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International Tax

United States Tax Alert

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Administration proposes six new international tax revenue raisers in its proposed FY2015 budget

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On March 4, 2014, the Obama Administration released its FY2015 Budget and the Treasury Department released the General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (the Greenbook).

In addition to 10 international tax proposals carried over from the FY2014 Budget (prior proposals) which would raise roughly $170 billion over the ten year budget window and whose descriptions in the new Greenbook are nearly identical to last year's, the new budget includes six new proposals raising over $100 billion that would tighten the subpart F, thin capitalization, and anti-inversion rules.[1]

The purpose of this alert is to briefly discuss the new provisions.

"Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups"

The proposal would generally impose a limit on the U.S. interest deductions of certain members of a group of entities based on their shares of the group's earnings before net interest expense, taxes, depreciation, and amortization (EBITDA), in the case of a group that reports at least $5 million of net interest expense on U.S. tax return(s) for a taxable year. Members of a group that is subject to the proposal would be exempt from section 163(j).

The proposal would apply to entities—*other than* "financial services entities"—that are members of a "financial reporting group": that is, a group that prepares consolidated financial statements in accordance with U.S. generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), or other reporting standards prescribed under regulations (which would be expected to include other countries' GAAP in appropriate circumstances).[2]

[1] Unless otherwise indicated, the international tax proposals are generally proposed to be effective for taxable years beginning after December 31, 2014.

[2] A U.S. subgroup within a financial reporting group would be treated as a single group member.

A member's U.S. interest expense deduction would be limited to (i) the member's interest income plus (ii) the member's "proportionate share" of the financial reporting group's net interest expense computed under U.S. income tax principles. "Proportionate share" would generally be based on the member's share of the group's reported EBITDA.[3] If such share is not substantiated, or the member so elects, the limit on its interest deduction would be 10% of adjusted taxable income (ATI) as defined in section 163(j).

Consistent with present-law section 163(j), disallowed interest would be carried forward indefinitely, and excess limitation would be carried forward three years.

Where applicable, the proposal would apply before the application of the Administration's prior proposal that defers interest deductions allocable to deferred foreign earnings.

Observations: In some respects this proposal is similar to Chairman Camp's 2011 and 2014 thin capitalization proposals. However, the Administration proposes a 10%-of-ATI floor under interest deductions, in contrast to the 40%-of-ATI floor in Camp's 2014 discussion draft. In addition, the Administration compares the U.S. subgroup's share of the group's interest expense to its share of the group's EBITDA, while Camp compares the U.S. subgroup's debt-to-equity ratio to that of the worldwide group, and Camp's proposal seems to apply only if the U.S. group includes a 10% U.S. shareholder in a foreign corporation.

"Create a New Category of Subpart F Income for Transactions Involving Digital Goods or Services"

The proposal would create a new category of subpart F income, "foreign base company digital income" (FBCDI). FBCDI would generally include income from the lease or sale of a digital copyrighted article or from the provision of a digital service provided that (i) the CFC uses intangible property developed by a related person, including property developed pursuant to a cost sharing agreement, to produce the income; and (ii) the CFC does not, through its own employees, make a substantial contribution to the development of the property or services that give rise to the income. A same-country exception would exclude income earned by a CFC from customers located in the CFC's country of incorporation, provided that the digital product or service is used or consumed in that country.

Observation: This proposal, as well as the proposals discussing hybrid arrangements, appear to respond to the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS), specifically Action 1 – "Address the tax challenges of a digital economy" and Action 2 – "Neutralize the effects of hybrid mismatch arrangements."

"Prevent the Avoidance of Foreign Base Company Sales Income ('FBCSI') Through Manufacturing Services Arrangements"

The proposal would expand FBCSI to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person (within or outside the United States). The existing exceptions to FBCSI (e.g., the same-country exceptions based on place of production, or the place of use, consumption or disposition for which the property is sold) would continue to apply.

[3] Financial services entities would be excluded from the group for this purpose.

Observation: While not specified in the Greenbook, the proposal would seem to permit the CFC that uses the manufacturing services of a related person nevertheless to avail itself of the regulatory "manufacturing exception" if the CFC is deemed to be the producer of the property under the "substantial contribution" test of Reg. §1.954-3(a)(4)(iv).

"Restrict the Use of Hybrid Arrangements That Create Stateless Income"

The proposal would deny deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. The Greenbook provides no further definition of "certain circumstances" or "hybrid arrangements," although it mentions "repos," hybrid instruments, and hybrid entities as targets of the proposal.

By way of examples, the Greenbook explains that the proposal would deny a U.S. deduction when a taxpayer makes an interest or royalty payment to a related party, and either (i) as a result of the hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign jurisdiction; or (ii) the hybrid arrangement would permit the taxpayer to claim an additional deduction for the same payment in another jurisdiction.

