SFC Chairman Baucus discussion draft features CFC minimum tax options

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In brief

On November 19, 2013, Senate Finance Committee Chairman Max Baucus (D-MT) released a comprehensive international tax reform discussion draft (discussion draft) that his committee staff prepared. Chairman Baucus stated that the discussion draft reflects Democratic and Republican proposals and concepts put forth in the past three years to "fix a broken system" and "motivate businesses to bring jobs and money back to the US."

The discussion draft proposes to tax currently certain foreign earnings of controlled foreign corporations (CFC). The discussion draft provides statutory language for two differing regimes that would generally impose current taxation on all CFCs' income at a minimum rate. The proposed changes would be a dramatic expansion of the current US anti-deferral regime on foreign income earned by foreign persons that do not have effectively connected income with a trade or business in the United States (ECI).

The discussion draft also proposes a one-time tax on pre-effective date deferred earnings of foreign subsidiaries that have not been previously subject to US federal income tax. This proposal would result in significant US taxes on APB 23 permanently reinvested earnings.

The discussion draft includes a wide variety of additional proposals, many of which would significantly change the US federal income tax system. They include allowing the CFC look-through rules to expire (although retaining CFC-to-CFC dividend exclusions), eliminating the use of 'check-the-box' entities for international tax purposes, disallowing the deduction of interest expense allocable to exempt foreign income, eliminating Section 902 deemed-paid foreign tax credits (FTCs), fundamentally altering the passive foreign income company (PFIC) regime, and adopting Obama Administration proposals to tighten rules on intangible transfers, deny deductions for certain reinsurance premiums, and codify Rev. Rul. 91-32 treatment of foreign-owned interests in US partnerships earning ECI.

The discussion draft does not propose a specific corporate tax rate reduction, which is expected to appear in a different discussion draft. Chairman Baucus has expressed support for reducing the corporate rate below 30%.

The discussion draft summary notes that Chairman Baucus "believes tax reform as a whole should raise significant revenue for deficit reduction," but international tax reform and a "significant" corporate rate reduction to be offset by broadening the corporate tax base are intended to be "revenue-neutral in the long-term."

In general, the discussion draft's provisions would be effective after December 31, 2014. Chairman Baucus has requested public comment by January 17, 2014 on the discussion draft's details and certain other issues listed in a separate Request for Comments.

In detail

The international tax discussion draft actually consists of three drafts. Two of them present minimum tax (anti-base erosion) Options Y and Z, respectively, and their corollary reforms, including subpart F and FTC effects. The third presents proposed reforms that would be common to Options Y and Z.

The discussion draft's summary echoes the Finance Committee staff's May report addressing current challenges and goals for tax reform in the international area. The report emphasized issues of global competitiveness but also discussed base erosion and profit-shifting. In addition, the report considered the 'lockout effect' that discouraged foreign subsidiaries from repatriating earnings to their US parent companies. As a general tax reform goal, the report mentioned the desire to reduce complexity, uncertainty and compliance burdens arising from the US federal income tax system. The discussion draft provides legislative language addressing these issues.

Observation: While the discussion draft speaks to the laudable goals of maintaining the competitiveness of US-based companies, it seems to seek most of its new revenue from US-based multinationals. Although it claims to address complexity, uncertainty and compliance, the discussion draft would retain many provisions in our current international tax system that lead to the greatest complexity, uncertainty and compliance burdens, such as anti-deferral rules and FTCs, while also introducing significant new complexity, such as per country limitations.

Minimum tax options

The discussion draft's central feature is the presentation of two anti-base erosion options, called Y and Z, which apply the concept of a minimum level of US federal income tax. This approach is similar to Option B in the 2011 discussion draft from House Ways and Means Chairman Dave Camp (R-MI). Option B proposes that all CFCs will be subject to a minimum level of current tax. The discussion draft presents both minimum tax options in fully developed form, but the proposed US federal income tax rate is bracketed to permit adjustments for the revenue effect of the Finance Committee's various tax reform proposals.

Observation: The Finance Committee's request for public comments asks specifically for comments on Committee Chairman Camp's anti-base erosion Option C (the 'carrot-and-stick' approach). This request for comments suggests that the Finance Committee may remain open to considering that approach, notwithstanding its apparent preference for a minimum tax. At a June 13, 2013 Ways and Means Committee hearing, Chairman Camp stated that Option C "continues to receive the most support from the business community."

Neither Option Y nor Option Z would extend the CFC 'look-through' rules of Section 954(c)(6), but they both would exclude certain CFC-to-CFC dividends from subpart F treatment. Under both Option Y and Option Z, the special subpart F regimes for active finance companies and insurance companies would be made permanent, as discussed in more detail below.

Note that both Option Y and Option Z would include a new Section 265A, disallowing deductions to US shareholders for expenses (including interest expense) allocable to a CFC's exempt income. This provision would operate on a basket-by-basket basis, with an ordering rule putting it first among US federal income tax deductibility limitations. The discussion draft includes detailed rules for the disallowance computation.

