Senate Finance Committee Chairman Baucus releases international tax reform discussion draft

November 20, 2013

In brief

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

The Finance staff international reform discussion draft (“discussion draft”) proposes to repeal or modify the current deferral system. In its place, the discussion draft provides statutory language for two differing regimes that would generally impose current taxation on all controlled foreign corporations (CFCs) income at a minimum rate.

The discussion draft also proposes a one-time tax on pre-effective date deferred earnings of foreign subsidiaries that have not been subject to US tax.

The discussion draft includes additional proposals that allow the CFC look-through rules to expire, eliminate "check-the-box" for international tax purposes, disallow the deduction of interest expense allocable to exempt foreign income, codify the “realistic alternatives” transfer pricing test, restrict the use of foreign tax credits, and prevent foreign investors from using RICs and REITS to avoid US taxation.

The discussion draft does not propose a specific corporate tax rate reduction. Chairman Baucus has expressed support for reducing the corporate rate below 30 percent.

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

Finance Chairman Baucus has requested public comment by January 17, 2014 on the discussion draft and other issues not addressed in the draft.

In detail

Minimum tax options

The central feature of the discussion draft is the presentation of two anti-base erosion options, called Y and Z, that apply the concept of a minimum level of US federal income tax. Both options apply a concept similar to Option B in the 2011 discussion draft from House Ways and Means

Chairman Dave Camp (R-MI), which proposes that all CFCs will be subject to a minimum level of current effective tax. The discussion draft present both minimum tax options in fully developed form, but the rate of proposed US federal income tax is bracketed to permit adjustments for the revenue effect of the Finance Committee's various tax reform proposals.

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

Option Y would provide a 100% DRD for the foreign source portion of dividends paid to a US shareholder out of non-subpart F income, but would significantly expand subpart F by adding two new categories of subpart F income. The first, "US-related income," would currently tax US shareholders income from the manufacture, production, extraction or sale of property ultimately used or consumed within the United States as well as income from the provision of services to persons located in the United States. The second new category of subpart F income would include all income items of a CFC that are not subject to an effective foreign tax rate (measured under US principles) of at least [80%] of the US corporate tax rate. Because low-taxed income would be currently taxed in the US, Option Y would repeal the foreign base company rules for sales, services, and oil-related income that subject this income to current US income tax under present law. The CFC "look-through" rules of Section 954(c)(6) would also not be extended, although certain CFC to CFC dividends would be excluded from subpart F. US shareholders could claim foreign tax credits with respect to subpart F inclusions, but the foreign tax credit limitation would be calculated using separate limitations for each of the six categories of subpart F income. Foreign tax credits would be denied with respect to dividends paid out of non-subpart F income.

Option Z would effectively eliminate the deferral of taxation of CFC income while providing a partial exemption from US tax for "active foreign market income." Active foreign market income would be income from the active production or sale of property for consumption or use outside of the United States and from the provision of service to persons located outside of the United States. Qualification as active foreign market income would require the taxpayer to have substantial activities in the CFC's residence country and would not include income derived from sale of goods and services into the US market.

Under Option Z, [60%] of active foreign market income earned by a CFC would be currently taxed to its US shareholders. 100% of the remaining income of the CFC (other than US ECI) would be currently taxed to its US shareholders. Option Z would provide separate FTC limitation baskets for (i) subpart F income from active foreign market income, (ii) passive income, and (iii) all other income. Foreign tax credits would be denied with respect to distributions from the [40%] portion of active foreign market income not currently taxed under subpart F.

Under both Option Y and Option Z, the special subpart F regimes for active finance companies and insurance companies would be made permanent. Under Option Y, such income would be excluded from foreign personal holding company income. Under Option Z, such income could qualify as active foreign market income.

Note that both options would disallow deductions to US shareholders for expenses (including interest expense) allocable to a CFC's exempt income.

