) 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.

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. Proposed section 954(f) would exclude same-country income from FBCEII.

The foreign tax rate threshold in the Administration proposal has a sliding scale element. In proposed section 954(f), the floor would be 10% and the ceiling only 15%; that is, all of the relevant income would be characterized as FBCEII if a CFC's effective rate is 10% or lower, and none of the relevant income would be characterized as FBCEII if a CFC's effective rate is 15% or higher. Between 10% and 15%, the proposal imposes a sliding scale based on the "applicable percentage" of the five percentage points between 15% and 10% (i.e., a 12% effective rate would result in a 60% 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.

The Administration estimates this proposal would raise almost $23 billion over 10 years, which is about $2 billion above the Administration's estimate for the FY 2012 version of this provision (and well above the $14.2 billion estimated by JCT staff after the Administration's proposed legislative language was issued in March 2011).

Observations

Changes to this proposal for FY 2012 were apparently made in response to comments from the JCT staff and others, requiring a closer connection between the transferred intangibles and the excess income. The 50% mark-up, the addition of all R&D costs to expenses directly allocable to covered intangibles, and the relatively low 15% ETR ceiling for FBCEII all seem taxpayer-favorable. However, for many CFCs, indirect expenses, particularly interest, may be much higher than direct expenses. Moreover, even a number of OECD countries have statutory rates under 20%, and Ireland currently has a 12.5% rate, so the effective rate threshold in this proposal might apply to income arising in many jurisdictions.

Note that 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. Note also that when a CFC acquires or develops IP pursuant to a cost sharing arrangement, the language does not explicitly require that a US person be a party to the agreement. In other words, a covered intangible could arise from a CFC-to-CFC cost-sharing arrangement to which no related US person has provided any IP, meaning that subpart F income could be triggered under the new provision even if there had been no transfer of the IP from a US person at all. This result may have been unintended. At a minimum, the reach of the term "covered intangible" appears potentially overbroad in light of the stated policy concerns regarding "outbound" migration of IP.

Deferral of deductions allocable to unremitted foreign earnings

Current law

Under current rules, a US person that incurs interest expense properly allocable and apportionable to foreign-source income may deduct those expenses, even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. The Obama Administration argues that the ability to deduct expenses from overseas investments while deferring US tax on the income from the investment may cause US businesses to shift their investments and jobs overseas, harming the domestic economy.

Proposal

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 the stock of foreign subsidiaries in proportion to the currently taxed earnings of those subsidiaries. Foreign-related deductions properly allocable or apportionable to foreign subsidiary stock beyond the proportionate amount of income that is currently taxed by the United States would be deferred; those deductions could be taken in subsequent years as previously deferred foreign earnings are repatriated and subjected to US taxation.

Unlike a bill introduced in 2007 by then House Ways and Means Committee Chairman Charles Rangel (D-NY) (the "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) (re-designating 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."

According to the language proposed in 2011, 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 US corporation from a section 902 corporation (basically, a 10%-owned foreign subsidiary), divided by (ii) the aggregate amount of US shareholder's pro rata share of the subsidiary's post-1986 undistributed earnings 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 exceeded 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 US 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 mechanics of this proposal:

- Changes in ownership of a section 902 corporation.
- Treatment of certain corporations that otherwise would not be members of the affiliated group as members of the affiliated group.
- A section 902 corporation with a deficit in E&P.
- Impact of ECI on (i) stock value determinations for section 902 corporations and (ii) foreign-related interest expense.
- Interest expense that is directly allocable to income.

The Administration's revenue estimate for the interest deduction deferral proposal in FY 2013 is about $37.3 billion over 10 years, similar to the Administration's FY 2012 estimate of $37.7 billion.

Observations

In the last Congress, members of both parties objected to action on this proposal outside the context of comprehensive corporate tax reform, or at least international tax reform. As long as it remains a potential revenue raiser, however, US multinationals with significant US interest expense are at some risk for major impact.

