Obama FY 2015 Budget tightens interest deduction limits and adds other international tax proposals

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In brief

The Treasury Department's 'Green Book,' released on March 3, 2014, outlines the Obama Administration's Budget proposals for fiscal year 2015 (FY 2015). Although it contains no significant changes to the ten international tax proposals retained from the previous two years' Budgets, it does add six new proposals, including a broad thin capitalization proposal that replaces proposed limitations on earnings-stripping by expatriated entities.

The Administration has again echoed a previous year's announcement that it would propose a minimum tax on overseas profits, but there is no specific Budget provision on this point. Other comments in Budget-related releases indicate the Administration's continued 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, particularly the R&E tax credit. However, the FY 2015 Budget is silent on extending the subpart F controlled foreign corporation (CFC) look-through and active financing exception rules.

For US multinationals, the focus in the Administration's FY 2015 Budget remains on outbound intangible property (IP) transfers and base erosion. New items include subpart F proposals regarding digital goods and services, hybrid entity arrangements, and toll manufacturing. Other key items in this area continue to be the 'excess return' proposal for IP transferred outside the United States and proposed limitations on shifting income through IP transfers. Also included in the international tax area are familiar proposals for deferring foreign-related interest expense, and pooling Section 902 foreign tax credits (FTCs). The Administration continues to propose limiting US companies' deductions for related-party payments, including significantly expanded earnings-stripping rules for interest payments and rules for reinsurance premiums paid to foreign affiliates.

In detail

Most of the international tax proposals in the FY 2015 Administration Budget would be effective for tax years beginning after December 31, 2014. The exceptions include the Section 338(h)(16) provision, which would apply to transactions after that date, and the aspect of the dual-capacity taxpayer proposal that would determine the amount of a foreign levy paid by such a taxpayer that qualifies as a creditable tax. That aspect would be effective for amounts that would be considered paid or accrued in tax years beginning after December 31, 2014. However, note that effective dates can change during the legislative process.

Like the Administration's FY 2013 and 2014 budgets, the FY 2015 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, part of the package involves denial of deductions for expenses in connection with 'outsourcing a US trade or business.'

Among the new international tax proposals, the one with the largest revenue estimate (over $48 billion during the ten-year Budget window) would expand Section 163(j) limitations on interest expense deductions to address foreign-parented multinationals' ability to disproportionately leverage a US subgroup's operations. In addition to the new subpart F proposals regarding digital goods and services, hybrid (and reverse hybrid) entity arrangements, and toll manufacturing, the Administration has also proposed tighter restrictions on the ability of US entities to expatriate (invert). The FY 2015 Budget does not address extending the subpart F CFC look-through and active financing exception rules.

In addition, the Budget 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 continues to pursue repeal of the Section 356 boot-within-gain limitation in the case of any reorganization transactions if the exchange has the effect of a dividend distribution (e.g., a 'Cash-D' reorganization). The Administration is also maintaining its previous proposals to limit loss importations under Section 267(d) and repeal both (i) the Section 707 technical termination rule for partnerships and (ii) the Section 197(f)(9) intangible asset anti-churning rule. In addition, the Administration has repeated its FY 2014 proposal exempting certain foreign pension funds from the Section 897 Foreign Investment in Real Property Tax Act (FIRPTA) rules.

The 16 international tax reform provisions in the FY 2015 Budget are scored by Treasury as increasing revenues by a total of $276.3 billion, a 75% increase over the FY 2014 budget's total of $157.5 billion for 11 international proposals. In addition, the proposals to repeal Section 351(g) and the boot-within-gain limitation are estimated to raise about $0.4 billion and $3.0 billion, respectively. The estimated revenue gain for the Section 267(d) loss importation and Section 707 technical termination rule repeal would again be about $0.9 billion and $0.2 billion, respectively. The Section 197 anti-churning rules repeal and the FIRPTA pension fund exemption are now estimated to cost over $2.6 billion and approximately $2.27 billion, respectively.

As in FY 2014, the Budget casts revenue estimates in terms of increases or decreases to the federal budget deficit, but the international tax proposals fall within a category of 'Reserve for Long-Run Revenue-Neutral Business Tax Reform.' The Congressional Joint Committee on Taxation (JCT) staff released its own revenue estimates for all FY 2015 budget provisions on April 15, 2014. The JCT estimates will serve as the official scoring for purposes of Congress' legislative action, if any. The JCT staff also customarily authors a lengthy description and analysis of the Budget provisions, which later in the year may add more details and perspectives to the Green Book's briefer write-ups.

The legislative prospects for these proposals in 2014 are uncertain. It seems unlikely that any major tax legislation will be enacted in 2014, or that Congress will deal with any significant tax issues before the midterm elections in November, including the usual tax extenders. Outgoing Chairman Dave Camp (R-MI) of the House Ways and Means Committee recently released a sweeping discussion draft that would reform many elements of the US federal income tax system and likely will help to set the terms of any international tax reform considerations, along with the Senate Finance Committee discussion draft offered in late 2013.

