Obama FY 2016 Budget proposes minimum tax on foreign income and adds other significant international tax proposals

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In brief

The Treasury Department's 'Green Book,' released on February 2, 2015, outlines the Obama Administration's Budget proposals for fiscal year 2016 (FY 2016). It explains the mechanics of a new proposal for a 19% minimum tax on foreign income and a one-time 14% transition tax on previously untaxed foreign income. In addition, it contains significant changes to some international tax proposals made in previous Budgets. These changes include elimination of three large items: deferring foreign interest expense deductions, pooling foreign taxes for foreign tax credit (FTC) purposes, and the subpart F 'excess return' proposal. However, all of these items are addressed in some fashion within the foreign minimum tax proposal; in particular, the new regime includes partial or complete denial of many foreign interest deductions. The FY 2016 Budget also adds five new proposals in the international tax area beyond the minimum and transition taxes, including permanent extensions of the CFC look-through and active financing subpart F exceptions.

The FY 2016 Budget reaffirms President Obama's support for 'business tax reform' that would lower the top US corporate tax rate to 28%, with a 25% rate for domestic manufacturing income. For US multinationals, the focus in the Administration's FY 2016 Budget has shifted from outbound intangible property (IP) transfers and base erosion to the minimum and transition tax concepts that would fundamentally change the US international tax system. While President Obama mentioned a 'minimum tax on overseas profits' in his 2012 business tax reform framework, the FY 2016 Budget is the first time the Administration has laid out specific proposals for a minimum tax on foreign earnings. Additional new international items include further subpart F tightening and immediate application of worldwide interest expense allocation. Other key international items include the far-reaching thin capitalization proposal and base erosion proposals paralleling the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) process. Previous years' Section 7874 proposal to limit corporate expatriation has expanded to include the sharing of tax return information with other US federal agencies but narrowed to exclude transactions where a US target's stock has less value than the foreign acquirer's stock. In addition, items in the international tax area include familiar proposals addressing business outsourcing/insourcing, outbound IP transfers, reinsurance premiums paid to foreign affiliates, sales of partnership interests, and various FTC reforms, including stricter rules for dual capacity taxpayers.

In detail

The international tax proposals in the FY 2016 Administration Budget would generally be effective for either tax years beginning after December 31, 2015 or transactions occurring after that date. The main exceptions are effective on the date of enactment: the one-time transition tax (for earnings from tax years beginning before January 1, 2016) and the job outsourcing/insourcing proposal. This latter proposal to "provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas" primarily involves incentives for 'insourcing' jobs into the United States. However, part of the package involves denying expense deductions in connection with "outsourcing a US trade or business."

The Administration has moved the proposal challenging the use of leveraged distributions from related foreign corporations (to avoid dividend treatment) out of the international tax area and into a corporate transactional tax category. That category also includes the long-standing proposal to repeal the Section 356 boot-within-gain limitation for reorganization transactions if the exchange has the effect of a dividend distribution (e.g., a 'Cash-D' reorganization). That grouping also includes previous proposals to limit loss importations under Section 267(d) and repeal both (i) the Section 708 technical termination rule for partnerships and (ii) the Section 197(f)(9) intangible asset anti-churning rule. Furthermore, this year's Budget has added proposals to (iii) prevent elimination of earnings and profits (E&P) through distributions of certain stock with basis attributable to dividend equivalent redemptions and (iv) treat purchases of hook stock by a subsidiary as giving rise to deemed distributions. The Budget continues to offer a proposal exempting certain foreign pension funds from the Section 897 Foreign Investment in Real Property Tax Act (FIRPTA) rules.

The 20 international tax reform provisions in the FY 2016 Budget are scored by Treasury as increasing revenues by a total of $506.4 billion, almost double the FY 2015 Budget's total of $276.3 billion for 16 international proposals. As in the previous two Budgets, the Administration this year has designated most of the international tax proposals as part of a 'Reserve for Long-Run Revenue-Neutral Business Tax Reform.' However, the Budget would apply the one-time transition tax to surface transportation spending. The Congressional Joint Committee on Taxation (JCT) staff will likely release its own revenue estimates for all FY 2016 budget provisions in the near future. Those 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 explanations.

The legislative prospects for the Budget proposals in 2015 remain uncertain. Congressional Republicans have expressed some openness to considering the headline minimum tax proposal, which echoes previous offerings from former House Ways and Means Chairman Dave Camp (R-MI) and former Senate Finance Committee Chairman Max Baucus (D-MT). Both of the new tax-writing committee chairs, Orrin Hatch (R-UT) of the Finance Committee and Paul Ryan (R-WI) of Ways and Means, have said they will work actively towards international tax reform in 2015. Former Chairman Camp's sweeping discussion draft on comprehensive US federal income tax reform is likely to serve as a starting point for consideration.

