Impact of recent legislative proposals on US inbound companies

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In brief

On February 26, 2014, House Ways and Means Committee Chairman Dave Camp (R-MI) released the 'Tax Reform Act of 2014,' a discussion draft for comprehensive tax reform of the Internal Revenue Code (the Camp discussion draft) which would lower the corporate tax rate from 35 to 25 percent and which includes several international tax proposals.

On March 4, 2014, the Obama Administration released its fiscal year 2015 (FY 2015) budget proposals in the Treasury Green Book which also includes several international tax proposals. The Administration's FY 2015 budget contains several international tax proposals from prior years, but also contains new proposals that could have significant impact for US inbound companies.

This insight summarizes the US inbound-specific provisions of the Camp discussion draft and the Administration's FY 2015 budget proposal. Some of the more noteworthy proposals include new restrictions on US interest deductibility, as well as new restrictions on deducting interest and royalties in certain types of hybrid arrangements. Although tax reform is unlikely this year or next, US inbound companies are encouraged to consider the impact of the inbound proposals in both the Camp discussion draft and the President's FY 2015 budget due to the potential for these proposals to be picked up as revenue raisers in other bills.

In detail

US interest deductibility

Camp: The Camp discussion draft proposes to tighten the Section 163(j) interest deduction limitation to 40 percent of a corporation's adjusted taxable income (ATI), compared to the 50 percent of ATI limitation under current law. Furthermore, excess limitation from taxable years beginning after December 31, 2014 may not be carried forward. The proposed change to a 40 percent of ATI limitation under Section 163(j) will further limit interest deductions of US inbound companies.

The proposal's 40 percent of ATI threshold appears to conform to separate changes to Section 163 introducing a thin capitalization rule that would limit deductions of interest expense for US companies that are members of worldwide affiliated groups (effectively a US group and its controlled foreign corporations) with excess domestic indebtedness. The rules are not entirely conformed as the thin capitalization rule includes a worldwide leverage exception that is not included in the Section 163(j) proposal. US inbound companies with controlled foreign corporations underneath their US groups will need to consider the impact of both the proposed new thin capitalization rule and the revised Section 163(j) provision. There are coordination rules between the two provisions in order not to disallow the same interest deduction twice.

Administration Budget: The Administration's FY 2015 budget proposal would introduce a new approach for restricting interest deductions of US inbound companies. Under the proposal, a member of a group that prepares consolidated group financial statements under US or international financial reporting standards would generally limit its US interest expense deduction to the member's interest income plus a proportionate share of the group's net interest expense computed under US tax principles. A member's proportionate share of the group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) reflected in the group's financial statements.

If a member fails to substantiate the member's proportionate share of the group's net interest expense, or if it so elects, the member's interest deduction would be limited to 10 percent of its ATI (as determined under Section 163(j)). Under the proposal, disallowed interest can be carried forward indefinitely and any excess limitation for a tax year can be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of Section 163(j).

US subgroups (i.e., a US entity that is not directly or indirectly owned by another US entity, and all domestic or foreign members owned directly or indirectly by such entity) will be treated as a single member of a financial reporting group under the proposal. This proposal would take effect before applying another Administration proposal that would deny deductions for income allocable to overseas income deferred from US tax (another provision relevant to inbounds with CFCs). The US subgroup's interest expense that remains currently deductible after the application of this proposal would be subject to deferral to the extent the remaining US interest expense is allocable to deferred foreign earnings.

Financial services entities are exempt from the proposal and are excluded from the financial reporting group. There is a *de minimis* rule that would provide an exception from this new provision for financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more US income tax returns for a taxable year, but such interest would continue to be subject to current law Section 163(j).

Observation: The Administration's FY 2015 budget proposal introduces a new, complex and far reaching approach to deny interest deductions of US inbound companies. The proposal essentially applies a proportionate worldwide leverage test to determine US interest deductibility. Thus, a foreign multinational group would need to assess its worldwide group net interest expense computed under US tax principles, and determine its US interest deduction limit based on the US group's proportionate share of such interest expense based on the US group's contribution to worldwide group earnings. In the absence of substantiating the US interest deduction calculation, or if a taxpayer otherwise elects, the US interest deduction would be limited to 10 percent of a taxpayer's ATI, significantly lower than the 50 percent of ATI threshold under current law. Unlike prior Administration proposals to tighten the Section 163(j) rules, which were limited in application to inverted companies, these proposed changes would generally apply to all US inbound companies (subject to the exceptions provided). Thus, the proposal may have substantial implications on the ability of US inbound companies to deduct interest.