The release of the legislative language answered many questions about the interest expense deferral proposal, but the regulatory delegations suggest that the mechanics still require clarification. The interest expense 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 staff has commented that, without WWIA, this interest expense deferral proposal would be an "overcorrection" of any perceived issue involving the deduction of US expenses allocable to foreign income.

Blending section 902 foreign tax pools

Current law

Under section 901, a taxpayer generally may claim a credit against its US income tax liability for income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or any possession of the United States. The taxpayer's ability to claim the credit is subject to certain limitations, up to the amount of the pre-credit US tax on the taxpayer's foreign-source income. Under section 902, a US corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend. Section 902 FTCs are calculated based on the post-1986 pools of earnings and foreign taxes of each foreign subsidiary. Pools of high-taxed and low-taxed foreign-source income may be "cross-credited" within the two categories of active and passive foreign-source income.

Proposal

The FY 2013 budget contains the same section 902 credit pooling proposal as the FY 2012 budget. This proposal would restrict a US-based multinational group's deemed-paid FTCs under section 902 to the average rate of total foreign tax actually paid on the combined earnings of all of a group's CFCs, eliminating the ability to selectively access earnings pools of high-tax CFCs. This proposal effectively would treat all of a taxpayer's CFCs as a single CFC for section 902 purposes.

The Administration's proposal to blend section 902 FTC pools has been coordinated with the interest expense deferral proposal to a significant degree, addressing some 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. FTCs 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 US 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:

- Changes in ownership of a section 902 corporation.
- Treatment of certain corporations that otherwise would not be members of the affiliated group as members of the affiliated group.
- A section 902 corporation with a deficit in E&P.
- Amounts taken into account under section 960.

The Administration's FY 2013 revenue estimate for this proposal is $60.8 billion over the 10-year budget window, an increase of $9 billion over the estimate of $51.4 billion by the Administration for the FY 2012 version.

Observations

Like the interest deduction deferral provision, this proposal has generated little support in Congress outside the context of comprehensive tax reform. Nevertheless, in an era of large budget deficits, it remains a potential revenue raiser that could impact US multinationals with significant section 902 deemed-paid tax credit pools.

The release of the legislative language resolved many questions about the FTC blending proposal, but the mechanics still require clarification. As noted in previous communications, a key question raised in the JCT staff'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. Proposed section 910 apparently makes no 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 proposal would interact with section 909, the "anti-splitter" provision. This proposal goes further than section 909, because it addresses the Administration's possible concerns with cross-crediting of foreign taxes; however, proposed section 910 would also create 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 taxpayers and the government.

Limiting income-shifting through outbound transfers of intangibles

Current law

As described above, section 482 authorizes the allocation of income among two or more organizations or businesses under common ownership or control whenever necessary to prevent evasion of taxes or clearly to reflect income, applying the standard of unrelated persons dealing at arm's length. In the case of intangible asset transfers, section 482 provides that the income must be commensurate with the income attributable to the transferred intangible assets. Under section 367(d), if a US person transfers IP (as defined in section 936(h)(3)(B)) to a foreign corporation in certain non-recognition transactions, the US person is treated as selling the IP for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property.

As in previous years, the FY 2013 Green Book expresses the Administration's concern that "[c]ontroversy often arises concerning the value of IP transferred between related persons and the scope of the IP subject to sections 482 and 367(d). This lack of clarity may result in the inappropriate avoidance of US tax and misuse of the rules applicable to transfers of IP to foreign persons."

Proposal

The Administration's efforts to limit perceived income-shifting through outbound transfers of IP have culminated in 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) consider what a controlled taxpayer could have realized by choosing a "realistic alternative" to the transaction.

The Administration estimates this provision would raise $1.62 billion over 10 years, slightly less than the $1.66 billion estimate in the FY 2012 budget.

Observation

The Administration has maintained this proposal for three budget cycles, attempting to address 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.

Modifying the tax rules for dual-capacity taxpayers

Current law

As described above, section 901 allows a taxpayer generally to claim a credit against its US income tax liability for income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or any possession of the United States. To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under United States tax principles, regardless of the label attached to the levy, and it must be a compulsory payment under the authority of a foreign government to levy taxes, not compensation for a specific economic benefit provided by the foreign country.

Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual-capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations under section 901 require that a dual-capacity taxpayer use either a facts and circumstances method or a safe harbor method in establishing that the foreign levy is an income tax.

Under the safe harbor method, if a foreign country has a generally imposed creditable income tax, a dual-capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed tax would yield. The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income (generally, 35% for corporate taxpayers) is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

As the Green Book emphasizes, the purpose of the FTC is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but may not achieve what the Administration views as the appropriate split between the two when a single payment is made in a case where, for example, a foreign country imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income.

Proposal

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 were it not a dual-capacity taxpayer.

The mechanism to limit creditability would 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 US 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.

The Administration estimates that these provisions would raise $10.72 billion over 10 years, slightly less than the $10.76 billion estimate in the FY 2012 budget.

Observation

The Administration has continued to maintain this proposal 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 are aimed primarily at 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.

Limiting earnings stripping by inverted companies

The Administration continues to propose further limitations on earnings stripping by inverted companies through interest deduction limitations.

The legislative language offered in September 2011 proposed a new section 163(j)(9) to tighten 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% adjusted taxable income threshold for the limitation to 25%, and (iii) limiting the carryforward for disallowed interest to 10 years and eliminating the carryforward of excess limitation. In addition, the language expands 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 to apply the provision to interest accrued by surrogate foreign corporations (as defined in section 7874) and successor persons. Presumably, those regulations would implement the Treasury explanatory 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.

The Administration estimates that this proposal would raise $4.4 billion over 10 years, slightly more than the $4.2 billion estimate in the FY 2012 budget.

Observation

The Administration has maintained this proposal for years with little change. It seeks to develop a rule that defines boundaries that differ among taxpayers. The proposal continues to apply to companies that inverted since 1989, long before any anti-inversion rules were contemplated.

For more information on this and other inbound-related proposals, please see the US Inbound Newsalert dated February 14, 2012.

Disallowance of the deduction for excess non-taxed reinsurance premiums paid to affiliates

This proposal, limiting deductions for reinsurance premiums paid by a US insurance company to its foreign affiliates, is important to foreign-owned US insurance companies. The provision is essentially unchanged from FY 2012, when it was revised from an earlier budget proposal. The concept of the proposal first appeared in a bill introduced by Congressman Richard Neal (D-MA) in 2009 (the "Neal Bill").

The proposal would (1) deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks to the extent that the foreign reinsurer (or its parent company) is not subject to US income tax with respect to the premiums received; and (2) would exclude from the insurance company's income (in the same proportion in which the premium deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied. A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat those

premiums and the associated investment income as ECI and attributable to a permanent establishment for tax treaty purposes. For FTC purposes, reinsurance income treated as ECI under this rule would be considered foreign-source income, placed into a separate basket under section 904.

The Administration estimates that this proposal would raise $2.4 billion over 10 years, slightly less than the $2.6 billion estimate in the FY 2012 budget.

Observation

This proposal carries over from FY 2012 and is based on an earlier version contained in the FY 2011 budget. The current proposal could significantly increase the US tax burden on most foreign-owned US insurance companies over the tax burden generated by the FY 2011 proposal and the Neal Bill, both of which had limitations on their impact (respectively, a 50% threshold and a limit on premium deductions based on certain industry factors by line of business). In general, the FY 2013 proposal maintains the broader reach of the FY 2012 version over the approaches in the FY 2011 budget and the Neal Bill.

Tax gain from the sale of a partnership interest on a look-through basis

Current law

The sale or exchange of a partnership interest generally is treated as the sale or exchange of a capital asset, and capital gains of non-resident alien individuals or foreign corporations generally are not subject to US federal income tax. Accordingly, sales by such foreign persons of interests in partnerships that receive ECI are generally not taxable in the United States, even where the underlying ECI would be.

Rev. Rul. 91-32 holds that gain or loss of a non-resident alien or foreign corporation from the sale or exchange of a partnership interest is ECI to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States ("ECI property"). The Administration expresses concern that foreign persons may take a position contrary to Rev. Rul. 91-32, in which they argue that no Code provision explicitly provides that gain from the sale or exchange of a partnership interest by a non-resident alien individual or foreign corporation is treated as ECI.

