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Ways and Means Chairman Camp releases Discussion Draft for corporate rate reduction, territorial tax system

Overview

House Ways and Means Committee Chairman Dave Camp (R-MI) on October 26 released for public comment a Discussion Draft on tax reform that lowers the top corporate income tax rate to 25 percent and adopts a territorial tax system. Under the Ways and Means Draft, a 95-percent dividends received deduction ("DRD") would be provided for eligible foreign-source dividends. The territorial tax system and related international tax proposals are intended to be revenue neutral and include a partial inclusion of historic earnings and profits of 10-percent or more U.S.-owned foreign companies as well as anti-base erosion options.

The current 35-percent top marginal tax rate for subchapter C corporations would be reduced to 25 percent, effective for tax years beginning after 2012. Chairman Camp stated that the corporate rate reduction would be offset by broadening the tax base, and that he plans to release future discussion drafts on other business and individual tax reform proposals.

Chairman Camp stated that the Discussion Draft offers an opportunity for the business community and other interested parties to provide input to future tax reform discussions. Chairman Camp has not set a deadline for public comments.

Below is an overview and analysis of certain key elements of the territorial tax Discussion Draft released by Chairman Camp.

Implementing a Modified Territorial Tax System

Applying the 95-Percent DRD

The Camp Draft would create a new section 245A that provides a 95-percent DRD for qualified foreign-source dividends received by a corporate 10-percent U.S. shareholder from a controlled foreign corporation ("CFC"). The DRD would result in a 1.25-percent tax rate (25 percent of five percent) on such dividends, which would include section 1248 amounts. No foreign tax credits ("FTCs") would be available to offset the taxable five percent of the dividends.

The Draft would allow any corporate U.S. shareholder of a 10/50 company in the top three tiers of a foreign corporate chain to elect to treat the 10/50 company as a CFC, and thereby be eligible for the DRD. A 10/50 company below the third tier would be ineligible for the election, and would be denied section 902 credits. Dividends from a 10/50 company ineligible for the DRD would generally remain subpart F income in the hands of a CFC payee.

The DRD would be available only if the CFC's stock has been held for at least one year by the 10-percent U.S. shareholder receiving the dividend, as determined using section 246(c). The Draft applies related-party rules to "tack" the holding period if a CFC's ownership has been restructured within a U.S.-headed global group.

> ***Observations:*** Under the Draft, the DRD regime would apply only to U.S. subchapter C corporations, but other provisions of the Draft would apply to all taxpayers. Consequently, the Draft moves only U.S. subchapter C corporations to a modified territorial regime, while, in some instances, increasing the U.S. tax burden on other shareholders of foreign corporations. Under the Draft, the 95-percent DRD is proposed to be effective starting in 2013. Unlike some earlier territorial proposals, the Draft preserves deductions that might be considered attributable to DRD-eligible income.

Three Tax Regimes for Foreign Earnings of U.S. Corporations

Under the Draft, the earnings of U.S. corporations received from related foreign corporations and foreign branches (excluding Passive Foreign Investment Corporations ("PFICs")) generally would be taxed under one of three regimes:

1. <u>Territorial regime</u>. As described above, dividends (gross of withholding tax) from CFCs -- and electing 10/50 companies -- derived from non-subpart F foreign income, and similar income of foreign branches, would be 95-percent exempt, with no FTCs;

2. <u>Portfolio investment regime</u>. Dividends (gross of withholding tax) from non-electing 10/50 companies, foreign companies in which the U.S. shareholder owns less than a 10-percent interest, and CFCs and electing 10/50 companies for which the one-year holding period is not satisfied would be fully taxable, with a direct section 901 FTC for any foreign withholding taxes. No indirect FTC would be allowed under section 902, which would be repealed.

3. <u>Subpart F regime</u>. Subpart F income of CFCs and electing 10/50 companies, and similar income of foreign branches, would be subject to current U.S. tax with a section 78 gross-up and credits for indirect (section 960) and direct (section 901) foreign taxes, as appropriate. No indirect FTC would be allowed under section 902. Distributions out of

previously taxed income ("PTI") would be taxed like other dividends, e.g., a five-percent inclusion if eligible for the 95-percent DRD.

Sales of Foreign Corporation Stock

The Draft would create a new section 1247, providing a 95-percent exemption for all gain recognized by U.S. subchapter C corporations on the sale of qualified shares of CFCs and electing 10/50 companies. This treatment would apply only if 30 percent or less of the foreign corporation's assets give rise to subpart F foreign personal holding company income during a three-year testing period. Losses on the sale of such shares would not be recognized. The rules for gains and losses from non-qualifying sales of foreign corporation stock, including sales by CFCs of CFC and 10/50 company shares, would not be not changed by the Draft.

Subpart F and Related Provisions

The Draft would repeal section 956, which taxes investments in U.S. property by CFCs, but would not narrow the current subpart F income categories or extend the active financing exception (sec. 954(h)) or the CFC look-through rules (sec. 954(c)(6)). Electing 10/50 companies would be subject to subpart F.

