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International Tax

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Administration Proposes Fundamental International Tax Reform in FY2016 Budget

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On February 2, 2015, the Obama Administration (the Administration) released its FY2016 Budget and the Treasury Department released the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (the Greenbook).

The Administration, along with proposing a reduction in the corporate tax rate from 35% to 28%[1], has called for significant changes to the U.S. international tax rules. However, unlike prior budgets, the FY2016 budget proposes the fundamental reform of the U.S. international tax rules to eliminate the "lock-out" effect of current law and depart from the primary reliance on foreign tax credits as the means to prevent international double taxation. The Administration's proposal generally calls for (i) a 100% exemption on dividends from controlled foreign corporations (CFCs), (ii) a 19% worldwide minimum tax on foreign earnings and (iii) a 14% tax on pre-effective date earnings of CFCs as a one-time transition tax into the new regime (the Transition Tax).

The rate at which the Transition Tax is imposed in this proposal is much higher than the rates proposed by former House Ways and Means Committee Chairman Dave Camp (R-MI) in his Tax Reform Act of 2014[2] (the Camp Proposal); however, the effective tax rate on future CFC earnings proposed by the Administration may be more similar than anticipated to rates under the Camp Proposal. The Administration has jettisoned some of its longstanding budget items in the FY2016 Budget because they would no longer be relevant under a dividend exemption system with a minimum tax. The FY2016 budget would make the international tax extenders (i.e., active financing and CFC look-through rules) permanent.

In general, the proposals would take effect for tax years beginning after December 31, 2015.

New Proposals

19% Minimum Tax on Foreign Earnings

[1] The reduction in U.S. corporate tax rate is consistent with the President's 2012 Framework for Business Tax Reform. See FY2016 Budget (pg. 56) and FY2016 Analytical Perspectives (pg. 262).
[2] *See* H.R. 1, 113th Cong. (2014).

Proposal description: The FY2016 Budget proposal generally eliminates the U.S. taxation of dividends received by corporate U.S. shareholders from CFCs and in its place would generally seek to ensure that at least a 19% worldwide tax is imposed on CFCs' earnings. This same treatment would generally apply to income of a foreign branch of a domestic corporation. CFC earnings would no longer be taxed to U.S. shareholders on the basis of CFC investments in U.S. property.

The minimum tax rate would not apply to subpart F income, which would continue to be subject to current U.S. tax at the full U.S. tax rate. Thus, for U.S. corporate shareholders all CFC earnings will be subject to immediate U.S. taxation at either full U.S. rates for subpart F income or the residual minimum tax rate (if greater than zero) for non-subpart F income.

Under the proposal, foreign earnings would be subject to current U.S. taxation to ensure a per-country minimum rate of taxation of 19% on all current foreign earnings of CFCs and foreign earnings of a U.S. corporation from a foreign branch or the performance of services abroad, less an "allowance for corporate equity" (ACE) that would exempt from U.S. tax a risk-free rate of return on equity invested in active assets. The residual (U.S.) minimum tax rate on earnings assigned to a particular foreign country would be computed by subtracting 85% of that country's foreign effective tax rate from the 19% tentative minimum tax rate. Interest expense allocated and apportioned to foreign earnings subject to the minimum tax would be deductible at the residual U.S. tax rate applicable to those earnings, if any.

A taxpayer's foreign effective tax rate for a country would be computed on an aggregate basis for all foreign earnings and associated taxes assigned to that country over a 60-month period[3] based on tax residence in that country under foreign law. If the same earnings are subject to tax in multiple jurisdictions, such earnings would be assigned to the jurisdiction with the highest tax rate.
There would be no U.S. tax on the sale of stock in a CFC to the extent the gain reflects undistributed earnings of the CFC already subject to minimum tax, subpart F or the Transition Tax.

Observations: The proposal is the Administration's response to tax reform proposals in Congress, which include a shift to a territorial system of taxing offshore income. As a result of allowing only 85% of the foreign effective tax rate to reduce the 19% minimum tax, taxpayers could pay as much as 22.35% worldwide and could suffer some double taxation unless the allowance for corporate equity is at least 15% of pre-ACE-deduction earnings that are used to compute the foreign effective tax rate.

It appears the Administration intends for section 902 to be repealed under the proposal because dividends would be 100% exempt from additional U.S. tax. As a result, and as under other territorial systems, low-taxed or non-taxed foreign source income (such as interest and royalties) would no longer be sheltered by excess foreign income taxes that are deemed paid in connection with dividends under present law.