Option Y

The discussion draft labels Option Y a participation exemption system, which would make it a territorial (rather than worldwide) tax system in principle. The mechanism for the participation exemption would be a 100% dividends-received deduction (DRD) for the foreign-source portion of dividends paid to a US shareholder out of non-subpart F income. For this purpose, a CFC's foreign-source undistributed earnings eligible for exemption must be attributable to income that is not ECI and is not received directly or indirectly from a US corporation. Proposed Section 245A would operate similarly to the current Section 245, which allows a 100% DRD for US-source dividends received by US corporations.

The proposed Section 245A DRD would be available only to 10% US shareholders that satisfy a one-year holding period requirement during the two-year period straddling the dividend distribution date. This requirement parallels the Section 246(c)(4) requirement for the Section 245 DRD, including provisions regarding binding obligations to sell the CFC stock or diminished risk of loss regarding the stock. In addition, proposed Section 245A would require

that the US shareholder retain that status for that CFC throughout the holding period.

Note that the 100% DRD is not available for dividends from 10/50 companies or for hybrid dividends (treated as a dividend for US federal income tax purposes but as a deductible payment for foreign purposes). Unlike the Camp territorial proposal, the Baucus discussion draft does not propose to change the US federal income tax treatment of foreign branches, so remittances from branches to US corporations would not receive dividend treatment.

Option Y would treat sales and exchanges of Section 1248 as stock eligible for the DRD, and would disallow deductions for losses on such sales; similarly, sales of lower-tier CFC stock satisfying the ownership requirements of Section 1248(a)(2) at a loss would not reduce earnings & profits (E&P). Option Y also makes various conforming changes to the Code with respect to the 100% DRD.

Observation: Although Option Y does not explicitly address sales gains from lower-tier CFC stock, since Section 964(e) would remain in place, it appears that gain from a lower-tier CFC stock sale would be recast as a CFC-to-CFC dividend, applying Section 1248 principles. Thus, that dividend amount would bring active earnings into the upper–tier CFC, where they would remain untaxed until a future date.

Option Y's key element is the scope of subpart F. In general, the discussion draft retains but significantly modifies the current subpart F regime. As explained in the Joint Committee on Taxation's (JCT's) Technical Explanation of the discussion draft, the modified subpart F rules are intended to ensure that the dividend exemption applies only to income from the conduct of an active foreign business and to limit shifting of income from the United States to low-tax foreign countries.

New categories of subpart F income

Option Y expands the scope of subpart F by adding two significant, new categories of subpart F income, 'United States-related income' and 'low-taxed income.'

The US-related income category (proposed Section 955) includes income from the manufacture, production, extraction, sale, lease, rental or licensing of imported property, collectively termed 'imported property income.' For this purpose, imported property is property that literally has been (or would reasonably be expected to be) imported into the United States, that is, being brought into the United States for consumption or use within the United States. Such importation includes property used in the manufacture or production of other property that would be imported into the United States, as well as any grant of the right to use property in the United States. Note that, if all dispositions of the property before ultimate use or disposition in the United States are between related persons, the CFC will be deemed to have had a reasonable expectation that the property would be imported.

In addition, the US-related income category includes 'United States services income,' which is income derived in connection with services (including insurance and finance-related business) provided with respect to persons, property or risks located in the United States.

The second new category of subpart F income, low-taxed income, would include all of a CFC's income items (other than CFC dividends) that are not subject to a foreign effective tax rate (ETR) of at least [80%] of the US corporate tax rate. For this purpose, US federal income tax principles would be applied to measure the foreign ETR, taking into account only taxes and other deductions related to the tested income item. The JCT Technical Explanation anticipates that rules similar to Treas. Reg. §1.904-6 would apply for this purpose, along with aggregating the items of income and deduction arising from activities giving rise to a foreign tax base and the related foreign income taxes.

Observation: Although previous anti-base erosion proposals were not entirely clear as to the impact of disregarded branches or payments on a CFC's ETR computation, eliminating check-the-box in the cross-border context would greatly reduce concerns about that issue in implementing Option Y.

In addition, Option Y would allow a CFC's US shareholder a [20%] deduction for the gross income amount attributable to low-taxed income. As the JCT Technical Explanation notes, the combination of including a CFC's low-taxed income in US taxable income while allowing this deduction effectively imposes a minimum worldwide tax rate on a CFC's income.

The new low-taxed income category would be codified as a new Section 956, replacing the current provision governing a CFC's income from US property. Because low-taxed income would be currently taxed in the United States, Option Y would also repeal the Section 954(d) foreign base company rules for sales, services, and oil-related income that subject this income to current US federal tax under present law. In addition, Option Y would repeal the following subpart F rules: (1) the rule exempting de minimis amounts from foreign personal holding company income (FPHCI) and insurance income, (2) the high-tax exception for FPHCI and insurance income, and (3) the 70%

full inclusion rule deeming all income of a CFC to be insurance income or FPHCI. Note that neither US-related income nor low-taxed income includes the following categories of subpart F income: (1) insurance income, (2) FPHCI, (3) international boycott income, (4) illegal bribes, etc., or (4) income from Section 901(j) countries.

Option Y maintains the present-law approach that would allow CFCs to reduce their subpart F income by taking into account deductions (including taxes) properly allocable to that income. In general, interest the CFC pays or accrues to a US shareholder (or any related CFC) is allocated first to passive FPHCI, as under present law. The discussion draft revises the definition of 'qualified activity' for the purpose of determining qualified deficits taken into account in reducing a CFC's E&P.