President's Budget: International tax proposals - FY15 & FY14 comparison (in millions)			
International tax proposals	**FY 2015 Budget**	**FY 2015 JCT**	**FY 2014 Budget**
FY 14 proposals repeated in FY 15			
Defer deduction of interest expense related to deferred income	*$43,138*	*$51,408*	*$36,520*
Reform foreign tax credit: Determine the foreign tax credit on a pooling basis	*$74,672*	*$58,630*	*$65,752*
Tax currently excess returns associated with transfers of intangibles offshore	*$25,965*	*$21,290*	*$24,005*
Limit shifting of income through intangible property transfers	*$2,728*	*$1,912*	*$2.108*
Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates	*$7,568*	*$8,959*	*$6.209*
Limit earnings stripping by expatriated entities	*N/A*	*N/A*	*$4,658*
Modify tax rules for dual capacity taxpayers	*$10,382*	*$12,238*	*$10,964*
Tax gain from the sale of a partnership interest on look-through basis	*$2,795*	*$2,603*	*$2,656*
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment	*$3,548*	*$3,077*	*$3,243*
Extend Section 338(h)(16) to certain asset acquisitions	*$960*	*$960*	*$960*
Remove foreign taxes from a Section 902 corporation's foreign tax pool when earnings are eliminated	*$423*	*$382*	*$389*
Total for FY 14 proposals repeated in FY 15	***$172,179***	***$161,459***	***$157,464***
New proposals in FY15			
Restrict deductions for excessive interest of members of financial reporting groups	*$48,581*	*$40,907*	*N/A*
Create a new category of subpart F income for transactions involving digital goods or services	*$11,660*	*$19,911*	*N/A*
Prevent avoidance of foreign base company sales income through manufacturing services arrangements	*$24,608*	*$14,130*	*N/A*
Restrict the use of hybrid arrangements that create stateless Income	*$937*	*$694*	*N/A*
Limit the application of exceptions under subpart F for certain transactions that use reverse hybrids to create stateless income	*$1,336*	*$763*	*N/A*
Limit the ability of domestic entities to expatriate	*$17,004*	*$17,251*	*N/A*
Overall total	***$276,305***	***$255,115***	***$157,464***

Summary of proposals

International business tax changes proposed by the Obama Administration in its FY 2015 Budget would:

- create a new category of subpart F income for transactions involving digital goods or services where the CFC uses IP developed by a related party without a substantial contribution by the CFC
- expand foreign base company sales income (FBCSI) treatment to include a CFC's sale income from property manufactured on behalf of the CFC (toll manufacturing) by a related person
- deny interest and royalty deductions for related-party payments where a hybrid arrangement results in either no foreign income inclusion or two deductions for the same payment
- prevent US shareholders from using the subpart F same-country or CFC look-through exceptions for income of foreign reverse hybrids held directly by US owners where that income is treated as a deductible payment received from a foreign related person
- expand in several ways the application of the Section 7874 anti-inversion rules to US entities (including partnerships) that are acquired by foreign entities
- 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)
- 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
- tax gain from the sale of a partnership interest on a look-through basis (i.e., legislation meant to shore up Rev. Rul. 91-32).

The following provides an overview of the proposals that are particularly relevant to US and foreign multinationals. As usual, given that the proposals generally would become effective for tax years beginning after the current calendar year, US multinationals may wish to examine how these proposals could affect their US federal income tax liabilities and the extent to which companies can manage that impact.

Although (as was the case with the Green Books from the previous four years) the descriptions of Administration proposals in this year's Green Book are sparse, the Administration did offer draft legislative language in the 2011 American Jobs Act and *President's Plan for Economic Growth and Deficit Reduction* for the ten proposals carried over from FY 2013 and FY 2014. The descriptions below reflect that language, for those proposals.

Discussion of specific proposals

There are no substantive changes in the ten FY 2015 international tax proposals that carried over from the FY 2014 Budget. They include all of the FY 2014 proposals except the one tightening Section 163(j) rules for inverted companies, which has been replaced by a wider-ranging thin capitalization provision. Like the FY 2014 Budget, the FY 2015 Budget does not propose to extend the CFC look-through rule (Section 954(c)(6)) or subpart F active financing exception (Section 954(h)).

New FY 2015 proposals

Four of the Administration's six new international tax proposals in the FY 2015 Budget involve expanding the subpart F rules. The other two relate to limiting interest deductions (thin capitalization) and further Section 7874 limitations on inversions.

Create a new category of subpart F income for transactions involving digital goods or services

Current law

The subpart F income regime in Sections 951, 952, and 954 is intended to ensure that US shareholders cannot defer tax on income that a CFC does not generate through an active trade or business. Digital transactions involving copyrighted articles can take the form of leases, sales, or services, each of which can generate a form of subpart F income. For example, a transaction involving a transfer of a computer program as a copyrighted article could be characterized as either a sale or a lease of the computer program, depending on the facts and circumstances concerning the program's benefits and burdens of ownership. The use of a computer program hosted on a server also might be characterized as providing a service to the user who accesses the server from a remote location.

The Administration expresses concern that the existing subpart F income categories do not adequately address mobile income earned from providing digital goods and services. The Green Book emphasizes that taxpayers can choose different forms for substantially similar digital transactions and thus potentially avoid existing subpart F rules, shifting digital income to low-tax jurisdictions, and possibly eroding the US tax base. It gives the example of a CFC that conducts business with remotely-located customers through the 'cloud' using intangibles acquired from a related party and without conducting any substantial business activities of its own.

Proposal

The Administration's proposal would create a new category of subpart F income, foreign base company digital income (FBCDI). FBCDI generally would include a CFC's income from leasing or selling a digital copyrighted article or providing a digital service in certain circumstances. Specifically, FBCDI treatment would apply where a CFC uses intangibles developed by a related party (including through a cost-sharing arrangement) to produce income and the CFC does not make a substantial contribution through its own employees to the development of the property or services that give rise to the income. A same-country exception would apply for customers located in the CFC's country of incorporation that use the copyrighted article or service in that country.

The JCT staff estimates that this new proposal would raise approximately $19.91 billion during the 10-year budget FY 2015 window, significantly more than the $11.66 billion Administration estimate.

Observations: The proposal states that "By choosing different forms for substantially similar transactions involving digital goods and services (leases, sales, or services), taxpayers may be able to avoid the application of the existing subpart F rules."