Regulations could deny deductions:

1. From certain conduit arrangements that involve a hybrid arrangement between at least two of the parties to the arrangement;
2. From hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions; and
3. With respect to payments that, as a result of the hybrid arrangement, are 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%.

Observation: This proposal bears some similarity to parts of proposed Code section 267A ("Related Party Payments Arising in a Base Erosion Arrangement") included in the staff discussion draft released in November 2013 by former Chairman Baucus.

"Limit the Application of Exceptions Under Subpart F for Certain Transactions That Use Reverse Hybrids to Create Stateless Income"

The proposal would provide that the exceptions from foreign personal holding company income in sections 954(c)(3) and 954(c)(6) (the "same country exceptions" and the "CFC look-thru" rule, respectively) do not apply to payments made to a foreign reverse hybrid held directly by a U.S. owner when such amounts are treated as deductible payments received from foreign related persons.

Observations: Although the budget does not appear to propose extending the now-expired section 954(c)(6), the description of this proposal contemplates at least the chance that it will be extended. With respect to the proposal itself, subpart F has generally provided (and the FBCDI proposal would provide) same-country exceptions that are based on the CFC's country of creation or organization. This proposal would represent a departure from that model.

"Limit the Ability of Domestic Entities to Expatriate"

The proposal would tighten the anti-inversion rules of section 7874 in several

ways:

- All “surrogate foreign corporations” as defined in the revised section 7874 would apparently be treated as domestic for U.S. tax purposes. Therefore, the alternative to domestic treatment, which now appears in section 7874(a)(1) (and applies only when continuity of ownership is at least 60% but less than 80%), would be eliminated.

- The definition of surrogate foreign corporation would generally be based on a greater-than-50% continuity of ownership test with respect to an expatriated entity, rather than the at-least-60% ownership test in current law.

- A foreign corporation could also be a surrogate foreign corporation, *notwithstanding* 50%-or-less continuity of ownership, if its affiliated group has substantial business activities in the United States and the corporation itself is primarily managed and controlled in the United States.

In the case of expatriated entities that are domestic partnerships, section 7874 could be applicable to an acquisition either of (i) substantially all of the assets of the domestic partnership (regardless of whether such assets constitute a trade or business), or of (ii) substantially all of the assets of a trade or business of a domestic partnership.

Prior Proposals

The descriptions of the prior proposals in the Greenbook are identical to those in last year's Greenbook, with limited exceptions. (See United States Alert dated April 10, 2013 for a discussion.)

The interest expense disallowance proposal for inverted companies that appeared in the FY2014 and prior budgets seems to have been superseded by the “excessive interest” expense disallowance provision discussed above. Last year’s leveraged dividend provision, which applied to *foreign* funding corporations and *foreign* distributing corporations, has been modified, in that the provision as described in the new Greenbook would apparently apply *without regard* to whether the funding or distributing corporations are foreign or domestic. The description of the proposal on limiting income shifting through intangible property transfers was also modified.

Extenders

The FY2015 Budget does not expressly propose to extend expiring provisions such as section 954(c)(6) and section 954(h) (CFC look-thru and active financing exceptions, respectively).

Treasury Budget Proposal Comparison FY 2014 vs. FY 2015		
Proposal	**Revenue Estimate 2014 Budget (in $billions)**	**Revenue Estimate 2015 Budget (in $billions)**
Defer deduction of interest expense related to deferred income	36.52	43.14
Determine foreign tax credit on a pooling basis	65.75	74.67
Tax currently excess returns associated with	24.0	25.97

transfer of intellectual property offshore		
Limit shifting of income through IP transfers	2.1	2.7
Disallow deductions for non-taxed reinsurance premiums paid to affiliates	6.2	7.57
Modify tax rules for dual capacity taxpayers	10.96	10.38
Tax gain from the sale of a partnership interest on look-through basis	2.65	2.80
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment	3.24	3.55
Extend section 338(h)(16) to certain asset acquisitions	.96	.96
Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated	.39	.42
Exempt certain foreign pension funds from the application of FIRPTA	-2.16	-2.27
Repeal gain limitation for dividends received in reorganization exchanges	2.7	3.05
Limit earnings stripping by expatriated entities	4.66	n/a
Restrict deductions for excessive interest of members of financial reporting groups	n/a	48.6
Create new category of subpart F income for transactions involving digital goods or services	n/a	11.66
Prevent avoidance of FBCSI through manufacturing service arrangements	n/a	24.6
Restrict the use of hybrid arrangements that create stateless income	n/a	.94
Limit the application of exceptions under subpart F to certain transactions that use reverse hybrids to create stateless income	n/a	1.34
Limit the ability of domestic entities to expatriate	n/a	17.0
Total for all international proposals	**157.97**	**277.08**

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