The proposal further indicates that to the extent a foreign branch's income is related to intellectual property, there will be a deemed royalty from the foreign branch to the U.S. corporation, and only foreign branch earnings net of the

[3] The 60-month period ends on the date on which the CFC's year ends (or domestic corporation's year in the case of foreign branch earnings or foreign earnings from services).

deemed royalty would be subject to the benefit of the minimum tax rate. The deemed royalty income would be subject to U.S. tax at full rates.

It is also important to note that with respect to a U.S. corporate shareholder's interests in non-CFCs, the foreign earnings of a non-CFC would not be subject to the minimum tax and thus dividends received from non-CFCs would not be eligible for the 100% dividend exemption. Because the minimum tax applies only to U.S. corporate shareholders of CFCs, it appears that pre-existing current law will continue to apply to any individual U.S. shareholders of CFCs.

14% Transition Tax on Accumulated Foreign Earnings

Proposal description: In connection with the transition to the minimum tax, the FY2016 Budget proposal would impose a one-time 14% (40% of current U.S. tax rate) Transition Tax on earnings accumulated in CFCs and not previously subject to U.S. tax. Foreign tax credits would be permitted to reduce the U.S. tax liability, limited to the amount of credits associated with such earnings multiplied by 40% (14%/35%). The tax due on the accumulated earnings would be payable ratably over five years.[4]

The accumulated earnings subject to the Transition Tax could be repatriated exempt from further U.S. tax.

The Transition Tax would apply to earnings accumulated for taxable years beginning before January 1, 2016.

Observations: A similar transition tax introduced in the Camp Proposal would tax accumulated earnings and profits (E&P) at a 3.5% rate, and accumulated E&P held in the form of cash or cash equivalents at an 8.75% rate, with an eight-year installment period to pay the tax liability. The Administration's proposal imposes a higher tax rate and shorter payback period for taxpayers, while failing (unlike the Camp Proposal) to take into account that not all earnings are associated with liquid assets. The Administration proposal, like the Camp Proposal, does not impose an interest charge on the deferred tax. The proposal is unclear on whether the Transition Tax would be imposed on a separate company basis or a pooled basis, and thus whether CFCs with accumulated earnings deficits would be able to offset CFCs with positive accumulated earnings.

The impact the Transition Tax could have on earnings for companies that assert the permanent reinvestment of foreign earnings under U.S. GAAP principles should also be considered.

Restrictions on Excessive Interest Deductibility for Members of Financial Reporting Groups

Proposal description: The FY2016 Budget modifies a similar proposal that appeared in the FY2015 Budget to limit excessive interest deductions. It should be noted the proposal is similar to the OECD proposal to limit interest deductions.[5]

A group of entities that prepares a consolidated financial statement would determine its net third-party interest expense and then allocate it among the members in order to place a limit on their interest deductions. The allocation would be on the basis of a member's economic activity, as measured by earnings

[4] There appears to be no interest associated with the five year pay-off.
[5] *See* Public Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments, issued December 18, 2014.

before interest, taxes, depreciation, and amortization (EBITDA), compared to that of the entire financial statement reporting group. The proposal treats a “U.S. subgroup” as a single member of a financial statement reporting group. A U.S. subgroup is defined as a U.S. entity that is not owned directly or indirectly by another U.S. entity, plus all foreign and domestic members of the financial statement reporting group owned directly or indirectly by such entity. In general, the steps below outline the process for determining the disallowed portion of a member’s net interest expense.

1. Determine the proportion of the member’s EBITDA, on a separate company basis, to the financial reporting group’s consolidated EBITDA for financial reporting purposes[6] (proportionate share).
2. Multiply the proportionate share by the group’s consolidated financial statement net interest expense (interest expense cap).
3. Compare the interest expense cap to the member’s net interest expense for financial reporting purposes. If the interest cap is less than the member’s net interest expense, determine the ratio of the excess interest expense to the member’s net interest expense (excess interest expense ratio).
4. Multiply the excess interest expense ratio by the member’s net interest expense for tax purposes to determine the disallowed interest deduction.

Consistent with present-law section 163(j), disallowed interest would be carried forward indefinitely, and excess limitation would be carried forward three years. Instead of the method describe above, the member could elect to deduct interest up to interest income plus 10% of adjusted taxable income.