Modified scope of FPHCI

Option Y would modify the scope of FPHCI in several ways, codified under new Section 954. Although it does not extend the existing CFC look-through rules, it does exclude CFC-to-CFC dividends from subpart F income. However, the amended Section 954(c) would narrow the same-country exception for dividends, interest, rents, and royalties. In general, the only exclusions from FPHCI are for (i) dividends and interest received by a CFC from a related corporation that are both subject to tax under the laws of the same foreign country and (ii) rents and royalties received by a CFC from a related corporation for the use of property within the country under whose laws the CFC is subject to tax. Moreover, the exclusion does not apply to the extent that (i) the payment reduces the payor's (or another CFC's) subpart F income or (ii) dividends are attributable to E&P accumulated when the person receiving the dividend did not own the stock.

With respect to the foreign currency gains business needs exception, proposed Section 954(a)(1)(D) would take currency gains and losses from the CFC's borrowing transactions into account in the currency gains inclusion. (The JCT Technical Explanation emphasizes that no inference is intended regarding the application of current law to non-functional currency borrowing transactions.)

With respect to financial institutions and their business, Option Y makes a number of changes, starting with repealing the exception for export financing interest derived in the conduct of a banking business. On a more positive note, Option Y broadens and makes permanent the exception for regular dealers in property that gives rise to passive income. For this purpose, dividends, interest, rents, royalties, and annuities (and certain equivalent amounts) from any transaction entered into in the ordinary course of the CFC's trade or business as a dealer are not taken into account in computing FPHCI. (The JCT Technical Explanation notes that this provision supersedes a separate temporary rule for dividends and interest received by securities dealers.) In connection with this modification, Option Y would repeal the application of the active financing exception to registered securities brokers and dealers, as well as the coordination rule for when a CFC is subject to the exceptions for both active financing and securities dealers.

Option Y would also modify the rule for CFC sales of 25%-owned partnership interests. The provision treats the partnership interest sale result as gain or loss from an interest in a trust, partnership, or REMIC in proportion to the CFC's subpart F income distributional share for the preceding three tax years compared to its gross income distributional share.

Under proposed Section 954(c), Option Y includes substantial language relating to the active financing exception (present-law Section 954(h)), which it would make permanent. Thus, FPCHI would not include (i) an eligible CFC's qualified banking or financing income or (ii) a qualifying insurance company's qualified insurance income. (Note, however, that these exceptions would not apply for purposes of determining low-taxed income treated as subpart F income.)

A CFC would be 'eligible' if it is either a regulated financial institution or if 80% of its gross income is derived from the active and regular conduct (as codified in a list of specific activities) of a lending, finance, or financial services business from transactions with unrelated customers located outside the United States. For this purpose, a regulated financial institution is defined as one engaged in the active conduct of a banking business and licensed to do business as a bank in the United States or a jurisdiction whose central bank is a member of the Basel Committee on Banking Supervision. If not a US bank, the institution must be subject to its jurisdiction's regulatory supervision and be wholly owned by a US bank or depository institution holding company (as defined under the Federal Deposit Insurance Act). Option Y would grant regulatory authority to expand this definition.

Further with respect to CFC eligibility, Option Y would repeal the CFC-wide eligibility determination if a CFC has one or more qualified business units (QBUs). Thus, rules for determining eligibility and the amount of qualified banking or financing income would apply separately to the CFC and to each QBU as if the QBU were a CFC. Accordingly, only items and activities properly allocable or attributable to that QBU are taken into account in computing its qualified banking or

financing income. Proposed Section 954(c) would repeal the limitation that treats no income of a CFC (or QBU) as qualified banking or financing income unless more than 30% of the tested gross income derives directly from actively and regularly conducting a lending or finance business with unrelated customers and located in the CFC's (or QBU's) home country.

With respect to qualified banking or financing income, Option Y would modify the definition in several ways. Specifically, the qualified income of regulated financial institutions includes income derived from (i) reserves required by banking regulations, (ii) deposits placed with the CFC's home country central bank, and (iii) investments in home country debt instruments. For these purposes, 'home country' has new definitions. For a CFC, it means the country under whose laws the CFC is subject to residence-based tax. For a QBU, it is the location of the QBU's principal office. With respect to customers' locations, natural persons are located where they are physically present when entering into the transaction, and customers that are not natural persons are located in the country from which the customer enters into the transaction.

Finally, with respect to banking business, activities of a related person's employees are treated as conducted directly by an eligible CFC if the related person is subject to tax in its home country and if (i) it is the same home country as the eligible CFC's, (ii) the activity is performed there, (iii) the related person is compensated on an arm's-length basis for its performance, and (iv) the home country's tax laws treat that compensation as earned there by the related person. It is not necessary for the related person to be a CFC.

Option Y retains the present-law definition of qualified insurance income for purposes of the FPHCI exception, but it modifies the definition of a qualifying insurance company along with the Section 953(e) definition of exempt insurance income. (According to the JCT's Technical Explanation, the proposal revises the definition to better address current international insurance market practices and abuse.) The proposed Section 953(e) language retains the requirements that a qualifying insurance company (i) be subject to home country regulation, (ii) derive more than 50% of aggregate net written premiums from contracts not involving related persons, (iii) be engaged in the insurance business, and (iv) be subject to tax under subchapter L if it were a domestic corporation. However, Option Y does not retain the present-law requirement that the CFC derive more than 50% of aggregate net written premiums from contracts covering home country risks.