In this regard, the proposal seems to justify the creation of a new category of Subpart F income, at least in part, on the premise that taxpayers choose different forms of 'digital products and services' -- as sales, leases, or services -- for tax avoidance reasons. This underlying premise is flawed. Products and services, digital or otherwise, and the manner in which they are offered to customers, are driven not by tax avoidance reasons but by technological innovations, business models, and customer choices. The proposal also suggests that current Subpart F rules are rendered inapplicable, and therefore need to be changed, when products and services are sold in digital form. However, taxpayers who sell or lease digital products, or provide digital services, in fact are subject to the application of the same Subpart F rules that apply to any taxpayer who sells or leases products, or provides services through 'non-digital' avenues. Thus, the current Subpart F rules are not rendered inapplicable merely because products and services are sold through digital means. The same set of rules applies to all taxpayers, regardless of whether they sell products and services through digital or other channels of commerce.

In addition, the concept of singling out 'digital' transactions for Subpart F treatment is at odds with the long standing principle of neutrality that has guided the development of US and international tax policy concerning computer software and electronic commerce. As stated in the US Treasury Department's 1996 report, "Selected Tax Policy Implications of Global Electronic Commerce":

"*A fundamental guiding principle should be neutrality. Neutrality requires that the tax system treat economically similar income equally, regardless of whether earned through electronic means or through more conventional channels of commerce. Ideally, tax rules would not affect economic choices about the structure of markets and commercial activities. This will ensure that market forces alone determine the success or failure of new commercial methods.*"

The principle of neutrality continues to be important today. As stated in the OECD's March 2014 Discussion Draft on the Tax Challenge of the Digital Economy:

"*... because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary*

lines to be drawn between what is digital and what is not." (See PwC's Tax Policy Bulletin (OECD summarises options for addressing the tax challenges of the digital economy, March 26, 2014)

As a result, the OECD Discussion Draft also concludes that "ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible."

The Administration proposal on FBCDI appears to be at odds with the principle of neutrality, as it creates a new category of subpart F on income earned through 'digital' means rather than through more conventional channels of commerce. For example, a CFC that sells electronic books would generate Subpart F income under this proposal, unless certain exceptions are met, while a competitor CFC that sells the same books printed on paper would be unaffected. A CFC that sells both the electronic and printed versions of the same books – even if both are sold to the same customer – could generate FBCDI in one sale but not the other. Thus, the FBCDI proposal, if enacted, could inappropriately interfere with market forces by increasing the tax burden of companies that offer electronic or digital products and services relative to competitors who offer 'non-digital' versions of the same products or services.

Prevent avoidance of FBCSI through manufacturing services arrangements

Current law

FBCSI generally includes income earned in connection with a purchase and subsequent sale of personal property where the property is purchased from (or on behalf of), or sold to (or on behalf of), a related person. FBCSI treatment only applies where the property is manufactured outside of the CFC's country of organization and sold for use or consumption outside that country. The Green Book expresses the Administration's concern that current law allows taxpayers to avoid FBCSI by structuring related party transactions by which a CFC obtains the property that it sells to customers as a toll or consignment manufacturing arrangement. In that type of arrangement, the related manufacturer is characterized as providing a manufacturing service to the CFC rather than as selling the property to the CFC. The Administration focuses particular attention on cases in which taxpayers take this position with respect to property produced in the United States on behalf of a related CFC. The Green Book expresses the view that policy concerns underlying the FBCSI rules (including concerns about US base erosion) apply to all income a CFC earns from selling property produced by a related party, regardless of whether the CFC obtains the property through a purchase transaction or a manufacturing service.

Proposal

The Administration's proposal would expand the FBCSI category to include a CFC's income from the sale of property manufactured on behalf of the CFC by a related person, that is, toll manufactured. The existing exceptions to FBCSI would continue to apply.

The JCT estimates that this new proposal would raise approximately $14.13 billion over 10 years, significantly less than the $24.61 billion Administration estimate.

Observation: The Green Book's reference to US base erosion signals that this new proposal may also have its roots in global BEPS issues. In any case, a subpart F rule treating toll manufacturing the same as buy-sell contract manufacturing arrangements would have a significant impact on the global value chains of many US multinational companies. A CFC using a toll manufacturer could presumably avoid an FBCSI income inclusion under this proposal through satisfying the subpart F regulations' 'substantial contribution' requirements.

Restrict the use of hybrid arrangements that create 'stateless income'

Current law

Subject to certain exceptions and limitations, interest and royalty payments made or incurred in carrying on a trade or business are generally deductible under current law without regard to the tax treatment of such payments in other jurisdictions. The Administration has expressed concern about tax planning techniques involving a variety of cross-border hybrid arrangements (e.g., hybrid entities, instruments, and transfers, such as sales-repurchase or 'repo' transactions), in which taxpayers may take inconsistent positions with respect to tax treatment of the property or income involved. The Green Book focuses on US taxpayers' ability to make payments giving rise to US deductions without corresponding inclusions in the payee's tax jurisdiction. Such arrangements may result in income that is not subject to tax in any jurisdiction (stateless income) or in multiple deduction claims for the same payment in different jurisdictions.

Proposal

The Administration's proposal would deny US federal income tax deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. The Green Book specifies that the proposal would

apply where a taxpayer makes interest or royalty payments to a related party and, as a result of the hybrid arrangement, either (i) there is no corresponding inclusion to the recipient in the foreign jurisdiction, or (ii) the taxpayer could claim an additional deduction for the same payment in another jurisdiction.