The Draft would eliminate the exemption for PTI arising before or after the effective date, meaning that repatriated subpart F income and section 1248 earnings would be subject to a second level of U.S. taxation. The repeal applies to all taxpayers, not solely subchapter C corporations eligible for the DRD.

Based on a 95-percent DRD system and repeal of the section 959 exemption for PTI, the effective rate on the repatriated subpart F income of U.S. subchapter C corporations would be 26.25 percent (before considering foreign taxes), assuming enactment of the proposed 25-percent corporate income tax rate.

> ***Observations:*** By eliminating PTI, the Draft would eliminate the "basis bump" for stock of CFCs earning subpart F income, thereby subjecting U.S. shareholders of CFCs to potential double U.S. taxation of the associated CFC earnings on a sale of CFC shares. The extra "double tax" would be limited to 1.25 percent if the sales qualified for the 95-percent DRD, but otherwise such double tax would be at the full rate applicable to the seller. In addition, S corporation shareholders that receive a PTI distribution from a CFC apparently would pay tax on those earnings twice at individual income tax rates. The Draft defers any narrowing of the subpart F rules until measures to protect the U.S. tax base and prevent income shifting are addressed.

Foreign Branches

First-tier foreign branches, including check-the-box branches of U.S. corporations, would be treated as CFCs, meaning they would be eligible for the 95-percent DRD regime and subject to the subpart F regime. A foreign branch of a U.S. corporation is "any trade or business...of such domestic corporation in a foreign country," and includes "any active trade or business."

> ***Observations:*** Most OECD countries that allow less than a 100-percent participation exemption regime nevertheless allow a 100-percent exemption for branches. Treating a foreign branch as a CFC raises a number of issues that are not addressed fully by the Draft or Technical Explanation. These issues include:

- Treating foreign branches as CFCs would cause payments (e.g., interest and royalties) between branches and their home office to become regarded, and subject to section 482.
- Treating foreign branches as CFCs may cause deemed asset sales to the new CFC on the effective date to the extent that disregarded loans become regarded; this could result in taxable gains, section 304 transactions, etc.
- The definition of a branch in the Draft plays off the "U.S. trade or business" concept applied to foreign taxpayers with U.S. operations, rather than the sections 367 and 989 definitions more commonly used for outbound business activities.
- Whether section 367 and various loss recapture rules would apply to branch assets on the effective date, as a result of the deemed CFC incorporation on that date.
- How section 367 would apply to assets that a branch acquires after the effective date.
- If section 367 is applied to all branch assets on the effective date, it would be appropriate to permit the "toll tax" to be paid in installments, like the tax on pre-enactment E&P.
- Whether the dividend equivalent rules in the branch profits tax regulations would be adapted for calculating the dividend amount paid by a branch.
- How the one-year holding period requirement would apply to foreign branches, which regularly acquire and dispose of business assets.
- Gain on sales or deemed sales of branch assets presumably would qualify for the 95-percent exemption under the same rules applicable to CFC asset sales. If branch assets are sold piecemeal, rather than all at once, presumably the sales tests would have to be applied on an asset-by-asset basis.
- Losses on sales or deemed sales of branch assets likewise presumably would be treated as deductible or non-deductible under rules paralleling those for stock sales.
- It appears that foreign branches of U.S. subchapter C corporations, like CFCs, would defer the 1.25-percent tax until repatriation.
- How section 482 would apply to an actual foreign branch, considering that a branch is not a legal entity and thus cannot be a contracting party.
- How the subchapter C reorganization provisions would apply to a foreign branch that is treated as a CFC.

Partnerships

The Draft grants Treasury broad authority to issue regulations providing "rules similar to [the 95-percent DRD rules for foreign branches and electing 10/50 corporations]. . . with respect to any interest held by a domestic corporation in a partnership (or other pass-thru entity . . .) with a trade or business in a foreign country." For these rules to apply, the U.S. corporation generally would need to own at least a 10-percent interest in the partnership.

Foreign Tax Credit Changes

The Draft provides several modifications to the U.S. FTC regime. Some changes are taxpayer-favorable; others are not. The Draft would repeal the indirect FTC in section 902 but preserve the indirect credit in section 960. As noted above, credits would not be available for dividends subject to the 95-percent DRD.

Allocation and apportionment of a U.S. person's expenses generally would be eliminated in determining the FTC limitation, except to the extent of "directly allocable" deductions. The Technical Explanation defines "directly allocable deductions" as "deductions that are directly incurred as a result of the activities that produce the related foreign-source income." This could include items such as salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign-source income, according to the Technical Explanation. The Technical Explanation states that "stewardship expenses, general and administrative expenses, and interest expenses are not considered directly allocable deductions."

Although the new regime would preserve the FTC limitation, it would place all foreign taxes in one basket. In addition, the recently enacted section 909 rules, regarding separation of foreign income from associated taxes, would be repealed. Furthermore, multi-year pooling would be eliminated for section 960 credits.

