

WNTS Insight



Revenue-raising proposals in revised extenders bill would have broad impacts

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Overview

House Ways and Means Chairman Sander Levin (D-MI) and Senate Finance Committee Chairman Max Baucus (D-MT) on May 20 proposed a 10-year, \$190 billion version of H.R. 4213, the "American Jobs and Closing Tax Loopholes Act," with tax and spending components.

The proposed legislation included tax extensions and disaster relief measures estimated to cost \$32.5 billion over fiscal years 2010 through 2020, including proposals retroactively extending through the end of 2010 the research credit, CFC look-through, Subpart F active financing income, and 15-year depreciation for leasehold, restaurant, and retail improvements. Additional tax proposals include modifications and extension of "Build America Bonds," pension funding relief, new 401(k) plan fee disclosure requirements, and other business tax relief. The bill also includes \$56 billion in revenue offsets, according to a revenue estimate provided by Joint Committee on Taxation staff.

The House passed an amended version of H.R. 4213 on May 28, 2010, but the Senate in June was unable to secure the 60 votes needed to pass the legislation as proposed due to concerns about spending provisions that would have added to the federal deficit and other concerns. Congress subsequently in late June approved a separate bill dealing with Medicare physician reimbursement rates, and in July approved a narrow version of H.R. 4213 dealing only with an extension of unemployment benefits.

The timing for future action to extend the research credit and other expired business and individual tax provisions is uncertain at this time, but it appears likely that the revenue-raising proposals discussed below will remain under consideration by Congress this year.

Below is an initial analysis of revenue-raising proposals included in the amended version of H.R. 4213 proposed on May 20 by Ways and Means Chairman Levin and Senate Finance Committee Chairman Baucus.

While some of the non-tax components of the legislation proposed on May 20 have been addressed separately, at this writing the tax extender provisions and proposed revenue-raising proposals have been subject only to limited modifications, as noted below.

International proposals

Overview: Some of the revenue-raising proposals described below were included in the Obama Administration's FY 2011 budget, but others embody new concepts that have not previously appeared in legislative proposals. In general, the international proposals would add considerable complexity to U.S. international tax rules.

Rules to prevent splitting foreign tax credits from income

This proposal addresses situations under present law in which a foreign tax credit is claimed under Code sections 901 or 902 for foreign taxes paid on income that has not yet been subjected to U.S. federal income tax. The proposal applies to foreign taxes paid or accrued by a U.S. person after May 20, 2010. The proposal applies with retroactive effect to any taxes paid or accrued by a foreign corporation to the extent that such taxes had not been deemed paid by a U.S. shareholder as of May 20, 2010. The proposal is estimated to raise \$6.3 billion. A similar proposal was included in the Administration's FY 2011 budget.

Observations: *Reaching beyond transactions described in recently proposed Treasury regulations - which involve the type of foreign consolidation planning addressed in the Guardian Industries case and the use of reverse hybrid entities - the proposal is broadly worded to defer including any foreign tax paid or accrued by an entity until that entity or a domestic shareholder recognizes the income on which such foreign tax was paid.*

This proposal will require U.S. multinational groups to recompute the tax pools of their controlled foreign corporations ("CFCs") and 10/50 companies as if the proposed legislative change always had been in effect. On enactment of the proposal, CFCs that had relatively high effective foreign tax rates on their earnings under the law prior to

enactment could have the effective tax rate on their earnings lowered with immediate effect.

This lowering of the effective tax rate on a CFC's historic earnings pool could have an immediate financial accounting impact if the U.S. shareholder has not made an indefinite reinvestment assertion for the impacted CFCs. In addition, deferred tax assets and any associated valuation allowances recorded with respect to foreign tax credits will need to be analyzed to determine any potential remeasurement implications.

Denial of foreign tax credit with respect to foreign income not subject to U.S. taxation by reason of covered asset acquisitions

This proposal limits a taxpayer's ability to credit foreign taxes paid following a section 338 purchase of a CFC or a purchase of shares of a disregarded entity. The proposal also could apply to the purchase of domestic entities that include foreign branch operations and to certain purchases of partnerships with foreign assets. The proposal applies to transactions between unrelated parties occurring after the date of enactment (with certain limited exceptions) and transactions between related parties occurring after May 20, 2010. The proposal is estimated to raise \$4.0 billion.