President's Budget: International tax proposals – FY16 & FY15 comparison (in millions)			
	FY 2016 Budget	**FY 2015 JCT**	**FY 2015 Budget**
International tax proposals			
Impose 19% minimum tax on foreign income of US companies and CFCs	***$205,976***	*N/A*	*N/A*
Impose 14% transition tax on previously untaxed foreign income	***$268,129***	*N/A*	*N/A*
Restrict deductions for excessive interest of members of financial reporting groups	***$64,126***	*$40,907*	*$48,581*
Provide tax incentives for locating jobs and business activity in the US and remove tax deductions for shipping	***-$247***	*N/A*	*N/A*

jobs overseas			
Repeal delay in the implementation of worldwide interest allocation	***-$12,207***	*N/A*	*N/A*
Extend the subpart F exception for active financing income	***-$81,333***	*N/A*	*N/A*
Extend the look-through treatment of payments between related CFCs	***-$9,733***	*N/A*	*N/A*
Limit shifting of income through IP transfers	***$3,072***	*$1,912*	*$2,728*
Disallow the deduction for excess nontaxed reinsurance premiums paid to affiliates	***$7,388***	*$8,959*	*$7,568*
Modify tax rules for dual capacity taxpayers	***$10,315***	*$12,238*	*$10,382*
Tax gain from the sale of a partnership interest on look-through basis	***$2,974***	*$2,603*	*$2,795*
Extend Section 338(h)(16) to certain asset acquisitions	***$672***	*$960*	*$960*
Remove foreign taxes from a Section 902 corporation's foreign tax pool when earnings are eliminated	***$317***	*$382*	*$423*
Create a new category of subpart F income for transactions involving digital goods or services	***$8,706***	*$19,911*	*$11,660*
Prevent avoidance of foreign base company sales income through manufacturing services arrangements	***$18,375***	*$14,130*	*$24,608*
Amend CFC attribution rules	***$3,400***	*N/A*	*N/A*
Eliminate the 30-day grace period before subpart F inclusions	***$1,195***	*N/A*	*N/A*
Restrict the use of hybrid arrangements that create stateless Income	***$1,133***	*$694*	*$937*
Limit the application of exceptions under subpart F for certain transactions that use reverse hybrids to create stateless income	***$1,402***	*$763*	*$1,336*
Limit the ability of domestic entities to expatriate	***$12,754***	*$17,251*	*$17,004*
Tax currently excess returns of IP transferred offshore	***N/A***	*$21,290*	*$25,965*
Defer deduction of interest expense related to deferred income	***N/A***	*$51,408*	*$51,408*
Reform FTC: Determine the FTC on a pooling basis	***N/A***	*$58,630*	*$74,672*
Total of international proposals	***$506,414***	***$255,115***	***$276,305***
Corporate tax revenue raisers relevant to international tax			
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment	*$250*	*$3,077 (included in total above)*	*$3,548 (included in total above)*
Limit the importation of losses under related party loss limitation rules	*$945*	*$1,129*	*$913*
Repeal gain limitation for dividends received in reorganization exchanges	*$632*	*$641*	*$3,051*
Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions	*Negligible*	*$391*	*$391*
Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions	*$58*	*N/A*	*N/A*

Discussion of specific proposals

The Obama Administration's FY 2016 Budget organizes its proposed business tax changes a little differently than in previous Budgets. For the first time, the Budget groups certain proposals under categories relating to particular aspects of US federal income tax law, although the specific items being grouped together have not necessarily changed.

Except where stated otherwise, these items generally are proposed to be effective for tax years beginning after December 31, 2015. As usual, 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 previous 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 proposals carried over from the FY 2013-15 Budgets. The descriptions below reflect that language, for those proposals.

Impose 19% minimum tax on foreign income of US companies and CFCs

The Administration proposes to supplement the existing subpart F regime with a per-country minimum tax on the foreign earnings of US corporations and their CFCs. The minimum tax would apply to US corporations that (i) are US shareholders of CFCs with foreign earnings or (ii) have foreign earnings from branches or from performing services abroad. The heart of the proposal would subject those foreign earnings to current US federal income tax at a rate (not below zero) of 19%, less 85% of the per-country foreign effective tax rate (ETR), termed the 'residual minimum tax rate.'