For a U.S. subgroup that owns one or more foreign corporations, the proposal makes it clear that the restrictions on excess interest deductions apply before the allocation and apportionment of interest expense to foreign earnings which, if subject to the minimum tax, would be deductible at the residual U.S. tax rate applicable to those earnings.[7]

Observations: The proposal generally adopts two approaches, described in Discussion Draft of BEPS Action Item 4, to limiting excessive interest deductions: the group-wide approach to limiting member interest deductions, and a low-threshold fixed ratio approach.[8] Because a U.S. subgroup includes all foreign members of the financial statement reporting group directly or indirectly owned by a U.S. member of the U.S. subgroup, it would appear that the group-wide approach would not apply to U.S.-based multinationals. The use of financial statement reporting as a means of calculating a group member’s proportionate share of interest deductions may not properly reflect an entity’s true tax reality due to earnings volatility that can skew results year over year, among other things. Additionally, the requirement for companies to create accurate separate company financials could increase compliance costs and administrative complexity associated with the allocation of interest expense.

Repeal Delay of Worldwide Interest Allocation

Proposal description: The proposal would make available the worldwide affiliated group election under section 864(f) for allocating interest expense deductions between U.S. and foreign source gross income, effective immediately.

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[6] U.S. GAAP, IFRS, or other method authorized by the Secretary under regulations.
[7] Interest allocated and apportioned to foreign earnings subject to subpart F would still be deductible at the full U.S. tax rate.
[8] *See* Public Discussion Draft on BEPS Action 4.

While section 864(f) was originally enacted for taxable years beginning after December 31, 2008, subsequent legislation deferred the election until tax years beginning after December 31, 2020.[9]

Observations: The election under section 864(f) would be beneficial to the taxpayer by reducing the amount of interest expense allocated against foreign source income, and thus would reduce the amount of interest expense that must be deducted at the lower U.S. residual minimum tax rates applicable to such income under the minimum tax proposal.

Subpart F Proposals

In the FY2016 Budget, the Administration lays out three new proposals related to subpart F that would tighten CFC attribution rules, eliminate the 30-day grace period for CFCs, and make extenders permanent. The Greenbook also contains three carryover items from the FY2015 budget that create a new category of subpart F for transactions involving digital goods and services, make the same-country and CFC look-through rules inapplicable for payments to reverse hybrid entities, and expand foreign base company sales income to include manufacturing services agreements.

New Subpart F Proposals

Proposal descriptions: Unlike current law, which does not provide for downward attribution of stock owned by a foreign parent to a U.S. subsidiary, the proposal would expand section 958(b) to attribute ownership of the stock of a foreign corporation that is owned by a foreign parent to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation, and therefore, whether the foreign corporation is considered a CFC. However, the U.S. shareholder's pro-rata share of a CFC's subpart F income would not be affected by the proposal, as a U.S. shareholder's pro-rata share is determined under the ownership rules of section 958(a). Also, the Administration proposes to eliminate the need for an uninterrupted 30-day period of CFC status to determine whether a U.S. shareholder is subject to subpart F inclusions with respect to a CFC.

Additionally, the FY2016 Budget contains proposals to permanently extend section 954(c)(6) (look-through treatment of payments between related CFCs) and section 954(h), (i), and related provisions (exceptions for active financing income from the definitions of foreign personal holding company income and subpart F insurance income).

Observations: The expansion of the ownership attribution rules to prevent the "de-control" of CFCs complement the proposed changes to the section 367(b) regulations in Notice 2014-52, which would generally result in a deemed dividend inclusion of the section 1248 amount attributable to the stock of the expatriated foreign subsidiary[10] in certain post-inversion nonrecognition transactions that dilute a U.S. corporation's ownership in a CFC.[11] Unlike the rules in the notice

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[9] The subsequent legislation consisted of a two year deferral by section 3093 of the Housing Assistance Tax Act of 2008 (H.R. 3221, Pub.L. No. 110-289), an additional seven-year deferral by section 15 of the Worker, Homeownership, and Business Assistance Act of 2009 (H.R. 3548, Pub.L. No. 111-92), and finally an additional three-year deferral by section 551 of the Hiring Incentives to Restore Employment Act of 2010 (H.R. 2847, Pub.L. No. 111-147).

[10] An expatriated foreign subsidiary is defined as a CFC for which an expatriated entity is a US shareholder, and then only for the 10-year inversion gain period of section 7874.

[11] *See* Notice 2014-52 which applies to transactions concluded on or after September 22, 2014.

relating to the de-control of CFCs, it would appear the proposal will apply to all inbound companies, regardless of whether a U.S. corporation recently inverted.