Observations: *If a deemed asset purchase produces a stepped-up depreciation basis for U.S. tax purposes without a corresponding step-up for foreign tax purposes, the effect of the proposal could be a higher effective foreign tax rate from a U.S. perspective on the business's future income. This technically complex proposal disallows a foreign tax credit for that portion of foreign taxes paid corresponding to the excess of the foreign tax base over the U.S. tax base.*

This proposal is a significant departure from U.S. foreign tax credit principles in that it makes a foreign tax non-creditable to the extent that it is imposed on a foreign tax base that does not correspond to the U.S. tax base. The effect appears to be similar to creating a separate foreign tax credit limitation basket for the income of, and tax paid by, each affected CFC or disregarded entity.

The proposal therefore creates considerable additional complexity in the

foreign tax credit limitation calculation. The proposal also is a “one way street,” in that taxpayers are limited to the lesser of (i) the foreign tax credit calculated under the usual rules governing computation of earnings and profits, including the specific limitations on depreciation of foreign situs assets, or (ii) the foreign tax credit calculated looking to foreign tax principles for calculating income.

Separate application of foreign tax credit limitation to items resourced under tax treaties

The proposal requires U.S. source income that is resourced as foreign source income under an income tax treaty to be placed in a separate limitation basket for foreign tax credit limitation purposes. This proposal applies to taxable years beginning after the date of enactment, and is estimated to raise \$253 million.

Observation: *Some U.S. income tax treaties already provide for such separate basket treatment of re-sourced income. Other treaties do not impose a separate limitation on such income.*

Limitation on the amount of foreign taxes deemed paid with respect to section 956 inclusions

This proposal limits a deemed paid credit for any section 956 inclusion to the *lesser* of (i) the foreign tax credit amount that would result if the amount included had been distributed as a dividend up through the ownership chain separating a CFC from its U.S. shareholder, or (ii) the amount of the foreign tax credit that would result under the current "hopscotch" rule. The statutory language also authorizes Treasury to issue anti-abuse guidance. The proposal applies to acquisitions of U.S. property made by CFCs after May 20, 2010, and is estimated to raise \$1.0 billion.

Observations: *The proposed legislation apparently is aimed at the affirmative use of section 956 to selectively repatriate high- or low-tax pools of earnings and profits from CFCs while avoiding the rate blending that would occur on an actual dividend distribution up through multiple tiers of CFCs. However, the proposal will adversely affect companies more broadly, operating as a whipsaw rule that would apply to all section*

956 inclusions.

Such a regime is a fundamental change in the operation of section 956 and might operate to prevent a taxpayer from ever having an opportunity to claim a foreign tax credit for all the foreign taxes paid on earnings taxed under section 956. The proposal likely will cause an increase in the complexity of section 902 and section 960 computations with respect to CFC groups. Instead of simply having to adjust the earnings, tax, and previously taxed income pools of the CFC with the investment in the U.S. property as is done under current law, it appears necessary under the proposal to track deemed distributions up through the earnings, taxes, and previously taxed income pools of multiple tiers of CFCs.

The proposal could have immediate financial statement impact in cases in which a taxpayer has a lower-tier CFC with a higher effective foreign tax rate on its earnings pool than the higher-tier CFCs in its ownership chain. Specifically, if the taxpayer has not treated as indefinitely reinvested the earnings of a lower-tier CFC, and has calculated its deferred tax provision for the lower-tier CFC under the assumption the unremitted earnings could "hopscotch" over the intervening low-tax pools, the change in law could trigger additional deferred taxes upon enactment. In addition, deferred tax assets and any associated valuation allowances recorded with respect foreign tax credits will need to be analyzed to determine any potential remeasurement implications.

Special rule with respect to certain redemptions by foreign subsidiaries

This proposal provides a special rule intended to limit the use of section 304 stock sales by foreign-parent multinational groups to trigger deemed dividends from CFCs that bypass the U.S. shareholder and flow directly to the foreign parent or a tax-indifferent foreign affiliate. Under this proposal, no earnings and profits would be taken into account in such a transaction if more than 50 percent of the deemed dividends arising from the section 304 transaction would be neither (i) subject to current U.S. federal income tax nor (ii) includible in a CFC's earnings and profits. The proposal applies to stock sales occurring after May 20, 2010, and is estimated to raise \$255 million.

Modification of affiliation rules for purposes of allocating interest expense

This proposal modifies current affiliation rules for the purpose of allocating interest expense involving effectively connected income earned by a CFC. The proposal applies to taxable years beginning after the date of enactment, and is estimated to raise \$405 million.