To illustrate the impact of this rule, a CFC viewed as earning income in a given foreign country at a 22.35% ETR (determined as described below) would owe no US tax (85% of 22.35% = the 19% minimum). A CFC earning income in a foreign country at a 0% ETR would owe the full 19% US tax, while a CFC earning income in a foreign country at a 15% ETR would owe 6.25% US tax (19% - (85% of 15%) = 6.25%).

For purposes of the proposed rule, the foreign ETR would be computed by aggregating all foreign earnings and associated foreign taxes assigned to a country (as described below) for the 60 months ending on the current tax year-end of the US corporation or the CFC. The relevant foreign taxes are those that (absent the proposal) would be creditable during the 60-month period. The relevant foreign earnings would generally be determined under US tax principles except that they would include disregarded payments deductible elsewhere, such as disregarded intra-CFC interest or royalties, and would exclude dividends from related parties. (Note, however, the impact of special rules for hybrid arrangements, described below.)

The proposal would assign foreign earnings and taxes to a country based on foreign law tax residence. Thus, if a CFC is incorporated in Country X but a tax resident of Country Y under both Country X and Country Y place-of-management tests for tax residence, the CFC's earnings and associated foreign taxes would be assigned to Country Y. If, instead, Country Y uses a place-of-incorporation test such that the CFC is stateless and is not subject to foreign tax anywhere, the CFC's earnings would be subject to the minimum tax at the full 19% rate. A CFC's earnings and taxes could be allocated to multiple countries if its earnings are subject to tax in those countries. In such cases, all of the earnings and associated taxes would be assigned to the highest-tax country. For example, if a CFC incorporated in high-tax Country Z has a permanent establishment (PE) in low-tax Country Q, and both Country Z and Country Q tax the PE's earnings, the earnings and all the associated taxes would be assigned to Country Z.

The Green Book explains the mechanics of the minimum tax computation for each particular country. Basically, it would involve multiplying the applicable residual minimum tax rate (as described above) by the minimum tax base for that country. A US corporation's tentative minimum tax base with respect to a country for the year would be the total foreign earnings assigned to that country (as above). The tentative minimum tax base would be reduced by an allowance for corporate equity (ACE). The ACE would equal a risk-free return on equity invested in 'active' assets, generally assets that do not generate foreign personal holding company income (determined without regard to the CFC look-through rule or any check-the-box election). The Green Book states that the ACE is intended to exempt from the minimum tax a return on actual business activities.

In assigning earnings to countries, for purposes of determining both the foreign ETR and the tentative minimum tax base for a particular year, the proposal would implement rules to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for US federal income tax purposes without triggering tax in the high-tax country. Thus, for example, the rules would not allow deductions for payments from low-tax countries to high-tax countries that would be treated as dividends eligible for a participation exemption in the high-tax country.

The Green Book emphasizes that the minimum tax would be imposed on current foreign earnings regardless of whether they are repatriated. All foreign earnings could be repatriated without further US tax. Thus, US federal income tax would be imposed on a CFC's earnings either immediately (under subpart F or the minimum tax) or not at all (if the income was subject to sufficient foreign tax or was exempt after the ACE).

Subpart F changes. Subpart F generally would still require US shareholders to currently include their share of the CFC's subpart F income, at the full US tax rate (applying FTCs as available). However, the subpart F high-tax exception would be mandatory for US corporate shareholders. The proposal would also repeal Section 956 rules on CFC investments in US property and Section 959 previously taxed income (PTI) rules for US corporate shareholders.

Interest expense denial. The proposal replaces the interest expense deferral concept with an approach that could result in partial or complete denial of interest expense deductions. The new rules would make interest expense that a US corporation allocates and apportions to foreign earnings on which it pays minimum tax deductible at the applicable residual minimum tax rate. Thus, no US federal income tax deduction would be permitted for interest expense where the US corporation pays no US income tax on high-tax foreign earnings.

Treating branches as CFCs. A US corporation's foreign branch would be treated like a CFC. Thus, to the extent the foreign branch used its owner's intangibles, the branch's royalty payments to its owner would be recognized for US tax purposes.

CFC stock sales. The proposal would impose no US tax on a US shareholder's sale of CFC stock to the extent any gain reflects its undistributed earnings, which generally would have already been subject to tax under (i) the minimum tax, (ii) subpart F, or (iii) the 14% one-time transition tax proposal (see below). Any gain attributable to unrealized (and untaxed) gain in the CFC's assets would be subject to (a) the minimum tax or (b) tax at the full US rate, to the extent that gain reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or subpart F, respectively.