Moreover, a partnership may elect under section 754 to adjust the basis of its assets on the transfer of an interest in the partnership to reflect the transferee partner's basis in the partnership interest. If the partnership has made such an election, the partnership's basis in its assets is also increased, thereby preventing any gain from being taxed in the future.

Proposal

The Administration's proposal would provide that gain or loss from the sale or exchange of a partnership interest is considered 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 proposal also would grant regulatory authority to specify the extent to which a distribution

from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

In addition, the transferee of a partnership interest would be required to withhold 10% of the amount realized on the sale or exchange of a partnership interest (or a lesser amount to the extent the transferor could provide a certificate from the IRS showing that its US federal income tax liability with respect to the transfer would be less than 10% of the amount realized) unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. If the transferee failed to withhold the correct amount, the partnership would have to satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

The administration estimates that this proposal would raise $2.6 billion over 10 years.

Observation

This new proposal apparently reflects a concern that inbound taxpayers have not been following Rev. Rul. 91-32, and that the Administration feels a need to codify the holding in that administrative guidance so as to provide a more robust legal basis for enforcing it. It is not clear why the revenue estimate for this provision is so substantial.

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

Current law

Under the general rules of section 301, distributions of property by a corporation to a shareholder are first treated as a dividend to the extent of the distribution corporation's applicable E&P. Any excess is treated as a reduction in the shareholder's adjusted tax basis in the stock of the distributing corporation, and then any remaining excess is treated by the shareholder as gain from the sale or exchange of property.

With respect to foreign corporations, these rules are generally applied on a stand-alone basis. The Administration expresses concern that the determination of whether a corporate distribution is a dividend effectively permits the E&P of a foreign corporation to be repatriated without being characterized as a dividend by having that corporation fund a distribution from a second, related corporation that has no E&P, but in which the distributee US shareholder has sufficient tax basis to characterize the distribution (in whole or substantial part) as a return of stock basis under the ordering rules of section 301.

Proposal

The proposal in the FY 2013 budget would provide that to the extent a foreign corporation (the “funding corporation”) funds a second, related foreign corporation (the “foreign distributing corporation”) with a principal purpose of avoiding dividend treatment on distributions to a US shareholder, the US shareholder’s basis in the stock of the distributing corporation will not be taken

into account for the purpose of determining the treatment of the distribution under section 301.

For this purpose, the funding corporation and the foreign distributing corporation would be considered related if they are members of a control group within the meaning of section 1563(a), but requiring only more than 50% ownership, rather than at least 80%. Under the proposal, funding transactions to which the proposal would apply might include capital contributions, loans, or distributions to the foreign distributing corporation, whether the funding transaction occurs before or after the distribution.

The administration estimates that this proposal would raise $3.3 billion over 10 years.

Observation

Like the proposal to repeal the boot-within-gain limitation, this new proposal is apparently aimed at the monetization of foreign assets without the generation of US income. In essence, the proposal, like other anti-abuse rules in the Code (e.g., section 304), would seek to convert asset value, when converted to cash, into income even when the taxpayer had no income.

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

Current law

Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is not treated as occurring for purposes of determining the source or character of any item for purpose of applying the FTC rules to the seller. Instead, for these purposes, the gain is generally treated by the seller as gain from the sale of the stock. Thus, section 338(h)(16) prevents a seller from increasing allowable FTCs as a result of a section 338 election. Additionally, section 901(m) denies a credit for certain foreign taxes paid or accrued after a covered asset acquisition ("CAA"), including section 338 elections and other transactions that are treated as asset acquisitions for US tax purposes but stock acquisitions for foreign tax purposes.

The Administration is concerned that while section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, it does not apply to the other types of CAAs subject to the credit disallowance rules under section 901(m).

Proposal

The proposal would extend the application of section 338(h)(16) to any CAA, within the meaning of section 901(m), granting regulatory authority as needed to carry out the purposes of the proposal.