Observation: *The proposal treats a foreign corporation as a member of an affiliated group for interest apportionment purposes if at least 50 percent of its gross income is effectively connected with a U.S. trade or business and at least 80 percent of its stock (by vote or value) is owned by members of the affiliated group. Thus, the foreign corporation's gross assets are included for purposes of apportioning the group's interest expense.*

Repeal of 80/20 company rules

This proposal repeals foreign sourcing rules for so-called "80/20 companies." The proposal includes fairly complex rules that would provide withholding tax relief for interest and dividends paid by certain *existing*, grandfathered 80/20 companies that are engaged in active businesses and meet other specific requirements. The proposal applies to taxable years beginning after the date of enactment, and is estimated to raise \$153 million. A similar proposal is included in the Administration's FY 2011 budget.

Observations: *Current sourcing rules provide withholding tax relief for payments by U.S. corporations that derive the large majority of their income from foreign business operations. For non-grandfathered taxpayers, a complete repeal of the 80/20 rules would eliminate an important withholding tax exception for interest paid to local creditors by foreign branches of U.S. corporations and by foreign*

disregarded entities of U.S. corporations.

Source rule for guarantee fees

This proposal overrides the holding in a recent Tax Court case (*Container Corp.*) with respect to the source of guarantee fees. The proposal sources guarantee fees based on the residence of the payor of the fee, rather than the residence of the guarantor (except if the fee is paid by a foreign person in connection with effectively connected income). The proposal applies to guarantees issued after the date of enactment, and is estimated to raise \$2.0 billion.

Observation: *If a foreign person guarantees debt of a U.S. issuer, the proposal would make a guarantee fee U.S.-source income and therefore potentially subject to U.S. withholding tax.*

Technical correction to statute of limitations provision in the HIRE Act

The proposal provides a technical correction to a statute of limitations provision recently enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147). The HIRE Act included a provision providing that the failure to file certain information with respect to cross-border transactions or foreign assets would toll the statute of limitations with respect to the entire tax return. The proposal provides that the failure to file certain information with respect to cross-border transactions or foreign assets would not toll the statute of limitations with respect to an entire tax return if such failure is due to reasonable cause and not willful neglect. Thus, the statute of limitations would be tolled only for the item (and any related tax) with respect to which there was a failure to file information. The proposal applies as if enacted as part of the HIRE Act and is estimated to have no revenue effect.

Observation: *Since the foreign information reporting penalties are subject to reasonable cause defenses, the correction should bring the entire return period of limitations provision in line with the existing penalty standard. If a taxpayer exercises reasonable and prudent diligence in reporting required foreign information sufficient to avoid information return penalties, extension of the limitations period to the*

entire return will be avoided.

The intended effect of the HIRE Act provision, nevertheless, will continue. As a result, even an excusable foot-fault in the omission of accurate information will extend the period of any assessment of tax related to the omitted information. If the proposal is enacted, the corrected provision still will mandate increased diligence in obtaining and accurately reporting information regarding foreign affiliated entities and foreign transactions.

The proposal also would seem to resolve the controversy whether the HIRE Act provision was a change or a clarification of prior law. As modified by the technical correction, the limitations proposal appears clearly a change from prior law and therefore should not imply any Congressional interpretation of the extension provision prior to the HIRE Act amendment.

From a financial accounting perspective, this proposal would alleviate the potential unanticipated extension of the statute of limitations, which may have impacted financial statement tax reserves if the release of such reserves was dependent upon the expiration of the statute of limitations.

Corporate proposals

Gain recognized in certain spin-off transactions (e.g., "reverse Morris Trust" transactions)

This proposal treats the distribution of securities of a controlled corporation issued in connection with a section 355 reorganization in the same manner as distributions of cash or other property to creditors. Subject to a transition rule, the proposal generally applies to exchanges after the date of enactment. The proposal is estimated to raise \$255 million. The House of Representatives in March 2010 approved a similar proposal as part of small business tax relief legislation (H.R. 4849).

Observations: *Currently, a distributing corporation that receives securities issued by a controlled corporation in connection with certain section 368 and section 355 reorganizations can exchange such securities for securities or other debt of the distributing company without the recognition of gain. In addition, a distributing corporation also can distribute money or other property (not including stock or securities) issued by the controlled corporation to its creditors without recognition of gain to the extent such money or other property does not exceed the adjusted net basis of the assets transferred to such controlled corporation.*

Under the proposal, a distributing company would be limited to the adjusted net basis of the assets transferred to the controlled corporation, with respect to cash, securities, and other property that it receives in a

section 355 reorganization from the controlled corporation that could then be distributed to creditors (including security holders) without the recognition of gain.