Foreign royalty and interest payments. The Green Book points out that foreign-source royalty and interest payments received by US corporations would continue to be taxed at the full US statutory rate. However, they could no longer be shielded by excess FTCs associated with dividends from high-tax CFCs, because the high-tax CFCs' earnings would be exempt from US federal income tax. Finally, the proposal would grant broad regulatory authority, including (i) addressing taxation of undistributed earnings when a US corporation owns an interest in a foreign corporation that has a change in CFC status, and (ii) preventing avoidance of minimum tax through outbound transfers of CFC stock or built-in-gain assets.

The Administration estimates that this new proposal would raise approximately $205.98 billion over the 10-year Budget window.

Observation: This proposal represents a radical departure from previous Obama Administration proposals on expense deferral and FTC pooling, which were adapted from legislation authored by former House Ways & Means Chair Charles Rangel (D-NY). Instead, this proposal bears similarities to legislative concepts introduced by former Chairmen Camp and Baucus, as acknowledged by Secretary Lew.

The minimum tax regime would not only repeal Sections 956 and 959, but it would effectively eliminate the application of Section 902 to CFCs. Essentially, the combination of new rules is designed to create a regime under which US corporations could not avoid currently paying a minimum of 19% on taxable foreign income earned directly or through CFCs. The proposal is largely silent on 10/50 companies, and it is not clear how FTC and interest expense regimes would operate with respect to them.

The use of foreign law to determine foreign subsidiaries' tax residence, as well as the concepts of regarding disregarded payments and treating branches as CFCs, are significant departures from current US federal income tax law. The deemed incorporation of branches at the effective date could have a significant impact on many US multinationals.

Furthermore, partially or completely denying interest expense deductions based on per-country ETR could have a more negative impact on US multinationals than the previous interest expense deferral proposal. Note that the terms regarding CFC stock sales seem complex and do not address lower-tier CFCs' stock.

Impose 14% transition tax on previously untaxed foreign income

The Green Book notes that the Administration's minimum tax proposal on foreign income would not impose US federal income tax on a CFC's future dividend payment. Accordingly, the Administration proposes a transition measure providing that previously accumulated deferred earnings also are subject to US tax. In connection with the transition to the minimum tax, this proposal would impose a one-time 14% tax on accumulated CFC earnings not previously subject to US tax.

The transition tax regime would allow a credit for the amount of foreign taxes associated with such earnings multiplied by the ratio of the one-time tax rate to the maximum US corporate tax rate for 2015 (at current rates, 14%/35%, or 2/5). The accumulated income subject to the one-time tax could then be repatriated without any further US tax. The transition tax would be payable ratably over five years.

This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning before January 1, 2016. The Administration estimates that it would raise approximately $268.13 billion over the 10-year Budget window.

Observation: Unlike the Camp proposal's transition rule, this proposal would not provide a lower tax rate for earnings that have been reinvested in business assets. Accordingly, it would likely cause significant liquidity issues for US companies that have used their CFCs' earnings to develop and expand overseas operations and do not have liquid assets available for paying the tax. Note also that, unlike most of the international tax proposals, which are reserved for business tax reform, the one-time transition tax is earmarked for surface transportation spending.

Extend the exception under subpart F for active financing income

The temporary active financing exception has generally been renewed for one or two years at a time since 1998, and it most recently expired as of December 31, 2014. The proposal would make the exception permanent, allowing US-based financial and insurance groups to continue their active international operations without being subject to subpart F. The Green Book notes that the Administration's minimum tax proposal would ensure that these businesses cannot reduce their ETR below 19%.

The Administration estimates that this new proposal would cost approximately $81.33 billion over 10 years.

Observation: The Administration has previously supported extensions of the active financing exception, but the permanent extension proposal is new.

Extend the look-through treatment of payments between related CFCs

The CFC look-through rule has generally been renewed for one or two years at a time since 2006, and it most recently expired as of December 31, 2014. The proposal would make this exception permanent, so that certain dividend, interest, rent, and royalty payments to a related CFC (attributable to active foreign earnings) would not incur subpart F income taxable at the full US statutory rate. The Green Book notes that the Administration's minimum tax proposal would ensure that these businesses cannot reduce their ETR below 19%.

Observation: The Administration has previously supported extensions of the CFC look-through exception, but the permanent extension proposal is new.