In addition, the Section 953(e) modifications add two new requirements for qualifying insurance company status. One new requirement mandates that more than 50% of the CFC's gross receipts for a tax year be insurance or reinsurance premiums in connection with property, liability or the lives or health of individuals, which the CFC's home country tax laws treated as earned by that CFC in that country. The other new requirement calls for the CFC's applicable insurance liabilities to be more than 35% of its total financial statement assets for the relevant tax year. For this purpose, insurance liabilities are defined as loss and loss adjustment expenses, unearned premiums, and certain reserves. In general, the CFC's applicable financial statement for this purpose must be made on the basis of GAAP or IFRS, or the annual statement filed with the home country insurance regulatory body. Option Y also delegates authority to provide for other means of satisfying this requirement.

Option Y generally applies the Section 953(e) percentage tests on a CFC-by-CFC (or branch-by-branch) basis and provides regulatory authority regarding (i) circumstances for treating all CFCs as one CFC and (ii) applying the 50% and 35% tests in the case of a startup or runoff company. Absent such guidance, the applicable rules for this purpose would be similar to Section 815.

In addition, Option Y modifies the definition of exempt contract by repealing the home-country risk prong of the 30% net written premium requirement for a qualifying insurance company (or branch). The modified Section 953(e) does retain the exempt contract requirement that the qualifying insurance company or branch derive more than 30% of its net written premiums from exempt contracts with respect to which no stakeholder is a related person. In addition, Option Y expands the substantial activity requirement to direct that any CFC insurance contract is an exempt contract only if the CFC conducts substantially all of the activities necessary to give rise to the income generated by the contract's substantial activities in its home country. An activity is considered directly conducted by a qualifying insurance company in its home country under similar conditions to those discussed above.

Finally, Option Y narrows the rule for determining whether an insurance contract was issued by a CFC or QBU where the contract is regulated as a life insurance or annuity contract by the CFC's or unit's home country and no stakeholder with respect to the contract is a US person. The revised rule would apply only to CFCs and qualifying insurance company branches.

Foreign tax credit changes

Option Y applies the Section 904(d) FTC limitation categories separately for six categories of income: (1) passive (FPHCI) income; (2) US-related subpart F income; (3) low-taxed subpart F income; (4) foreign branch income, (5) insurance subpart F income; and (6) all other income. Look-through rules apply to characterize subpart F inclusions based on the CFC's income to which it is attributable. Passive income includes passive income earned by a branch but does not include high-taxed income. For this purpose, the special rule for certain income from loans of a CFC would apply only in the case of a CFC's income. High-taxed income, which would not be in the passive category, is defined as income that would otherwise be passive if the sum of (1) the taxpayer's foreign taxes with respect to the income, and (2) the taxpayer's foreign taxes deemed paid under amended Section 960 exceeds the highest applicable tax rate multiplied by the amount of the income (including the Section 78 gross-up where applicable).

Option Y would include in foreign branch income the taxpayer's business profits attributable to one or more QBUs in one or more foreign countries. The proposed rules would determine business profits in a treaty country in accordance with the treaty but in non-treaty countries under Treasury/IRS guidance that is expected to be similar to the US model income tax treaty.

Taxes carried forward to any tax year beginning on or after January 1, 2015, would be treated differently depending on their prior characterization: in the passive category if attributable to passive category income under rules for tax years beginning in 2014, and in the 'other' category if attributable to general category income under rules for tax years beginning in 2013. Taxes carried back from a tax year beginning on or after January 1, 2015, would be subject to Treasury/IRS guidance. For each item of income re-sourced under a US tax treaty, the FTC limitation is applied separately. Option Y includes base differences in the 'all other income' category. With respect to the Section 904(d) modifications, the proposed Option Y rules would grant regulatory authority as necessary or appropriate to carry out its purposes.

With respect to the proposed Section 245A DRD, Option Y would disallow an FTC for taxes paid with respect to CFC income that is (i) not treated as subpart F income or (ii) for taxes paid with respect to any dividend eligible for the deduction. As the JCT Technical Explanation explains, proposed Section 901(n), combined with amended Section 960, is intended to allow an indirect FTC or deduction only for foreign taxes on subpart F income. Option Y would also disallow direct credits for income that a CFC earns.

Observation: Allowing a US shareholder a full FTC with respect to the subpart F income inclusion attributable to low-taxed income appears designed to ensure that the US shareholder pays a consistent amount of worldwide tax equal to [80%] of the maximum Federal corporate income tax rate if the foreign effective tax rate is less than [80%] of such maximum rate.

Option Z

Option Z of the discussion draft generally imposes current tax on CFCs' US shareholders for those shareholders' pro rata shares of all CFC income, while retaining the structure of subpart F. It repeals the existing definitions of subpart F income, insurance income, foreign base company income, shipping income, and investment in US property.

In effect, this approach would currently tax all CFC income, while providing a partial exemption from US tax for active foreign market income. As described in more detail below, Option Z would tax [60%] of a CFC's active foreign market income and 100% of the CFC's remaining income (other than US ECI) currently to its US shareholders.