The proposal grants regulatory authority as needed to carry out the proposal's purposes, specifically including regulations that would (1) deny deductions from certain conduit arrangements involving a hybrid arrangement between at least two of the conduit arrangement parties; (2) deny interest or royalty deductions arising from certain hybrid arrangements involving unrelated parties in circumstances such as structured transactions; and (3) deny all or part of deductions for interest or royalty payments that, as a result of the hybrid arrangement, are subject to inclusion in the recipient's jurisdiction under a preferential regime that effectively reduces the generally applicable statutory rate by at least 25%.

The JCT staff estimates that this new proposal would raise $694 million over 10 years, less than the $937 million Administration estimate.

Observation: Here again, the Green Book uses terms such as 'stateless income' and 'hybrid arrangements' that echo the global BEPS process. The low revenue estimate for this proposal raises questions as to its anticipated scope. This proposal would primarily affect foreign multinationals.

Limit the application of exceptions under subpart F for certain transactions that use reverse hybrids to create 'stateless income'

Current law

A reverse hybrid is an entity that is a corporation for US federal income tax purposes but is a fiscally transparent entity (such as a partnership) or a branch under foreign law. Because the US treats the reverse hybrid as a corporation, a reverse hybrid's income generally will not be subject to current US tax. The Green Book expresses concern about tax planning techniques involving cross-border reverse hybrid arrangements, noting that even if the reverse hybrid is treated as a CFC, its income from certain foreign related persons might escape current US taxation as a result of subpart F same-country exceptions or CFC look-through. The Administration notes that payments to a reverse hybrid generally are not subject to tax in the foreign jurisdiction in which it is established or organized, because the foreign jurisdiction views the reverse hybrid as fiscally transparent. Thus, a reverse hybrid's income generally would not be subject to tax currently in either the United States or a foreign jurisdiction if owned directly by a US company.

Proposal

The Administration's proposal would provide that the Section 954(c)(3) same-country exception and Section 954(c)(6) CFC look-through rule do not apply to payments made to a foreign reverse hybrid held directly by a US owner when such payments are treated as deductible amounts received from foreign related persons.

The JCT staff estimates that this new proposal would raise $763 million over 10 years, much less than the $1.34 billion Administration estimate.

Observation: This proposal also uses BEPS terms. The revenue estimate for this proposal is rather low, which again raises questions as to anticipated scope. Reverse hybrids owned by foreign companies whose countries impose little or no tax on the reverse hybrid's income would be unaffected by the proposal.

Restrict deductions for excessive interest of members of financial reporting groups

Current law

Business interest payments generally are deductible from taxable income while dividend payments are not. Section 163(j) denies US tax deductions for interest paid by a US corporation to a related party when (1) the corporation's debt-to-equity ratio exceeds 1.5 to 1, and (2) net interest expense exceeds 50% of the corporation's adjusted taxable income (adding back net interest expense, depreciation, amortization, depletion, net operating loss deductions, and Section 199 deductions). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year, and the corporation's excess limitation for a tax year may be carried forward to the three subsequent tax years.

The Green Book expresses concerns about the ease of adjusting the mix of debt and equity in a controlled entity, due to the fungibility of money. Because Section 163(j) does not consider the leverage of a multinational group's US operations relative to the leverage of the group's worldwide operations, the Administration believes that multinational groups (particularly those that are foreign-parented) can 'inappropriately' reduce their US federal income tax on income earned from US operations by over-leveraging those operations relative to operations in lower-tax jurisdictions.

Proposal

The proposal generally would apply to members of groups that prepare consolidated financial statements ('financial reporting group') in accordance with US Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or another method authorized by Treasury regulations. The mechanics of the proposal are somewhat complex. In general, the proposal would limit a member's US interest expense deduction to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense (using US federal income tax principles). The share of interest expense would be determined using the member's proportionate share of the group's earnings reflected in the financial statements (adding back net interest expense, taxes, depreciation, and amortization).

The default interest deduction rate would be 10% of the member's 'adjusted taxable income' (as defined under section 163(j)). This rate would apply for a member that fails to substantiate its proportionate share of the group's net interest expense, or a member could elect it as a safe harbor. Whether a taxpayer used the safe harbor or proportionate share method, disallowed interest would be carried forward indefinitely, and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would not be subject to Section 163(j).

US subgroups (any US entity not owned directly or indirectly by another US entity, and all members – US or foreign -- owned directly or indirectly by such entity) would be treated as a single member of a financial reporting group for purposes of the proposal. The proposal includes an ordering rule that this proposal would apply before interest expense deferral where a US member of a US subgroup owns foreign corporation stock. The US subgroup's interest expense that remains currently deductible after applying this proposal would be subject to deferral to the extent it is allocable to deferred foreign earnings.

Importantly, the proposal would not apply to financial services entities, which would also be excluded from the financial reporting group for purposes of applying the proposal. In addition, a de minimis rule would exempt financial reporting groups that would otherwise report less than $5 million of net interest expense. However, such entities exempted from this proposal would remain subject to Section 163(j).

The proposal would grant regulatory authority as needed, with specific reference to (i) coordinating the application of the proposal with other interest deductibility rules; (ii) defining financial services entities; (iii) permitting financial reporting groups to compute non-US net interest expense without making certain adjustments required under US income tax principles; and (iv) providing for the treatment of pass-through entities. If a financial reporting group does not prepare financial statements under US GAAP or IFRS, the Green Book notes that regulations would be expected to generally permit the use of financial statements prepared under other countries' GAAP in appropriate circumstances.

The JCT staff estimates that this new proposal would raise approximately $40.91 billion over 10 years, significantly less than the $48.58 billion Administration estimate.

Observation: The Administration previously proposed further limitations on earnings-stripping by inverted companies through Section 163(j) interest deduction limitations. This thin capitalization proposal is much more complex and far-reaching. The safe harbor does not appear very attractive.