Repeal delay in the implementation of worldwide interest allocation

The American Jobs Creation Act of 2004 (AJCA) modified the interest expense allocation rules by providing a one-time election to determine a US group's taxable income by allocating and apportioning interest expense of a worldwide affiliated group's US members as if all members of the worldwide affiliated group were a single corporation. For this purpose, the worldwide affiliated group includes all US corporations in an affiliated group and all CFCs in which one or more US group members own (in aggregate) at least 80% of the vote and value, directly or indirectly. US members' foreign-source taxable income would be determined by allocating and apportioning their third-party interest expense to foreign-source gross income in an amount equal to any excess of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio of the worldwide affiliated group's foreign assets to the group's total assets, over (2) the foreign group members' third-party interest expense, to the extent that interest would be allocated to foreign sources if worldwide interest allocation principles were applied separately to those foreign members.

The AJCA made the worldwide interest allocation (WWIA) election available for taxable years beginning after December 31, 2008. Subsequent legislation has deferred its availability until tax years beginning after December 31, 2020.

As discussed above, the Administration's foreign minimum tax proposal would require taxpayers to allocate and apportion interest expense among foreign-source gross income (i) that is subject to tax at the full US rate, (ii) that is subject to various rates of US tax under the minimum tax, and (iii) on which no US tax is paid. Interest expense allocated and apportioned to income subject to the minimum tax would be deductible only at the applicable minimum tax rate, while no deduction would be permitted for interest expense allocated and apportioned to income on which no US tax is paid.

The proposal would make the worldwide affiliated group election available for tax years beginning after

December 31, 2015. The Administration estimates that this would cost approximately $12.27 billion over 10 years.

Observation: This new proposal would benefit US multinationals by making interest expense and income treatment symmetrical, as the AJCA intended. However, the mechanics of combining WWIA with the foreign minimum tax proposal may introduce new complexities.

Close loopholes under subpart F

The Administration has grouped certain proposals, both new and carried over, under broader categories. One of those categories addresses what the Budget characterizes as "loopholes under subpart F." The Green Book states that the existing subpart F categories, and the threshold requirements for applying subpart F, rely on technical distinctions that may be manipulated or circumvented.

The Green Book sets up the four items in this category by explaining the Administration's concerns and then laying out the specific proposals. The Budget further groups the proposals under two headings: (1) two items that would modify the thresholds for applying subpart F and (2) two items that would expand the categories of subpart F income.

In the discussion below, the specific concerns addressed by each proposal are included with the respective proposal.

Modify the thresholds for applying subpart F

Eliminate the 30-day grace period before subpart F inclusions

The Administration's proposal would eliminate the requirement that a foreign corporation be a CFC for at least 30 days continuously in order for a US shareholder to currently include in gross income the CFC's subpart F income.

The Administration estimates that this proposal would raise approximately $1.2 billion over 10 years.

Amend CFC attribution rules

The Administration expresses concern that a foreign corporation's acquisition of a US-parented group may lead to the new foreign parent (or a non-CFC foreign affiliate) acquiring enough stock of the former US-parented group's foreign subsidiaries so that those foreign subsidiaries cease to be CFCs. Thus, the former US shareholders would no longer be subject to subpart F inclusions.

The proposal would amend the Section 958(b) ownership attribution rules so that certain stock of a foreign corporation owned by a foreign person is attributed to a related US person in determining whether the related US person is a US shareholder of the foreign corporation and thus whether the foreign corporation is a CFC.

The pro rata share of a CFC's subpart F income that a United States shareholder is required to include in gross income would continue to be determined based on direct or indirect ownership of the CFC, without application of the ownership attribution rules of Section 958(b).

The Administration estimates that this new proposal would raise approximately $3.4 billion during the 10-year budget FY 2015 window.

Observation: This new proposal reflects Administration concerns about 'inversions'. It seems to have a similar rationale as a planned regulation announced in Notice 2014-52 that treats certain ex-CFCs' ownership of other foreign corporations' obligations as a Section 956 investment. However, the Budget proposal is less onerous, because any subpart F inclusion would reflect only the US shareholders' actual (direct and indirect) ownership interests.

Expand the categories of subpart F

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

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 Administration estimates that this proposal would raise approximately $8.7 billion during the 10-year Budget FY 2015 window, significantly less than last year's $19.91 billion JCT staff estimate (presumably because of the projected impact of other new proposals).