The administration estimates that this proposal would raise $960 million over 10 years.

Observation

This new proposal seeks to make consistent the characterization of gain from all types of CAAs subject to section 901(m), extending the principles of

section 338(h)(16) to transactions that do not specifically involve section 338 elections. Note that implementation guidance for section 901(m) in the form of a Notice is anticipated soon.

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

Current law

Under section 902, a US domestic corporation owning at least 10% of the voting stock of a foreign corporation can claim deemed-paid FTCs for foreign taxes paid by the foreign corporation if the US corporation receives a dividend (or, in some cases, a deemed dividend) from the foreign corporation.

The Administration has concerns about the application of the deemed-paid FTC rules where certain transactions result in a reduction, allocation, or elimination of a corporation's E&P other than by reason of a dividend or deemed dividend, or by reason of section 381. The Green Book specifically uses the example of a corporation that redeems a portion of its stock, where the redemption is treated as a sale or exchange, thus leading to a reduction in any E&P of the redeeming corporation under section 312(n)(7). The Green Book also cites the example of certain section 355 distributions that can result in the reduction of the distributing corporation's E&P under section 312(h).

Proposal

The Administration's proposal would reduce the amount of foreign taxes paid by a foreign corporation in the event a transaction results in the elimination of the foreign corporation's E&P other than through an actual or deemed dividend, or by reason of a section 381 transaction. The amount of foreign income taxes that would be reduced would equal the amount of foreign taxes associated with the eliminated E&P.

The administration estimates that this proposal would raise $389 million over 10 years.

Observation

This new proposal apparently is aimed at tax planning techniques involving reductions in E&P under section 312.

Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas

Current law

In the Administration's view, under current law there are limited tax incentives for US employers to bring offshore jobs and investments into the United States, while costs incurred to outsource US jobs generally are deductible for US federal income tax purposes. The Administration has expressed its intention to make the United States more competitive in attracting businesses by creating tax incentives to bring offshore jobs and investments back into the United States while reducing the tax benefits under current law for moving US jobs offshore.

Proposal

The proposal would create a new general business credit equal to 20% of the eligible expenses paid or incurred in connection with insourcing a US trade or business, that is, reducing or eliminating a business (or line of business) currently conducted outside the US and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in US jobs. While the creditable costs may be incurred by the foreign subsidiary of the US-based multinational company, the tax credit would be claimed by the US parent company.

In addition, to reduce tax benefits associated with US companies moving jobs offshore, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a US trade or business, that is, reducing or eliminating a business (or line of business) currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of US jobs. In determining the subpart F income of a CFC, no reduction would be allowed for any expenses associated with moving a US trade or business outside the United States.

Note that, for purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a US trade or business are limited solely to expenses associated with the relocation of the trade or business and do not include capital expenditures or costs for severance pay and other assistance to displaced workers. The proposal includes regulatory authority for rules to implement the provision, including rules to determine covered expenses.

Unlike the other proposals described above, this one would be effective for expenses paid or incurred after the date of enactment. It is estimated to essentially break even over the 10-year budget window, costing the US Treasury $90 million total.

Observation

This new proposal echoes a bill offered previously by Sen. Richard Durbin (D-IL). This proposal seems very difficult for both the taxpayer and the government to administer.

Legislative Outlook

There is a realistic possibility that fundamental tax reform could be considered during the latter part of FY 2013. On the Administration side, the President and Treasury officials have made general statements recently about proposed changes to the corporate tax base and rate, and they have now announced release of the Administration's corporate tax reform package later in February. On the Congressional side, both Chairman Camp (R-MI) of the Ways and Means Committee and Sen. Enzi (R-WY) of the Senate Finance Committee have issued draft legislative language on a possible territorial tax system.

For more information on the Camp discussion draft, please see the US Outbound Newsalert dated November 1, 2011.

For more information on the Enzi territorial bill, please see the US Outbound Newsalert dated February 15, 2012.

As previously mentioned, the JCT staff's analysis and revenue estimates for the Administration's current international proposals are expected soon. As in previous years, this analysis may provide additional perspectives on the Administration's proposals.

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