New categories of subpart F income

Option Z would provide a new definition of subpart F income in Section 952 that introduces the concepts of modified active income, modified non-active income, and active foreign market income. Subpart F income would be the sum of modified active income, which is [60]% of active foreign market income, and modified non-active income, which is the net income of a CFC determined without regard to active foreign market income. The effect of the new definition is to eliminate deferral of income by a CFC and to provide a partial exemption from US tax for active foreign market income. As in present law, subpart F income would not include ECI (unless exempted under a tax treaty).

Properly allocable expenses would reduce each component of subpart F income. Active foreign market losses and qualified losses would also reduce active foreign market income in computing modified active income. Only qualified losses (amounts by which allocable expenses exceed a CFC's gross income without regard to active foreign market income) could reduce modified non-active income (but not below zero). For tax years beginning after December 31, 2014, qualified losses from non-active foreign market operations in a taxable year would carry forward. Similarly, for post-December 31, 2014 taxable years, active foreign market losses

would carry forward to reduce active foreign market income. Option Z has ordering rules for the use of qualified losses from more than one tax year.

Option Z characterizes active foreign market income as attributable to economically significant activities of a qualified trade or business in connection with (i) property sold or exchanged for use outside the United States or (ii) services performed outside the United States with respect to persons or property located outside the United States. To qualify, CFC officers or employees must perform the activities outside the United States and make a substantial contribution to the production of income. The rules for determining whether income is active foreign market income would apply item-by-item. A trade or business would be 'qualified' if it (i) manufactures, produces, grows, or extracts property, or provides services, outside of the United States, or (ii) makes 'substantial contributions' to the qualified trade or business of another person through the activities of a CFC's employees. Thus, active foreign market income generally excludes income attributable to US-market sales or services.

Like the Option Y rule on 'imported property' (see above), a special rule generally excludes an item of income from active foreign market income if it was reasonable for a CFC or related person to anticipate that property giving rise to that item (or incorporated into another item) would be used, consumed, or disposed of in the United States. As with Option Y, there is a presumption of ultimate US use if all sales in a series of transactions are among related persons. Note that a single sale to an unrelated person does not create a presumption to the contrary.

Although active foreign market income would not generally include passive income, passive-type income could be active foreign market income, and thus eligible for the deduction, if it satisfies the exceptions for active banking, finance, or insurance income, or is certain rent and royalty income. The passive income category would include passive income as defined in the amended Section 954(a), and subpart F income attributable to passive income.

Option Z applies the same approach as Option Y in modifying the foreign currency gains business needs exception and broadening the exception for regular dealers in property giving rise to passive-type income. Like Option Y, Option Z would exclude from subpart F distributions from one CFC to another CFC. Unlike Option Y, the tax exemption would fall under the modified Section 959 previously-taxed income (PTI) rules.

Option Z adopts the same approach as Option Y to the rule for sales of CFCs' 25%-owned partnership interests. The excluded portion would be characterized as active foreign market income and non-active foreign market income under the rules for characterizing gain or loss from the sale or exchange of certain equity interests (discussed below). Like FPHCI under Option Y, Option Z passive income would not be subject to a de minimis exception, a 70% full inclusion rule or a high-tax exception, and export financing interest from a banking business would not be exempt from passive income.

Note that Option Z's passive income definition would also provide the definition of passive income for the purposes of the passive foreign investment company (PFIC) rules (with limited exceptions).

As mentioned above, Option Z provides rules for determining how much of the gain or loss from the sale of CFC stock or the sale of a partnership interest is active foreign market income. Gains or losses on partnership interest sales are generally taken into account only if a CFC is a 25% owner (directly, indirectly or constructively), and in proportion to the CFC's distributable share of the partnership's active foreign market income over the previous three years.

Option Z coordinates the rules on subpart F inclusions with the Section 959 PTI rules, treating all subpart F income generally as previously taxed. An ordering rule designates E&P distributions as made first from the deemed Section 965 repatriation's deductible portion, then from active foreign market income deducted in determining subpart F income, before applying general ordering rules requiring that a distribution be considered made from PTI even if the CFC otherwise has (or would have) an overall E&P deficit. (The JCT Technical Explanation notes that these ordering rules override the Rev. Rul 86-131 position that E&P in the various Section 959(c) categories must equal the CFC's total earnings.

Note that Option Z would amend the Section 361(e)(1)(B) anti-loss importation rules to provide that a CFC is considered to be subject to tax (and thus not subject to those rules), except as provided under regulations.

Active financing exception and insurance income

Option Z treats the active financing exception very similarly to Option Y (see above), making it permanent and modifying it in much the same way (substituting the term 'passive income' for FPHCI). An item of income eligible for the active financing exception would be active foreign market income under amended Section 953. Option Z similarly modifies the definition of a qualifying insurance company provision, although it makes the

related modifications to the exempt insurance income definition under new Section 955(c), which is specific to Option Z.

Option Z treats insurance income generally as a gross income concept, but otherwise does not change its treatment from present-law Section 953(a) and (b). Similarly, treatment of captive insurance companies would not change from present-law Section 953(c) and (d). Neither a CFC's insurance income nor a captive insurance company's related-person insurance income (RPII) would be active foreign market income. Option Z would also follow present law in excluding exempt insurance income from subpart F treatment (regarding it as active foreign market income). Option Z makes permanent the active financing exception rules for exempt insurance income. The definitions and tests regarding insurance income and insurance companies are essentially the same for Option Z as for Option Y (see above).