Observation: This proposal addresses one of the issues raised in the OECD's BEPS project, taxation of the digital economy. The OECD has not made definitive recommendations on this issue, and the Administration proposal may be an effort to demonstrate how the US government would prefer to treat this issue. The 2014 OECD reports directly relevant to the digital economy taxation focus primarily on aspects of nexus and permanent establishment, as well as withholding and consumption taxes.

One might question whether this new subpart F income category is needed if the new minimum tax proposal is adopted, subjecting all CFC income to a minimum tax rate of at least 19%.

Prevent avoidance of FBCSI through manufacturing services arrangements

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 FBCSI exceptions would continue to apply.

The Administration estimates that this new proposal would raise approximately $14.13 billion over 10 years, less than the $18.38 billion JCT staff estimate for FY2015.

Observation: The FY 2015 Green Book referred to US base erosion in presenting this proposal, suggesting that this proposal may have had 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. Nevertheless, 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. Again, one might question whether this new subpart F income category is needed if the new minimum tax proposal is adopted, subjecting all CFC income to a minimum tax rate of at least 19%.

Modify Sections 338(h)(16) and 902 to limit credits when non-double taxation exists

The FY 2016 Budget groups together two proposals carried over from the FY 2015 Budget that relate to the US FTC regime, applying to them the OECD BEPS concept of 'double non-taxation.'

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

Section 338(h)(16) provides that the deemed asset sale resulting from a Section 338 election is generally ignored in determining the source or character of any item when applying the FTC rules to the seller. 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' (CAAs), including Section 338 elections and other transactions 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 Section 901(m). The proposal would extend the application of Section 338(h)(16) to all CAAs, within the meaning of Section 901(m), granting broad regulatory authority.

The Administration estimates this proposal would raise approximately $672 million over 10 years, less than the $960 million FY 2015 JCT estimate.

Observation: This proposal seeks to make consistent the characterization of gain from all types of CAAs subject to Section 901(m), applying 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. It is unclear how this proposal would interact with the new minimum tax proposal as it relates to CFC stock sales.

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

The Administration has expressed concerns about applying the Section 902 FTC rules where transactions reduce a foreign corporation's E&P but do not correspondingly reduce the associated foreign taxes. The specific concern is that a corporate shareholder could claim Section 902 FTCs on earnings that will no longer fund a dividend distribution for US federal income tax purposes. The Green Book cites specific examples where (i) a corporation redeems a portion of its stock, if 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).

The Administration's proposal would reduce the amount of foreign taxes taken into account for FTC purposes by a foreign corporation where a transaction reduces 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 an amount proportionate to the reduced E&P.

The Administration estimates this proposal would raise approximately $317 million over 10 years, a little less than the JCT staff's $382 million FY 2015 estimate.

Observation: It is not clear what impact this proposal would have after adoption of the new minimum tax proposal.

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

The Administration's 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 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 US 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. Similar rules would provide payments for insourcing to certain US possessions. The proposal includes regulatory authority for implementation, including rules to determine covered expenses.

This proposal would be effective for expenses paid or incurred after the date of enactment. The Administration estimates that it would essentially break even over the 10-year Budget window, costing the US Treasury $247 million total (similar to the $217 million cost in last year's JCT Budget estimate).

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

Limit income-shifting through outbound transfers of intangibles

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."

The 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 Administration estimates this proposal would raise approximately $3.07 billion over 10 years, significantly more than the JCT staff's $1.91 billion FY 2015 estimate.

Observation: The Administration has maintained this proposal in essentially the same form for five budget cycles.

Modify the tax rules for dual-capacity taxpayers

The Administration has also maintained this proposal for five years. Although offered under a single heading, it consists of two separate elements, one that addresses the creditability of certain foreign levies and one that addresses the amount of tax that may be creditable specifically in the case of oil and gas income.

Creditability. Taxpayers that are subject to a foreign levy and also receive a specific economic benefit from the levying country (dual-capacity taxpayers) may not credit the portion paid for that benefit. The Administration offered legislative language for this proposal in 2011 that would modify the FTC rules for dual-capacity taxpayers by creating a new Section 901(n). This rule would limit the amount of foreign tax that a dual-capacity taxpayer (or any member of its worldwide affiliated group) could credit to the amount that the taxpayer would have been required to pay were it not a dual-capacity taxpayer. Any amount paid to a foreign government in excess of that amount would not be treated as 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.

Limitation. There is no separate Section 904 FTC limitation category for oil and gas income. However, Section 907 limits the amount of creditable foreign taxes imposed on foreign oil and gas income in any one year to the applicable US tax on that income. The 2011 legislative language for this proposal would create a separate Section 904(d) FTC basket for combined foreign oil and gas income (as defined in Section 907(b)(1)), in the process repealing 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 Administration estimates this proposal would raise approximately $10.32 billion over 10 years, less than the JCT staff's $12.24 billion FY 2015 estimate.