Taxation of dividends received in certain business reorganizations

This proposal repeals the "boot-within-gain" rule if the receipt of boot in a reorganization would have the effect of a distribution of a dividend. The proposal also provides that with respect to certain reorganizations under section 368, shareholders would look to the earnings and profits of both the target and acquiring corporation in the reorganization to determine the extent to which boot would be taxed as a dividend.

In addition, the proposal conforms the ordering and sourcing of such earnings and profits with section 304 – generally first from the acquiring corporation and then from the target corporation. Finally, the proposal amends section 312 by applying similar earnings and profit reduction rules to gain recognized under section 356. The proposal applies to both domestic and cross-border reorganizations. Subject to a transition rule, the proposal would apply to exchanges after the date of enactment. The proposal is estimated to raise \$510 million. A similar proposal was included in the Administration's FY 2011 budget.

Observation: *Under current law, shareholders in a reorganization recognize income (either capital gain or dividend income) to the lesser of the amount realized or the "boot" (generally non-stock consideration) received. While the proposal will likely affect many related-party asset reorganizations in which boot is issued, the proposal also could impact the tax treatment of asset reorganizations of public companies by potentially causing target corporation shareholders to recognize taxable income in excess of the amount of gain realized.*

Oil Spill Liability Trust Fund

The House-approved version of H.R. 4213 proposes to increase the oil spill liability trust fund tax to 32 cents per barrel. The proposal also removes the current single incident expenditure cap for the trust fund. The proposal is effective for the first quarter beginning 60 days after date of enactment and expenditures made after date of enactment. The increased tax rate is scheduled to sunset on December 31, 2020, and is estimated to raise \$10.9 billion.

The most recent Senate version of this proposal would increase the oil spill liability trust fund tax to 49 cents per barrel, and is estimated to raise \$18.3 billion.

Individual Proposals

Carried interest

The House on May 28 approved a carried interest proposal that would treat net profits and gains from investment services partnership interests for services as 50-percent ordinary income until December 31, 2012, and thereafter as 75-percent ordinary income, with the remaining share continuing to be classified as under current law. To the extent that the profits and gain of the partner are with respect to invested capital, including amounts previously allocated but not distributed, the income would not be recharacterized as ordinary. Under the proposal, invested capital does not include any amounts loaned from the partnership or a related party. In addition, net income or net loss from an investment services partnership interest that is treated as ordinary also would be subject to self-employment taxes. The House-approved proposal is proposed to be effective for taxable years ending after December 31, 2010, and is estimated to raise \$14.2 billion.

The Senate in June considered additional modifications to the carried interest provision as approved by the House. The most recent Senate carried interest provision offered on June 23 by Finance Chairman Baucus proposed to tax as ordinary income 75 percent of net profits and gains from investment services partnership interests for services for taxable years beginning after December 31, 2010, but also proposed that assets held for more than five years would be treated as 50-percent ordinary income and 50-percent capital gain income. The Senate amendment proposed additional modifications to the proposal as passed by the House. The most recent Senate carried interest provision proposed on June 23 was estimated to raise \$13.6 billion.

Observation: *The proposal would apply broadly to partners providing services to partnerships holding specified assets, including securities, real estate held for rental or investment, interest in partnerships, commodities, or options or derivative contracts. The proposal does not include any carve-outs for specific types of investments.*

Collection of self-employment tax for certain S corporation and limited partnership income

This proposal subjects certain S corporation shareholders to self-employment tax with respect to their income from the S corporation (including income allocable to certain family members). The proposal would apply to S corporations that are partners in a partnership which is engaged in a professional services business if substantially all of its activities are performed in connection with the partnership and to S corporations engaged in professional service businesses if the principal asset of the S corporation is the reputation and skill of three or fewer employees.

In addition, for a limited partner providing substantial services in designated professional services, the bill overrides the rule in current law that provides that a limited partner's distributive share is not subject to self-employment tax. That rule would be overridden if the limited partner provides designated professional services. The provision as approved by the House is proposed to be effective for tax years beginning after December 31, 2010, and is estimated to raise \$11.2 billion.

The Senate has considered additional technical modifications to this provision as approved by the House. Under the most recent Senate proposal, the provision would apply in the second case only if 80 percent or more of the professional service income of the corporation is attributable to the services of three or fewer owners of the corporation. The version proposed in the Senate on June 23 is estimated to raise \$9.2 billion.

Observation: *The proposal applies to professional services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, investment advising, or management or brokerage services.*

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