Foreign tax credit changes

Option Z applies the FTC limitation separately for three separate categories of income: (1) subpart F income from active foreign market income; (2) passive income; and (3) all other income. FTCs would be denied with respect to distributions from the [40%] portion of active foreign market income not currently taxed under subpart F. In general, the definition of passive income is similar to present-law FPHCI, with similar exclusions, such as high-taxed income or rents and royalties received from an unrelated party in the active conduct of a trade or business.

As under Option Y, the special rule for certain income from CFC loans would apply only to a CFC's income, and 'base difference' income would be included in the 'all other income' category. Option Z also places financial services income (defined similarly to present law) in the 'all other income' category.

Option Z has rules similar to Option Y for dealing with items re-sourced by treaties and FTCs carried over the effective date.

One-time tax on pre-effective date deferred income

The discussion draft proposes a one-time tax on foreign subsidiaries' pre-effective date earnings that have not been subject to US federal income tax. The foreign taxes paid on these accumulated earnings would be creditable to the extent that the earnings are taxed. Based on the formula provided in the discussion draft, the effective tax rate on the previously deferred earnings would be 20%, assuming a 35% statutory rate in the year the transition rule applies. This one-time tax could be paid over a period of up to eight years.

The discussion draft includes detailed language as to the operation of this tax. Essentially, it involves tax on 'accumulated deferred foreign income,' defined as the portion of the corporation's undistributed earnings that exceeds undistributed US earnings (including, e.g., distributions from regulated investment company (RICs) or real estate investment trust (REITs)). The mechanism requires a new ordering rule for PTI, which would attribute distributions first to the deductible portion of previously-deferred foreign income. The JCT Technical Explanation clarifies that this ordering rule ensures that additional FTCs would not be disallowed on a distribution. Absent this rule, additional foreign taxes imposed on PTI distributed to a US shareholder would be partly disallowed.

Additional reforms

The proposed international tax reforms common to both of the minimum tax options include provisions previously put forward by the Obama Administration and some members of Congress. These proposals appear under the heading 'Provisions to Prevent Base Erosion:'

- Limitations on income-shifting through intangible property transfers (tightening Sections 367(d) and 482)

The proposal closely follows the Obama Administration budget proposals on these issues to expand the definition of 'intangible property' and tighten the applicable valuation methodology to require use of the 'realistic alternative' approach. However, the discussion draft also has a few meaningful differences. A new proposed revision of the Section 936(h)(3)(B) definition would define the residual category of 'any similar item' to mean 'any other item the value of which is not attributable to tangible property or the services of any individual,' making it a negatively-defined catch-all provision. A second new proposed revision would remove the flush language ("which has substantial value independent of the services of any individual") after "any similar item" in existing Section 936(h)(3)(B)(vi) to clarify that the source or amount of value of any item is not relevant to whether property that is one of the specified types of intangible property is within the scope of the definition. Note that the discussion draft acknowledges expansion of the intangible property definition to include goodwill, workforce-in-place, and going-concern value to be as an amendment, and not just a 'clarification.'

- Prevention of avoidance of tax through reinsurance with non-taxed affiliates

The discussion draft proposal is identical to the most recent bill (H.R. 2054) introduced by Rep. Richard

Neal (D-MA), with his co-sponsor Rep. William Pascrell (D-NJ), on May 20, 2013, except for the effective date. The proposal would disallow insurance companies a deduction for non-taxed reinsurance premiums paid to their foreign affiliates with respect to risks other than life insurance risks. Furthermore, the insurance company's income computation would not take into account items of income, such as ceding commissions, reinsurance recovered, and return premiums, properly allocable to the non-taxed premiums paid. The proposal includes detailed language defining key terms and (similar to H.R. 2054) providing an election to treat the relevant income as taxable ECI. The discussion draft would delegate regulatory authority for several purposes. The Administration has not yet proposed legislative language on this issue, but its description in the 2014 Budget Proposal is similar to the current draft proposal. The proposal would be effective for tax years beginning after 2013.

- Treatment of foreign persons' gain or loss from the sale of interests in partnerships conducting a US trade or business (Rev. Rul. 91-32 codification)

This proposal would codify the IRS's position in Rev. Rul. 91-32, which treats gain realized by a foreign person from disposition of a partnership interest as taxable income to the extent attributable to the partnership's assets used in the conduct of a US trade or business. The proposal also provides for a withholding tax to implement the provision. This provision would generally require the purchaser of an ECI-generating partnership interest to withhold the tax. Where a purchaser failed to withhold the required tax, the partnership would have to withhold on distributions that would otherwise be made to the purchaser.

Observation: The IRS is currently litigating its Rev. Rul. 91-32 position, which some observers have questioned as lacking legislative authority.

Other significant reforms include proposals to:

- Generally eliminate the use of check-the-box rules for entities wholly or partially owned by CFCs

New Section 7705 would treat as a corporation any business entity that would otherwise be eligible under the Section 7701 entity classification rules to elect its tax status, if it is wholly owned by a CFC or owned by two or more members of an expanded affiliated group, one of which is a CFC.