Observation: The Administration has continued to maintain this proposal with little change, although the 2011 legislative language broke it into two proposed Code sections. This item 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.

Limit the ability of domestic entities to expatriate

Section 7874 applies if (i) a foreign acquiring corporation acquires substantially all of a US 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 incorporation. Similar provisions apply if a foreign acquiring corporation acquires substantially all 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 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.

Concerns about inversions have led to the enactment of statutory rules that require certain US federal agencies not to contract with multinational groups that have 'inverted.' Federal agencies, however, generally do not have access to the identity of such groups. To the extent the IRS has collected (or is authorized to collect) this information, Section 6103 would restrict the IRS from sharing it with other agencies.

The Administration's Section 7874 proposal has expanded in certain ways from FY 2015. As in the prior year, it would broaden the definition of an 'inversion' transaction by reducing the 80% test to a greater than 50% test. It would also eliminate the 60% test altogether. In addition, a transaction would be treated as an 'inversion' if there is a direct or indirect acquisition of (i) substantially all of the assets of a US corporation or partnership, (ii) substantially all of the trade or business assets of a US corporation or partnership, or (iii) substantially all of the US trade or business assets of a foreign partnership. Moreover, the proposal would provide the IRS with authority to share tax return information with US federal agencies for the purpose of administering such agencies' anti-'inversion' rules. Agencies receiving this information would be subject to the Section 6103 safeguarding and recordkeeping requirements.

The proposal would narrow Section 7874 with a 'special' rule whereby, regardless of shareholder continuity level, a business combination will be treated as an inversion if (i) immediately before the acquisition, the fair market value of the US entity's stock is greater than the fair market value of the foreign acquiring corporation's stock, (ii) the foreign corporation's 'expanded affiliated group' (EAG) is primarily managed and controlled in the United States, and (iii) that EAG does not conduct substantial business activities in the acquiring corporation's country of incorporation.

The proposals that would limit the ability of US entities to expatriate would be effective for transactions completed after December 31, 2015. The proposal providing the IRS with the authority to share information with other agencies to assist them in identifying companies involved in an 'inversion' transaction would be effective January 1, 2016, regardless of when the transaction occurred.

The Administration estimates that this new proposal would raise approximately $12.75 billion over 10 years, significantly less than the $17.25 billion FY 2015 JCT staff estimate.

Observation: Section 7874 issues continue to generate significant legislative proposals that may be of concern to the business community for their unintended consequences. Note that the Budget proposal does not adopt the May 2014 effective date in recently-proposed anti-'inversion' bills (HR 415 and S 198), even though Treasury Secretary Lew has previously endorsed that date for Section 7874 legislation.

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

The Green Book groups together two proposals carried over from FY 2015 that echo OECD BEPS project language.

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

The Administration expresses concern about tax planning techniques involving cross-border reverse hybrid arrangements. The Green Book notes that, even if the reverse hybrid is treated as a CFC, its income from certain foreign related persons might escape current US taxation through the subpart F same-country or CFC look-through exceptions. Where a foreign jurisdiction views the reverse hybrid as fiscally transparent, payments to the entity generally are not subject to tax in that foreign jurisdiction. Thus, a reverse hybrid's income may not be subject to current US or foreign tax if the US company owns the entity directly.

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

The Administration estimates that this new proposal would raise $1.4 billion over 10 years, much more than the $766 million FY 2015 JCT staff estimate.

Observation: This proposal also has not changed from FY 2015. The revenue estimate for this proposal is rather low, which raises questions as to anticipated scope.

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

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 Administration estimates that this proposal would raise $1.13 billion over 10 years, more than the $694 million FY 2015 JCT staff estimate.

Observation: This proposal has not changed from FY 2015. Although it shares some features with the recent OECD BEPS discussion draft on hybrid arrangements, it also has significant differences that could potentially lead to double taxation due to inconsistent adoption of OECD recommendations. The relatively low revenue estimate for this proposal continues to raise questions as to its anticipated scope. This proposal would primarily affect foreign multinationals.