> ***Observation:*** By treating branches as CFCs, the Draft apparently would eliminate the section 901 credit for taxes on their non-subpart F type income. The special rules in section 907 for foreign oil and gas income apparently would be preserved in the Draft, as would the 10-year carryforward of pre-enactment section 904(c) taxes. It appears that foreign taxes paid by a 10/50 company before enactment would be denied indirect credits if the CFC election is not made; as discussed above, section 902 would be repealed.

"Deemed Repatriation" of Pre-Enactment Earnings

Under the Draft, pre-enactment earnings of foreign companies (including 10/50 companies regardless of whether they elect the territorial system) would be included in the current income of all 10-percent U.S. shareholders as of the last tax year ending before the regime became effective. A DRD, tentatively set at an 85-percent rate, would be allowed, and credits for a corresponding portion of indirect foreign taxes would be allowed (similar to section 965) for U.S. corporations. With an 85-percent DRD, the maximum tax rate on pre-enactment foreign earnings for U.S. corporations would be 5.25 percent (35 percent of 15 percent), plus an additional 1.25 percent (25 percent of 5 percent) when this income is repatriated. Previously taxed earnings would not be subject to the 5.25-percent tax.

Under mechanics specified in the Draft, taxpayers could elect to pay the tax on the deemed repatriation of pre-enactment earnings in two to eight equal annual installments, with interest.

> ***Observation:*** Because an actual distribution of a CFC's pre-enactment earnings in tax years beginning before the effective date would not be eligible for the 85-percent DRD, this rule could have a chilling effect on repatriating pre-enactment earnings before that date. The Draft does not distinguish between earnings held in cash and equivalents versus earnings reinvested in plant, property, or equipment.

New Subpart F Categories

The Draft contains three alternative new subpart F income categories intended to mitigate concerns that increased base erosion might result under a territorial system. The new subpart F rules apparently would apply to all U.S. shareholders, whether or not eligible for the DRD. The third alternative, in addition to expanding subpart F, is intended to provide a benefit for certain IP-related income in the form of a lower tax rate than the standard rate. The three proposals are as follows:

1. The Administration's "excess returns" proposal with the modification that excess returns would not be in a separate foreign tax credit basket. For more details on that proposal, see WNTS Insight, "Legislative Language for Administration's 'Excess Returns' Proposal Raises Issues," October 21, 2011.

2. Treat all income (including active income) of a CFC that is taxed at a foreign effective rate of 10 percent or less (on a country-by-country basis) as subpart F income, with a same-country exception for active income earned through a local office or fixed place of business. There are specified rules for applying the same-country exception, but they do not address all types of income, particularly rents and royalties.

3. Create a new category of subpart F income ("foreign base company intangible income") consisting of the portion of income from the sale of goods or services attributable to IP without regard to where the IP is developed or exploited. The Subpart F high-tax exception would be applied for this purpose, using a 54-percent rather than 90-percent rate test. Both this new category of subpart F income and IP-related income earned directly by U.S. corporations would be eligible for a 40-percent deduction if earned from foreign customers (with a specified definition).

   Observation: The last alternative proposal generally is intended to achieve equal taxation of IP income, whether IP is exploited at home or abroad; however, IP income earned by a foreign affiliate would be subject to an additional 1.25-percent (if qualified for the 95-percent DRD) when repatriated. The Draft only would apply to the intangible income portion of income earned by a CFC or U.S. persons from the sale of property or the provision of services with embedded intangible property, but it provides no mechanism for determining what portion of such income is intangible income.

Thin Capitalization Rules

The Draft includes a provision to limit deductions for net interest expense of U.S. corporations, aimed at preventing erosion of the U.S. tax base by companies borrowing in the United States to finance overseas operations that may be eligible for the proposed dividend exemption.

Generally, in the case of a U.S. corporation and its CFCs, the Draft would disallow a portion of the U.S. corporation's net interest expense if (1) the U.S. corporation is overleveraged compared to the worldwide affiliated group (the "relative leverage test"), and (2) the U.S. corporation's net interest expense exceeds an unspecified percentage of adjusted taxable income (the "ATI test"), using section 163(j) rules. These two disallowance tests are explained in the Draft and Technical Explanation. The lesser of the amounts determined under these tests is the amount by which deductible interest is reduced.

Interest disallowed under this provision could be carried forward to subsequent tax years and the amount of any disallowance would reduce any amount of interest disallowed under section 163(j).

Request for Feedback

The summary of the Discussion Draft states that the Committee invites input on all aspects of the discussion draft, but is especially interested in the following:

- Which of the three anti-base erosion options bests protects the U.S. tax base with the least impact on competitiveness? Are there better options?
- How can thin capitalization rules be designed to protect the U.S. tax base with the least impact on competitiveness?
- Should foreign branches be treated as CFCs?
- How should foreign partnerships be treated?
- Is the 95-percent exemption of capital gains appropriate? Are additional anti-abuse rules needed in this area?

For additional insights, please join PwC on November 3 at 3:00 pm for a webcast covering the Discussion Draft.

For more information, please do not hesitate to contact:

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