Observation: This proposal would have a significant impact on current tax structures that many US multinationals have put in place. Note that the Section 7705 entity could be US or foreign, and it would affect hybrid partnerships as well as disregarded entities.

- Eliminate Section 902 indirect FTCs (including for 10/50 companies) and modify the Section 960 FTC rules

Both minimum tax options make Section 901 amendments that deny FTCs for taxes attributable to amounts excluded from a US shareholder's income. Thus, subpart F inclusions and subsequent PTI distributions are the only means for US persons to credit CFCs' foreign income taxes. Any Section 78 gross-up would become a subpart F inclusion.

New Section 960 deemed-paid credit rules would limit a taxpayer's indirect credit to the amount of tax that is attributable to income included in subpart F.

- Eliminate the Section 909 anti-splitter rules

The JCT Technical Explanation points out that the discussion draft's new Section 960 rules would make Section 909 unnecessary, because they effectively prevent taxpayers from taking into account CFC taxes before the year in which the related CFC income is included in income under subpart F. Moreover, Option Y and Option Z would amend Section 901 and prevent taxpayers from crediting directly-imposed taxes relating to exempt income.

- In addition, the discussion draft proposes to deny deductions for related-party payments arising in a 'base erosion arrangement' involving a hybrid transaction, instrument or entity, or an exemption or conduit financing arrangement.

Proposed Section 267A would define a 'related-party payment' as one made by a US corporation (or a foreign corporation with ECI) to a related party unless the payment gives rise to a subpart F inclusion. The discussion draft defines a base erosion arrangement as any arrangement that reduces the amount of foreign income tax paid or accrued. A 'hybrid transaction or instrument' would be an instrument, transaction, or series of transactions that the issuer treats as debt for purposes of any relevant income tax and the holder treats as other than debt. A 'hybrid entity' would be any entity treated as fiscally transparent for purposes of any relevant income tax, if the entity is not treated as fiscally transparent for purposes of any other relevant income tax. An 'exemption arrangement' would be any provision of foreign income tax law that has the effect of reducing the generally applicable statutory rate of foreign income tax by 30% or more (but does not include any foreign income tax law that requires economically significant expenditures in order to obtain the

foreign tax benefit). A 'conduit financing arrangement' would be an arrangement under which a financing entity advances money or property to a financed entity directly through the involvement of one or more intermediate entities. The proposal also provides definitions of key terms and regulatory authority to carry out its purpose.

Observation: The base erosion arrangement proposal appears aimed primarily at non-US multinationals (*i.e.,* inbound companies). It has potentially far reaching and significant implications for various related-party arrangements that involve a deduction for US tax purposes and that have the effect of reducing foreign income taxes. The proposal is broadly drafted in a number of respects and may have significant unintended consequences for US subsidiaries claiming US deductions. In requesting comments on the proposal, Chairman Baucus states that "foreign multinational corporations have substantial opportunities to avoid taxation through financing and licensing arrangements involving their US subsidiaries. For example, foreign multinationals can take advantage of differences between US and foreign tax laws to qualify for income tax treaty benefits while paying little or no US or foreign tax on income earned in the United States." See further the section below on Requests for Comments. The proposal raises serious concerns of unilateral action in an area that is now subject to multilateral consideration in the OECD base erosion and profits shifting (BEPS) Action Plan.

Other major proposals include:

- Repeal the portfolio interest withholding tax exemption for interest paid on corporate debt

This brief proposal would simply repeal the provisions of Sections 871(h) and 881(c) that exempt portfolio interest from withholding tax for debtholders that are foreign corporations or non-resident aliens. As the JCT Technical Explanation notes, because the provision does not override treaties, the portfolio interest exemption for corporate debt would effectively be available to foreign persons only in symmetrical situations where US residents are eligible for similar exemptions under income tax treaties.

Observation: This proposal could significantly impact the amount of foreign capital available to US companies and the US economy generally. Since 1984, there has been a global capital market for debt issued by US corporations in a single class that any unrelated person in the world can hold free of withholding tax. If repeal occurs, certain capital exporting areas of the world might no longer find US corporate debt competitive with foreign issuers' debt, given that most major countries have the equivalent of a portfolio interest exception. This proposal may also affect foreign multinationals lending to their US affiliates, where the loans can be linked to public debt issuances that no longer qualify for the portfolio interest exemption. In addition, the mechanics of withholding tax compliance would become complicated, given that treaties would provide the only available relief from US withholding tax.

- Change in the impact of subpart F CFC definition by eliminating the 30-day holding requirement for income inclusions and adding a value test for ownership by US shareholders
- PFIC reforms: elimination of the interest charge and qualifying election fund options, adding a new imputed income for non-traded securities; and other reforms

These proposals would simplify the PFIC regime, eliminating the interest charge when a US person who owns stock of a PFIC receives an excess distribution in respect of that stock, the Section 1293-1295 rules relating to qualified elective funds and elective annual taxation. Instead, the proposal would deem a US person owning non-publicly-traded PFIC stock to earn (and include) an annual PFIC stock return equal to the Federal short-term rate plus five percent. The proposal includes detailed rules for this new regime.