One-time tax on pre-effective date deferred income

The discussion draft proposes a one-time tax on foreign subsidiaries' pre-effective date earnings that have not been subject to US federal income tax. A portion of the foreign taxes paid on these accumulated earnings would be creditable. The Finance staff summary of the discussion draft suggests that this one-time tax could be "for example, 20%, paid over eight years."

Additional reforms

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

- Limitations on income-shifting through intangible property transfers (tightening Sections 367(d) and 482).
- Prevention of avoidance of tax through reinsurance with non-taxed affiliates (limiting deductions for certain reinsurance premiums).
- Treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the

United States (Rev. Rul. 91-32 codification).

Other reforms include proposals to generally eliminate the use of check-the-box rules for entities wholly or partially owned by a CFC, Section 902 indirect foreign tax credits, and the Section 909 anti-splitter rules. In addition, the discussion draft proposes to deny deductions for related-party payments arising in a "base erosion arrangement" involving a hybrid transaction, instrument or entity, or an exemption or conduit financing arrangement.

Other proposals include:

- Repeal of the portfolio interest withholding tax exemption for interest paid on corporate debt.
- Expanding the CFC definition by eliminating the 30-day holding requirement and adding a value test for ownership by US shareholders.
- Changes to Section 960 foreign tax credit rules.
- PFIC reforms: elimination of the interest charge and qualifying election fund options, adding a new imputed income for non-traded securities; and other reforms.
- Source and allocation rule reforms: acceleration of the worldwide interest allocation election; repeal of the interest expense apportionment fair market value method; reform of inventory sale title passage rules; and disregard of certain asset acquisitions in determining income source and character.

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

- Termination of special rules for domestic international sales corporations (DISCs).
- Repeal of dual consolidated loss (DCL) rules.

Two others involve changes to regimes of particular interest to inbound taxpayers:

- Modifications (both tightening and relaxing) to the section 897 FIRPTA tax on foreign investments in US real property interests.
- Denying deductions (as US-source dividends) for dividends from foreign corporations attributable to RIC and REIT dividends.

Observation: Some of the reforms proposed by the Finance Committee staff, such as the elimination of foreign check-the-box rules, would have a significant impact on current tax structures put in place by US multinationals. Other, such as the repeal of the DCL rules and section 909, would be significant simplification.

Request for public comment

Finance Chairman Baucus has requested public comment on the international tax reform staff discussion draft and other issues not addressed in the draft. In addition to Option C in House Ways and Means Chairman Camp's 2011 international tax reform discussion draft, a detailed list of issues on which comments are requested include additional ways to address base erosion, transition issues, and a possible temporary transition rule to allow US multinationals to bring intangible property held by their foreign subsidiaries back to the United States on a tax neutral basis.

Comments are requested by January 17, 2014 but will be accepted after that date.

The takeaway

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

As Chairman Baucus advises, stakeholders should provide the Finance Committee with feedback on the international reform staff discussion draft, and should consider carefully the request for comments on issues not addressed in the current draft. We expect the discussion of tax reform options to continue into 2014, as reflected in Chairman Baucus' request for comments by January 17 of next year. The comprehensive tax reform bill currently being developed by House Ways and Means Committee Chairman Dave Camp (R-MI) will be an important part of this ongoing discussion.

Links to Senate Finance Committee international tax reform discussion draft materials

International tax one-pager

International tax staff summary

International tax discussion draft common provisions - statutory language

International tax discussion draft option Y - statutory language

International tax discussion draft option Z - statutory language

Detailed request for comments

Joint Committee on Taxation
technical explanation

Let's talk

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

Tax Policy Services

Pam Olson
(202) 414-1401
pam.olson@us.pwc.com

Brian Meighan
(202) 414-1790
brian.meighan@us.pwc.com

Rohit Kumar
(202) 414-1421
rohit.kumar@us.pwc.com

Ed McClellan
(202) 414-4404
ed.mcclellan@us.pwc.com

Peter Merrill
(202) 414-1666
peter.merrill@us.pwc.com

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

Larry Campbell
(202) 414-1477
larry.campbell@us.pwc.com

International Tax Services

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

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

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

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