Limit the ability of domestic entities to expatriate

Current law

Section 7874 applies adverse tax consequences to certain 'inversion transactions' in which a US corporation (an expatriated entity) is replaced by a foreign corporation ('foreign acquiring corporation') as the parent company of a worldwide affiliated group of companies. Section 7874 applies if (i) a foreign acquiring corporation acquires substantially all of a domestic corporation's assets; (ii) the US corporation's historical owners retain at least a 60% aggregate ownership interest in the foreign acquiring corporation; and (iii) the foreign acquiring corporation (together with its affiliated group) does not conduct substantial business activities in its country of creation or incorporation. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a US partnership's trade or business.

If the historical US shareholders' continuing ownership in the foreign acquiring corporation is 80% or more (by vote or value), the new foreign parent corporation is treated as a US corporation for all US federal income tax purposes (the '80% test'). If the continuing shareholder ownership is at least 60% but less than 80%, the foreign status of the acquiring corporation is respected, but certain other adverse tax consequences apply, including the inability to use tax attributes to reduce certain corporate-level income or gain ('inversion gain')

recognized by the expatriated entity (the '60% test').

The Green Book notes that US entities have sought to reduce US federal income taxes by combining with smaller foreign entities such that the historical US shareholders' level of continued ownership is between 60 and 80%. The combination will often result in the US and foreign entities being subsidiaries of a newly-formed foreign parent company in a tax-favorable jurisdiction. The Administration expresses concern that inversion transactions facilitate US base erosion through deductible payments by the remaining US members of the multinational group to the non-US members, and through aggressive transfer pricing for transactions between US and non-US members. In addition, the resulting group's foreign subsidiaries may no longer be CFCs subject to subpart F rules, thus avoiding US federal income tax on certain highly mobile income.

The Green Book observes that existing adverse tax consequences of 60% inversion transactions have not prevented the occurrence of inversion transactions with US shareholder continuity between 60 and 80%. In particular, the Administration objects to permitting inversion transactions when a US entity's owners retain a controlling interest in the resulting entity, make only minimal operational changes, and create a significant potential for substantial US base erosion. The Green Book goes on to state that, even if a cross-border business combination does not result in the US entity's shareholders maintaining control of the resulting multinational group, the combination should still be considered an inversion transaction if the foreign acquiring corporation's affiliated group has substantial business activities in the United States and the foreign acquiring corporation is primarily managed and controlled in the United States.

Proposal

The Administration's Section 7874 proposal is relatively simple. It would broaden the definition of an inversion transaction by reducing the 80% test to a greater than 50% test, eliminating the 60% test altogether. The proposal would also add a special rule whereby, regardless of shareholder continuity level, a business combination will be an inversion transaction if the foreign corporation's affiliated group has substantial business activities in the United States and the foreign corporation is primarily managed and controlled in the United States. Finally, the proposal would provide that an inversion transaction can occur where there is an acquisition either of substantially all of a US partnership's assets (regardless of whether such assets constitute a trade or business) or of substantially all of the assets of a US partnership's trade or business.

The JCT staff estimates that this new proposal would raise approximately $17.25 billion over 10 years, very similar to the $17 billion Administration estimate.

Observation: This proposal would further tighten Section 7874 restrictions on corporate expatriation that have recently been the subject of additional regulatory guidance.

FY 2014 proposals carried over to FY 2015

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 US federal income tax 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 2015 budget, the Administration generally retains the FY 2014 version of this proposal, including the details first articulated in the September 2011 legislative language.

Proposed Section 954(a)(4) would create a new subpart F category of

foreign base company excess intangible income (FBCEII) under proposed Section 954(f). FBCEII would derive from any Section 936(h)(3)(B) intangible that (i) a US related person (as defined in Section 954(d)(3)) sells, leases, licenses, or otherwise transfers (directly or indirectly) to a CFC, or (ii) is subject to a shared risk or development agreement (including a cost-sharing agreement) between a CFC and any related person.

The threshold for an 'excess return' in this proposal is a 50% mark-up over the CFC's directly allocable costs, specifically excluding interest and taxes. The income subject to potential FBCEII treatment includes gross income from (i) the sale, lease, license, or other disposition of property in which a covered intangible is used (directly or indirectly), and (ii) 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. FBCEII would not include same-country CFC income.

The foreign tax rate threshold in the FBCEII proposal has a sliding scale element. Proposed Section 954(f) would set a floor at 10% and a ceiling at 15%; that is, all of the relevant income would be FBCEII if a CFC's effective rate is 10% or lower, and none of the relevant income would be 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 deductible in 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 Section 904 FTC basket and would not be treated as any other kind of Section 954 foreign base company income.

The JCT staff estimates this proposal would raise $21.29 billion during the 10-year budget FY 2015 window, which is about $4 billion less than the Administration's FY 2015 estimate (itself about $2 billion more than the FY 2014 Budget estimate).

Observation: This proposal has been essentially in its current form for three Budget cycles. 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, some foreign jurisdictions, even among OECD countries, have statutory income tax rates under 20% (e.g., Ireland, at 12.5%), so the effective rate threshold in this proposal could potentially apply fairly widely.

Note that the proposed Section 954(f) language would apparently apply to all covered intangible transfers, whenever they may have occurred. Note also that the language does not explicitly require a US person to be a party to a cost-sharing arrangement giving rise to a CFC's covered intangible. 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

The Administration's proposal would allow deductions of 'foreign-related interest expense' only to the extent that such expenses are properly allocable or apportionable to foreign subsidiaries' stock in proportion to those subsidiaries' earnings currently taxed by the United States. The relevant foreign-related deductions beyond that currently taxed amount would be deferred. Deductions would be allowed in subsequent years as previously deferred foreign earnings are repatriated and subject to US taxation.