- Source and allocation rule reforms: acceleration of the worldwide interest allocation election by six years; repeal of the interest expense apportionment fair market value method; reform of inventory sale title passage rules (making the income entirely US-source when a taxpayer's US office or fixed place of business within the United States is a material factor in the sale); and disregard covered asset acquisitions other than Section 338 transactions in determining income source and character.

Two of the additional reforms in the discussion draft involve complete removal of special tax regimes:

- Termination of special rules for domestic international sales corporations (DISCs)

This proposal would terminate any US corporation's existing DISC election and prohibit any future such elections. It would also provide transition rules.

- Repeal of dual consolidated loss (DCL) rules

This proposal would simply repeal the Section 1503(d) limitation on the

deductibility of losses subject to tax in more than one jurisdiction.

Two other reforms in the discussion draft involve changes to regimes of particular interest to inbound taxpayers:

- Modifications (both tightening and relaxing) to the Section 897 Foreign Investment in Real Property Tax Act (FIRPTA) tax on foreign investments in US real property interests

This proposal would modify various aspects of the rules determining United States real property interest (USRPI) status. On the one hand, the modifications would expand the scope of USRPIs; for example, the rule excepting a US corporation's ownership from USRPI if the corporation owns no USRPI at the time of the share sale, and all of the USRPIs that it held in the previous five years was disposed of in fully taxable transactions would no longer apply to stock of current (and, in some cases, former) RICs and REITs. On the other hand, the proposal would reduce the scope of USRPI in certain ways for foreign investors. First of all, an investor could own up to 10% of a regularly-traded REIT's stock during the five-year period before disposition and not have the stock considered a USRPI, easing the current five percent threshold. The discussion draft would also override Notice 2007-55 by making certain RIC or REIT distributions not subject to tax under Section 897(h) if Sections 301(c), 302 or 331 would treat the distributions as sales. In addition, the discussion draft would exempt gain on the disposition of USRPIs owned by foreign pension funds from Section 897 treatment. The proposal would generally apply to USRPI dispositions after the enactment date.

- Denying deductions (as US-source dividends) for dividends from foreign corporations attributable to RIC and REIT dividends.

This provision would exclude RICs and REITs from the category of US corporations whose dividends to a foreign corporation are treated as US-source for purposes of the Section 245 DRD.

Observation: Some of the reforms proposed by the Finance Committee staff would have considerable impact on certain tax structures, business arrangements, and economic trends. Others represent simplifications of the US international tax regime. Still others appear to be primarily anti-abuse provisions targeted at specific concerns.

Request for public comment

Chairman Baucus has requested public comment on the items in the discussion draft and other issues not addressed in the draft. In addition to Chairman Camp's Option C, the discussion draft provides a detailed list of key issues:

- the treatment of US corporations' foreign branches
- additional ways to address US base erosion by foreign multinationals, particularly where there may be tax arbitrage or treaty benefits involved
- transition rules and effective dates "that allow for an equitable and orderly transition that is neither punitive nor results in windfalls"
- whether the present-law 'thin capitalization' rules (addressing US companies that owe excessive debt to foreign affiliates) should be tightened and expanded, applying to all debt that a US corporation owes

Observation: Such a broad approach could have significant implications for US inbound companies.

- a temporary transition rule allowing US multinationals to bring intangible property held by their foreign subsidiaries back to the United States on a tax-neutral basis
- taxation of foreign subsidiaries doing business in the US territories and international tax rules addressing individuals
- other opportunities for simplifying the international tax system in a manner consistent with the proposed changes
- Chairman Baucus has requested that comments be submitted by January 17, 2014 but will accept them after that date.

The takeaway

Chairman Baucus states that the discussion draft is intended to spur a conversation on areas where Democrats and Republicans may be able to reach an agreement on tax reform. Finance Committee Ranking Member Orrin Hatch (R-UT) and other Finance Committee Republicans expressed concern about the timing of the discussion draft's release. A budget conference is attempting to reach an agreement on FY 2014 federal spending by December 13, and some Democrats in Congress have proposed using revenue from closing 'tax loopholes' to replace scheduled 'sequestration' spending cuts.

As Chairman Baucus advises, stakeholders should provide the Finance Committee with feedback on the international reform staff discussion draft, and should consider carefully the request for comments on issues not addressed in the current draft. We expect the discussion of tax reform options to continue into 2014, as reflected in Chairman Baucus'

request for comments by January 17 of next year. The comprehensive tax reform bill currently being developed by Chairman Camp will be an important part of this ongoing discussion.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

International Tax Services

Tim Anson
(202) 414-1664
tim.anson@us.pwc.com

Mike Urse
(216) 875-3358
michael.urse@us.pwc.com

Alan Fischl
(202) 414-1030
alan.l.fischl@us.pwc.com

Chip Harter
(202) 414-1308
chip.harter@us.pwc.com

Oren Penn
(202) 414-4393
oren.penn@us.pwc.com

Mike DiFronzo
(202) 312-7613
michael.a.difronzo@us.pwc.com

Kevin Levingston
(678) 419-1235
kevin.m.levingston@us.pwc.com

Carl Dubert
(202) 414-1873
carl.dubert@us.pwc.com

Greg Lubkin
(202) 360-9840
greg.lubkin@us.pwc.com

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