Restrict deductions for excessive interest of members of financial reporting groups

The proposal generally would limit the interest expense deductions of a worldwide group's US members where the US members are more highly leveraged than the worldwide group as a whole. The proposal 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)), much lower than the current 50% threshold. This rate would apply for a member that fails to substantiate its proportionate share of the worldwide 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 (US entities not owned directly or indirectly by another US entity, and all members – US or foreign – owned directly or indirectly by such entities) would be treated as a single member of a financial reporting group for purposes of the proposal. If a US member of a US subgroup owns foreign corporation stock, this proposal would apply before the Administration's minimum tax proposal. The minimum tax proposal provides that an interest expense deduction which is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the applicable minimum tax rate. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no US tax is paid. Based on the ordering rule, a US subgroup's interest expense that remains deductible after applying this proposal would then be subject to the minimum tax proposal's deductibility limitations.

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 Administration estimates that this proposal would raise approximately $64.1 billion over 10 years, significantly more than the roughly $40.91 billion JCT estimate from FY 2015.

Observation: This complex and far-reaching thin capitalization proposal interacted with the interest expense deferral proposal when first introduced in the FY 2015 Budget but now interacts with the minimum tax proposal. The FY 2016 version makes changes that would increase administrative complexity, as well as providing carryforward rules similar to those currently in Section 163(j). The safe harbor does not appear very attractive.

Disallow 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, primarily affects 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 effectively connected to a US trade or business, or ECI (attributable to a permanent establishment for tax treaty purposes). For FTC purposes, reinsurance income treated ECI under this rule would be considered foreign-source income in a separate Section 904(d) basket.

The Administration estimates this proposal would raise approximately $7.39 billion over 10 years, slightly less than the JCT staff's $8.96 billion FY 2015 estimate.

Observation: This proposal is essentially the same as in the FY 2015 Budget. It is based on an earlier version in the FY 2011 Budget and is similar to other bills previously introduced on this issue.

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

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 with ECI, it is unclear whether the sales proceeds are taxable in the United States.

Rev. Rul. 91-32 articulates the IRS position that gain or loss resulting when a non-resident alien or foreign corporation partner sells or exchanges a partnership interest may be ECI. Specifically, the IRS position is that the partner's gain or loss will be ECI to the extent the result is attributable to that partner's distributive share of the partnership's unrealized gain or loss which is, in turn, attributable to property held for use in the partnership's US trade or business.

The Administration's proposal would essentially codify Rev. Rul. 91-32. Gain or loss from a partnership interest's sale or exchange would be considered ECI as described above. The proposal also would grant regulatory authority to specify the extent to which a partnership distribution is treated as a partnership interest's sale or exchange and to coordinate the new rule with non-recognition Code provisions.

In addition, the partnership interest transferee would be required to withhold 10% of the amount realized on the sale or exchange unless the transferor could certify that it is either (i) not a non-resident alien or foreign corporation, or (ii) a non-resident alien 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 Administration estimates this proposal would raise approximately $2.9 billion over 10 years, similar to the JCT staff's $2.6 billion FY 2015 estimate.

Legislative outlook

At this point, it will be difficult for fundamental tax reform to be enacted this year, but the process has begun and tax reform proposals developed now can be expected to inform future tax reform efforts. Both Ways and Means Committee Chairman Ryan and Senate Finance Committee Chairman Hatch have declared their intention to produce bills, or at least draft legislative language on international tax reform, in 2015.

The path to tax reform is still not clear. However, Congressional Republicans have expressed some openness to considering the Administration's minimum tax proposal, and Secretary Lew has stated that the approach is similar to former Chairman Camp's proposal. In the meantime, Democratic lawmakers such as Sen. Durbin and Rep. Lloyd Doggett (D-TX) continue to propose legislation intended to curb perceived abuses.

Although Republicans have showed little willingness to raise revenues of any kind outside revenue-neutral tax reform, 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 takeaway

The FY 2016 Budget introduces significant new international tax proposals that could provide a basis for business tax reform efforts. In addition, the Budget retains items that reflect ongoing concerns with corporate expatriation or that coincide in part with the OECD's BEPS initiative. That BEPS process may well affect US international tax law going forward, either directly or indirectly. With the focus now turning to the Ways and Means Committee and Senate Finance Committee, it will be important for companies to stay engaged in the tax reform discussion.

See also:

- PwC Tax Insight: President Obama's FY 2016 budget calls for business tax reform; proposes new international and individual tax increases
- PwC 2015 Tax Policy Outlook: Opportunities and challenges ahead
- PwC Tax Insight: Congressional Democrats introduce 2015 versions of anti-'inversion' and anti-tax haven bills
- PwC Tax Insight: 2014 Camp discussion draft changes previously proposed international tax regime

Let's talk

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