The Administration's proposed language would create a new Section 163(n) (re-designating the current Section 163(n)). 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.' That ratio is a percentage reflecting (i) the sum of a US corporate shareholder's current-year dividends and subpart F inclusions (without the Section 78 gross-up) from a 'Section 902 corporation' (basically, a 10%-owned foreign subsidiary), divided by (ii) the aggregate amount of the 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.

Proposed Section 163(n) would determine 'foreign-related interest expense' by apportioning interest expense under Sections 861 and 864(e) to foreign-source income a US company did not earn directly. Thus, foreign-related interest expense would be the interest expense percentage for the tax year apportioned to foreign-source income that corresponds to the proportion of (i) all Section 902 corporation stock value to (ii) the value of all assets that produce foreign-source income. The aggregate amount of foreign-related interest expense that would be disallowed as a deduction in prior years under the current inclusion ratio formula would become the 'deferred foreign-related interest expense.' If the allowable amount of foreign-related interest expense using the ratio exceeded the actual foreign-related interest expense for the year, the proposal would allow deduction of (i) the remaining deferred foreign-related interest expense or (ii) the amount of the excess, whichever is less.

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

- changes in a Section 902 corporation's ownership
- treating certain corporations as members of the affiliated group that otherwise would not be so treated
- a Section 902 corporation with an E&P deficit
- the impact of effectively connected income (ECI) on (i) Section 902 corporation stock value determinations and (ii) foreign-related interest expense
- interest expense that is directly allocable to specific income items.

The JCT staff estimates this proposal would raise approximately $51.41 billion over 10 years, which is substantially higher than the Administration's $43.14 billion FY 2015 estimate (itself about $5 billion more than the FY 2014 Budget estimate).

Observations: Although Members of Congress have said that this proposal should not be considered outside comprehensive tax reform, it remains a potential revenue raiser that could have significant impact on US multinationals with substantial interest expense. The 2011 legislative language answered many questions about this proposal, but the regulatory delegations suggest that the mechanics still require clarification.

The JCT staff has commented that, without worldwide interest expense apportionment (WWIA), this proposal would be an 'overcorrection' of any perceived issue involving the deduction of US expenses allocable to foreign income. Legislation enacted in 2009 and 2010 postpones the effective date of WWIA until 2021.

Blending Section 902 foreign tax pools

Current law

Section 901 generally allows a taxpayer to claim an FTC 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 US possession. The amount of the FTC allowed is subject to certain limitations, up to the amount of the pre-credit US federal income tax on the taxpayer's foreign-source income. Section 902 deems a US corporation to have paid the foreign taxes actually paid by certain foreign subsidiaries from which it receives a dividend. Section 902 FTC calculations are based on each foreign subsidiary's post-1986 pools of earnings and foreign taxes. In general, pools of high-taxed and low-taxed foreign-source income may be 'cross-credited' within the two Section 904(d) FTC limitation categories of active and passive foreign-source income. Section 960 has a similar deemed-paid mechanism for taxes attributable to subpart F inclusions.

Proposal

The FY 2015 budget retains the Administration's Section 902 FTC pooling proposal. This proposal would restrict a US-based multinational group's Section 902 deemed-paid FTCs to the average rate of total foreign tax actually paid on the total combined earnings 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 2011 legislative language has coordinated this proposal with the interest expense deferral proposal to a significant degree. The proposed mechanics of the two provisions would be similar, based to some extent on shared computations. A new Section 910 would limit the aggregate amount of deemed-paid (under Section 902 or 960) post-1986 foreign income taxes creditable in a given tax year to the 'current inclusion ratio' for the sum of the current-year foreign income taxes and the 'suspended post-1986 foreign income taxes.' The current inclusion ratio would be the same as for the interest expense deferral proposal, and FTCs would be suspended (and subsequently allowable) in a similar manner to the deferral process described above. Consistent with the interest expense deferral proposal, currency translations would use the average exchange rate for the current year, with computations applied separately to each Section 904(d) basket. Any suspended FTCs allowed in a subsequent year would be treated as paid by the US corporation in the year the credit is allowed.

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

- changes in a Section 902 corporation's ownership
- treating certain corporations as members of the affiliated group that otherwise would not be so treated
- a Section 902 corporation with an E&P deficit
- amounts taken into account under Section 960.

The JCT staff estimates this proposal would raise approximately $58.63 billion over 10 years, much less than the Administration's $74.67 billion FY 2015 estimate (itself about $9 billion more than the FY 2014 Budget estimate).

Observations: This proposal has generated little Congressional support 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 pools. The mechanics still require clarification, and proposed Section 910 apparently makes no distinction between pre-effective date earnings and post-effective date earnings. This could have a significant impact on post-enactment financial accounting positions. It is also unclear how the Administration envisions that this proposal would interact with Section 909, the 'anti-splitter' provision. Finally, the proposal raises serious questions of administrability for both taxpayers and the government.

Limiting income-shifting through outbound transfers of intangibles

Current law

Section 482 provides that income in the case of intangible asset transfers must be commensurate with the income attributable to the transferred intangible assets (as defined in Section 936(h)(3)(B)). Section 367(d) provides that a US person transferring such intangibles to a foreign corporation in certain non-recognition transactions will be treated as selling them for a series of payments contingent on the intangibles' productivity, use, or disposition that are commensurate with the transferee's income from the intangibles. The payments generally continue annually over the property's useful life.