Hybrid arrangements

Administration Budget: The Administration's FY 2015 budget proposal includes a provision that would deny deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. Hybrid arrangements are described as including use of hybrid entities, hybrid instruments, and hybrid transfers (such as a sales-repurchase or 'repo' transaction, in which the parties take inconsistent positions in respect of the ownership of the same property). For example, deductions would be denied where interest or royalties are paid to a related party and as a result of a hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign jurisdiction, or the arrangement would permit the taxpayer to claim an additional deduction for the same payment in another jurisdiction.

The proposal includes a regulatory delegation to the Secretary to issue regulations (1) to deny deductions from certain conduit arrangements that involve a hybrid arrangement between at least two of the parties to the arrangement; (2) deny interest or royalty deductions arising from certain hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions; and (3) deny all or a portion of a deduction claimed with respect to an interest or royalty payment that, as a result of the hybrid arrangement, is subject to inclusion in the recipient's jurisdiction pursuant to a preferential regime that has the effect of reducing the generally applicable statutory rate by at least 25 percent.

Observation: This hybrid arrangement provision in the Administration's proposal reflects an area that is being addressed in the ongoing OECD base erosion and profit shifting (BEPS) project and raises issues as to unilateral action prior to consideration of those issues that might lead to double taxation. The hybrid arrangement proposal shares similar features with the recent OECD BEPS discussion draft on neutralizing the effects of hybrid mismatch arrangements, as well as the Senate Finance Committee international tax discussion draft proposal that would deny deductions to related parties in certain base erosion arrangements. For a discussion of the OECD BEPS discussion draft on hybrid arrangements, see OECD releases two discussion drafts on hybrid mismatch arrangements, March 21, 2014.

The Administration's proposal also has some different features from the OECD BEPS discussion draft and the Senate Finance Committee proposal, such as limiting the scope of the hybrid arrangement proposal generally to interest and royalties (as opposed to all types of deductible payments). However, the Administration's proposal seeks broad regulatory authority to address other types of transactions. The Camp discussion draft does not contain this proposal.

Anti-Inversion Rules and Corporate Residency

Administration Budget: The Administration's FY 2015 budget proposal includes a provision that would significantly broaden the definition of an inversion transaction. Under the proposal, a foreign corporation generally would be treated as a US corporation for US tax purposes where (among other requirements) it acquires substantially all of the assets of a US corporation and there is greater than 50 percent continuity of ownership in the foreign acquiring corporation by the shareholders of the acquired corporation. This is significantly lower than the 80 percent or greater continuity of ownership threshold under current law. The proposal would also add a special rule whereby, regardless of the level of shareholder continuity of ownership, an inversion transaction will occur if (i) a foreign corporation acquires substantially all the assets of a US corporation, (ii) the affiliated group that includes the foreign corporation has substantial business activities in the United States, and (iii) the foreign corporation is primarily managed and controlled in the United States.

Observation: The Administration's proposal would substantially expand the scope of current anti-inversion rules to encompass common cross-border business merger transactions, and would also introduce a corporate residency concept based on where a foreign acquiring corporation is managed and controlled. The breadth of the proposal could cause a foreign parent corporation to be treated as a US parent corporation when it simply purchases a relatively insignificant US corporation. Such results would suggest the need for further consideration about the purpose and scope of such a proposal. In recent years, similar proposals to determine corporate tax residency based on the place of management and control have generated significant concerns in the business community due to uncertainty as to how they may be applied, as well as their unintended consequences of encouraging corporate executive and management level positions to leave the United States. The Camp discussion draft does not contain this proposal.

Reinsurance

Camp: The Camp discussion draft would disallow insurance companies a deduction for non-taxed reinsurance premiums paid to their foreign affiliates with respect to risks other than life insurance risks, but it would also exclude from such companies' taxable income that income properly allocable to the non-taxed premiums paid, such as ceding commissions and return premiums. This reinsurance proposal is identical to proposals from the Senate Finance Committee international tax discussion draft and Representative Neal (D-MA).

Administration Budget: The Administration's FY 2015 budget proposal contains provisions that are similar to the reinsurance proposal in the Camp discussion draft referenced above, except that the Administration proposal also includes a 'high taxed reinsurance exception' whereby if the taxpayer demonstrates to the IRS that a foreign jurisdiction taxes the reinsurance premiums at a rate as high as or higher than the US corporate rate, the deduction for the reinsurance premiums would be allowed.

Limitation on treaty benefits

Camp: The Camp discussion draft would deny treaty-based withholding tax reductions for deductible payments made to related parties, if the payment would not be eligible for any treaty-based relief if the payment had instead been made to the foreign parent.