The Administration continues to express the 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 proposal involves 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 intangibles to which the Section 936(h)(3)(B) definition applies, such as the Section 954(f) 'excess return' proposal. The proposal would also add virtually identical language to the end of both Sections 367(d) and 482 regarding valuation of intangibles, providing that the IRS could (i) aggregate transfers of intangibles 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 JCT staff estimates this proposal would raise approximately $1.91 billion over 10 years, significantly less than the Administration's $2.73 billion FY 2015 estimate (itself a 30% increase over the FY 2014 Budget estimate).

Observation: The Administration has maintained this proposal for four budget cycles, attempting to address perceived abuses in outbound transfers of foreign businesses with significant enterprise intangibles that the IRS considers have been valued in an unreliable or unrealistic manner. Gven the press coverage relating to US intangibles' foreign use, as well as

other factors, there is a significant chance that this proposal could be adopted as a revenue-raiser.

Modifying the tax rules for dual-capacity taxpayers

Current law

Section 901 provides that a foreign levy can be a creditable tax only if it is (i) substantially equivalent to an income tax under US tax principles, (ii) a compulsory payment under a foreign government's authority, and (iii) not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy that may be a tax but also receive a specific economic benefit from the levying country are called dual-capacity taxpayers. Such taxpayers may not credit any portion of a foreign levy paid for the benefit. The current Treasury regulations under Section 901 require a dual-capacity taxpayer to use one of two methods (either facts and circumstances method or a safe harbor) in establishing that a foreign levy is an income tax.

The safe-harbor method permits a dual-capacity taxpayer to treat as a creditable tax the portion of any foreign levy that application of a generally-imposed creditable income tax would yield. The balance of the levy is treated as compensation for the economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment up to the applicable US federal income tax rate on net income (generally, 35% for corporate taxpayers) is treated as a creditable tax.

The Administration emphasizes that the FTC's purpose 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 may not achieve what the Administration views as the appropriate split between the two potential aspects of a levy 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 than other income.

Proposal

In 2011, legislative language articulating the Administration's proposal to modify the FTC rules for dual-capacity taxpayers created a 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 used 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 subject to a levy in a foreign jurisdiction that also receives (directly or indirectly) a specific economic benefit from that jurisdiction. The language specifies that proposed Section 901(n) would not override any US tax treaty and provides a general regulatory delegation.

The proposal would also 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 Section 907(a), (c)(4), and (f). The legislative language includes transition rules for carryovers and losses. The carryover rule would permit any unused foreign oil and gas taxes 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 would not apply the repeal of Section 907(c)(4) to foreign oil and gas extraction losses from tax years beginning on or before enactment.

The JCT staff estimates this proposal would raise approximately $12.24 billion over 10 years, almost 20% more than the Administration's $10.38 billion FY 2015 estimate (itself similar to the $10.96 billion FY 2014 Budget estimate).

Observation: The Administration has continued to maintain this proposal with little change, although the legislative language breaks it into two proposed Code sections. The proposal is aimed primarily at taxpayers in the oil and gas industry, but proposed Section 901(n) would also affect dual-capacity taxpayers in other industries, such as mining.

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 proposal is essentially unchanged from FY 2013, when it was revised from an earlier budget proposal.

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 on the amounts received, and (2) exclude from the insurance company's income (in the same proportion in which the deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a deduction was denied. A foreign reinsurance company could elect to treat those premiums and the

associated investment income as ECI (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 in a separate Section 904(d) basket.

The JCT staff estimates this proposal would raise approximately $8.96 billion over 10 years, almost 20% more than the Administration's $7.6 billion FY 2015 estimate (itself somewhat higher than the $6.2 billion FY 2014 Budget estimate).

Observation: This proposal is based on an earlier version in the FY 2011 budget and is similar to the most recent bill on this issue (H.R. 2054) introduced by Rep. Richard Neal (D-MA) and co-sponsor Rep. William Pascrell (D-NJ) on May 20, 2013. The current proposal could increase the US tax burden on most foreign-owned US insurance companies significantly more than the FY 2011 proposal or earlier versions of the Neal Bill, both of which had elements limiting their impact that do not appear in the FY 2015 Budget.

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. Capital gains of non-resident alien individuals or foreign corporations generally are not subject to US federal income tax. Accordingly, when such foreign persons sell interests in partnerships that receive ECI, the sales proceeds are generally not taxable in the United States, even if the underlying ECI would be.

Rev. Rul. 91-32 articulates the IRS position that a non-resident alien or foreign corporation's gain or loss from the sale or exchange of a partnership interest is ECI to the following extent: the partner's distributive share of unrealized partnership gain or loss attributable to property held for use in the partnership's US trade or business ('ECI property'). The Administration's proposal addresses concerns that foreign persons may take a position contrary to Rev. Rul. 91-32.

Proposal

The Administration's proposal would essentially codify Rev. Rul. 91-32. It would provide that gain or loss from the sale or exchange of a partnership interest would be 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 partnership distribution is treated as a sale or exchange of a partnership interest and to coordinate the new rule with non-recognition Code provisions.

In addition, the transferee of a partnership interest would be required to withhold 10% of the amount realized on the sale or exchange of that interest unless the transferor could certify that it is either (i) not a non-resident alien individual or foreign corporation, or (ii) a non-resident alien individual or foreign corporation whose US federal income tax liability would be less than 10%, according to the IRS. If the transferee failed to withhold the correct amount, the partnership would have to satisfy the withholding obligation using future distributions that otherwise would have gone to the transferee partner.

The JCT staff estimates this proposal would raise approximately $2.6 billion over 10 years, similar to the Administration's $2.8 billion FY 2015 estimate (itself similar to the $2.66 billion FY 2014 Budget estimate).

Observation: This proposal apparently reflects an Administration view that it needs a more robust legal basis for enforcing the position in Rev. Rul. 91-32. 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

The general rules of Section 301 treat a corporation's distributions to a shareholder first as a dividend to the extent of the distributor's applicable E&P. Any excess is then treated as a non-taxable return of the shareholder's adjusted tax basis in the stock of the distributing corporation, and any excess beyond adjusted basis as gain from the sale or exchange of property.

These rules are generally applied to foreign corporations on a stand-alone basis. The Administration's proposal arises from a concern that a foreign corporation can repatriate E&P without being characterized as a dividend if that corporation funds 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 Section 301 return of stock basis.

Proposal

The Administration's proposal would provide that a US shareholder's basis in the stock of a distributing foreign corporation will not be taken into account for Section 301 purposes, to the extent that 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 the US shareholder.

This proposal would treat a funding corporation and a foreign distributing corporation as related if they are members of a control group within the meaning of Section 1563(a) (with a threshold of more than 50% ownership, rather than at least 80%). The proposal could apply to funding transactions that include capital contributions, loans or distributions to the foreign distributing corporation, whether the funding transaction occurs before or after the distribution.

The JCT staff estimates this proposal would raise approximately $3.08 billion over 10 years, somewhat less than the Administration's $3.55 billion FY 2015 estimate (itself slightly higher than the $3.24 billion FY 2014 Budget estimate).

Observation: Like the Administration's proposal to repeal the Section 356 boot-within-gain limitation, this proposal is apparently aimed at taxpayers trying to monetize foreign assets without generating US income. In essence, the proposal, like certain other anti-abuse rules (e.g., Section 304), would seek to convert asset value into income, even when the taxpayer has no income.

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

Current law

Section 338(h)(16) is an anti-abuse rule providing (subject to certain exceptions) that the deemed asset sale resulting from a Section 338 election is ignored in determining the source or character of any item when applying the FTC rules to the seller. Instead, for these purposes, any gain is generally treated by the seller as derived from the sale of stock. Thus, Section 338(h)(16) prevents a seller from increasing allowable FTCs as a result of a Section 338 election. Section 901(m) denies FTCs for certain foreign taxes paid or accrued after 'covered asset acquisitions' (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 Section 338(h)(16) currently applies only to qualified stock purchases for which a taxpayer makes a Section 338 election, and not to the other types of CAAs subject to the Section 901(m) FTC disallowance rules.

Proposal

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

As in previous years, the JCT staff and Administration both estimate that this FY 2015 proposal would raise $960 million over 10 years.

Observation: This 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) has been expected for several years.

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

Current law

The Administration has expressed concerns about the application of the deemed-paid Section 902 FTC rules where transactions result in a reduction, allocation or elimination of a corporation's E&P other than through a dividend, deemed dividend or Section 381 process. The Green Book cites specific examples where (i) a corporation redeems a portion of its stock, where the redemption is treated as a sale or exchange, with an E&P reduction under Section 312(n)(7); and (ii) certain Section 355 distributions can reduce 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 where a transaction eliminates the corporation's E&P other than through an actual or deemed dividend, or by reason of a Section 381 transaction. The foreign income taxes would be reduced by the amount associated with the eliminated E&P.

The JCT staff estimates this proposal would raise approximately $382 million over 10 years, somewhat less than the Administration's $423 million FY 2015 estimate but very similar to the $389 million FY 2014 Budget estimate).

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

Current law

The Administration has reiterated its previously expressed view that current law provides 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's intention is 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 for moving jobs offshore.

Proposal

To reduce the tax benefits for US companies moving jobs offshore, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a US trade or business. For this purpose, outsourcing would mean reducing or eliminating a trade or business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States. The disallowance would apply to the extent that this outsourcing results in fewer US jobs. In determining a CFC's subpart F income, no deduction would be allowed for any expenses associated with moving a US trade or business outside the United States.

The proposal would also 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. This proposal would mirror the companion outsourcing proposal. Insourcing would mean reducing or eliminating a trade or business currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business inside the United States. The credit would apply to the extent that this insourcing results in more US jobs. Although the creditable costs might be incurred by a foreign subsidiary of a US-based multinational company, the US parent company could claim the tax credit.

Note that, for purposes of this proposal, expenses paid or incurred in connection with insourcing or outsourcing a US trade or business would be limited solely to expenses associated with the relocation of the trade or business. Those expenses would not include capital expenditures or costs for severance pay and other assistance to displaced workers. The proposal includes regulatory authority for implementation, 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. The JCT staff estimates this proposal to essentially break even over the 10-year budget window, costing the US Treasury $217 million total, very similar to the $212 Administration's FY 2015 Budget estimate.

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

Legislative outlook

At this point, fundamental tax reform likely will not occur during the latter part of FY 2014 or the beginning of FY 2015. Both Ways and Means Committee Chairman Camp (R-MI) and former Senate Finance Committee Chairman Baucus (D-MT) have issued draft legislative language on international tax reform, but their proposals have not been introduced as bills. With the 2014 midterm elections approaching and changes in leadership expected in both tax-writing committees, the path to tax reform is not clear, nor is the form that a new international tax system might take. However, Democratic lawmakers such as Sen. Levin and Rep. Doggett continue to introduce legislation intended to curb perceived abuses. Although Republicans have showed little willingness to raise revenues of any kind, they may consider certain legislation that might close perceived tax 'loopholes.' Specific anti-abuse proposals could be adopted as revenue-raisers for deficit reduction or other legislative priorities.

The JCT staff's analysis of the Administration's current international proposals is expected later this year. As in previous years, this analysis may provide additional perspectives on the proposals.

The takeaway

The FY 2015 budget repeats the previous year's proposals and introduces significant new international tax proposals. These new proposals reflect ongoing concerns that coincide in part with the OECD's BEPS initiative. The BEPS process may well affect US international tax reform efforts going forward.

Let's talk

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

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