Observation: This proposal would primarily impact foreign parent companies that are not located in a US tax treaty jurisdiction. The proposal is the same as a bill introduced by Rep. Lloyd Doggett (D-TX) and passed by the House of Representations in previous years (e.g., H.R. 1556, introduced in April 2013 and H.R. 64, introduced on January 5, 2011). The proposal would reflect a treaty override for deductible payments made to treaty-eligible affiliates of the foreign parent corporation that meet the requirements of an applicable treaty. For this reason, this proposal historically has not garnered support in the Senate, which has the responsibility for ratifying US tax treaties. The Administration budget does not contain this proposal.

Investments in US real property

Camp: Under current Foreign Investment in Real Property Act (FIRPTA) rules, US real property interests (USRPIs) do not include stock of a corporation, if as of the date of disposition of such stock, the corporation does not hold any USRPIs and all of the USRPIs held by such corporation at any time during the shorter of (i) the period after June 18, 1980, during which the taxpayer held such stock of the corporation, or (ii) the five-year period ending on the date of disposition of such stock, were disposed of in transactions in which the full amount of gain (if any) was recognized. This is referred to as the cleansing rule. Under the Camp discussion draft proposal, the cleansing rule would not apply to any interest in a corporation that is or was taxable as a REIT or RIC under subchapter M during the relevant testing period, or that is a successor to a corporation taxable under subchapter M in which the taxpayer held an interest at any time during the five-year period ending with the date of disposition of the interest in the successor. The proposed effective date has a retroactive impact in that it applies to dispositions after December 31, 2014 of interests currently held by a foreign person.

Administration Budget: The Administration's FY 2015 budget proposal would provide a favorable exemption from tax for gains on the disposition of USRPIs owned by foreign pension funds. The proposal is similar to a favorable proposal in the Senate Finance Committee international tax discussion draft.

Foreign person's sale of partnership interests

Administration Budget: The Administration's FY 2015 budget proposal would codify the IRS' ruling position in Rev. Rul. 91-32 by taxing foreign investors' gains from sales or exchanges of interests in partnerships conducting a US trade or business. The proposal would also include a new enforcement provision to require the tax to be withheld by the purchaser of the partnership interest, and where the purchaser fails to do so, by the partnership itself on distributions to the purchaser.

Observation: The Administration's proposal is identical to prior proposals from the Administration and the Senate Finance Committee international tax discussion draft. The IRS is also currently litigating its ruling position which has been questioned by many practitioners. The Camp discussion draft does not contain this proposal.

FATCA

Administration Budget: The Administration's 2015 budget proposal would require certain financial institutions to report the account balance (including the cash value or surrender value for a cash value insurance or annuity contract) for all financial accounts maintained at a US office and held by foreign persons. The proposal would expand the current reporting required with respect to US source income paid to accounts held by foreign persons to include similar non-US source payments. The Secretary would be granted authority to issue regulations including requiring financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, and information with respect to financial accounts held by certain passive entities with substantial foreign owners.

Observation: This proposal is consistent with a commitment made by the United States in its intergovernmental agreements (IGAs) implementing FATCA. It would allow the United States to provide foreign governments the same scope of information regarding US accounts maintained by residents of the IGA partner country that the partner country obligates to provide to the United States and expands the information reporting requirements for US financial institutions. The Camp discussion draft does not contain this proposal.

Passenger cruise income

Camp: The Camp discussion draft would change the taxation of foreign persons' income derived from the operation of passenger cruises by treating the portion of passenger cruises earned on any day in US territorial waters as taxable income that is effectively connected with a US trade or business.

Observation: The Camp proposal would eliminate the nearly century-long exemption from US federal income tax for income from passenger cruises, but unlike an earlier Senate proposal, would not override existing treaty obligations.

The takeaway

The Camp discussion draft and the Administration's 2015 Budget proposal contain a number of significant US inbound proposals. Although tax reform in the near future is unlikely, US inbound companies should consider the impact of the various proposals, as it is possible certain provisions may be used as revenue raisers in other bills.

Let's talk

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

International Tax Services

Oren Penn
+1 202 414 4393
oren.penn@us.pwc.com

Bernard Moens
+1 202 414 4302
bernard.moens@us.pwc.com

Steve Nauheim
+1 202 414 1524
stephen.a.nauheim@us.pwc.com

US Inbound Tax

Joel Walters
+1 202 414 4323
joel.walters@us.pwc.com

For more information

For a more in-depth discussion of the international tax proposals in the Camp discussion draft, the Administration FY 2015 budget, and the Senate Finance Committee discussion draft, see the following insights:

- 2014 Camp discussion draft changes previously proposed international tax regime, March 11, 2014.
- Obama Administration FY 2015 budget focuses on tax reform, deficit reduction, and new initiatives, March 4, 2014.
- Senate Finance Committee Chairman Baucus releases international tax reform discussion draft, November 20, 2013.
- Senate Finance Committee discussion draft includes certain proposals impacting US inbound investment, November 27, 2013.