The proposal would apply for tax years beginning after December 31, 2015 and thus, structures that pre-date the effective date of the proposal could be subject to the provision for post-effective date years.

Carryover Subpart F Proposals

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

Proposal description: 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 – *"Addressing the Tax Challenges of the Digital Economy"* and Action 2 – *"Neutralising the Effects of Hybrid Mismatch Arrangements."*

Apply Subpart F to Stateless Income from Reverse Hybrids

Proposal description: 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-through" 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.

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

Proposal description: 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.

Observation: While not specified in the Greenbook, the proposal would seem to permit a 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).

Inversion Proposal

Proposal description: The budget includes a revised version of the anti-inversion provision the administration proposed in FY2015. For transactions that are completed after December 31, 2015, the revised proposal would, like last year's, amend section 7874 to reduce the current 80% continuity-of-ownership test (for determining whether a new foreign parent would be treated as domestic for U.S. tax purposes post-inversion) to a greater-than-50% test and eliminate the 60% test entirely. However, this proposal adds a special rule providing that an inversion transaction would be deemed to occur – regardless of the continuity of ownership – if:

- Immediately before the acquisition, the fair market value of the stock of the domestic entity is greater than that of the foreign acquirer;
- The expanded affiliated group (EAG) is primarily managed and controlled in the United States; and
- The EAG does not conduct substantial business in the country where the foreign acquirer is created or organized.

The IRS would be given the authority to share tax return information with other federal agencies for the purpose of administering anti-inversion rules with an effective date of January 1, 2016, regardless of when the inversion transaction occurred.

Observations: Relative to last year's proposal, the FY2016 proposal significantly clarifies and narrows the scope of the new anti-inversion rules that would apply regardless of continuity of shareholder ownership, because the FY2016 proposal would expressly exclude transactions where foreign corporations acquire smaller (by value) domestic entities from being classified as inversion transactions absent sufficient continuity of shareholder ownership.

Hook Stock

Proposal description: The budget includes a new proposal that will treat a subsidiary's acquisition of a parent company's stock (hook stock) for property as a deemed distribution (through any intervening entities) from the subsidiary to the stock issuer. The hook stock would be treated as a contribution from the issuer to the subsidiary acquiring the hook stock. The proposal would also grant the Secretary authority to prescribe regulations to apply the rule to subsidiary purchases of interests in entities other than corporations and provide rules related to hook stock in a consolidated group.

Observations: The purchase of hook stock by a CFC subject to the 19% minimum tax would not result in any further U.S. taxation due to the 100% dividend exclusion, but the deemed distribution would be subject to U.S. withholding tax when deemed paid to a non-U.S. seller. Assuming the hook stock has zero basis, the deemed contribution of the hook stock could create a series of tax implications, including gain recognition under section 367(a) equal to the fair market value of the U.S stock deemed contributed to a CFC.

Other Carryover Proposals from Prior Budget Proposals

The descriptions of carryover proposals in the Greenbook are nearly identical to those provided in last year's Greenbook.

Business Tax Incentives

Proposal description: The FY2016 Budget, like the FY2015 budget, includes incentives to bring offshore jobs and investments into the U.S. The proposal would create a new business credit that would allow for 20% of eligible expenses incurred with insourcing a U.S. trade or business to be credited by the taxpayer. Eligible expenses do not include capital expenditures or costs for severance pay and other assistance to displaced workers.

On the other hand, the proposal reduces the tax benefits of moving a U.S. trade or business offshore by disallowing eligible expenses paid or incurred with outsourcing a U.S. trade or business. Additionally, no deduction will be allowed against the subpart F income of a CFC associated with moving a U.S. trade or business offshore.

The proposal would be effective for eligible expenses paid or incurred after the date of enactment.

Observations: The proposal seems to be aligned with the Administration's attempts to strengthen the current system's tools to combat incentives to shift income outside the United States by imposing greater costs on transferring assets offshore.

Restrict the Use of Hybrid Arrangements

Proposal description: 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%.

Observations: The proposal is generally consistent with the BEPS Action Item 2 – *"Neutralising the Effects of Hybrid Mismatch Arrangements."* This proposal also 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.

Exempt Foreign Pension Funds from FIRPTA

Proposal description: The Foreign Investment in Real Property Tax Act

(FIRPTA) generally imposes a tax on gains of foreign individuals or foreign corporations from the disposition of U.S. real property interests. The proposal would exempt from the application of FIRPTA the gains of foreign pension funds derived from the disposition of U.S. real property interests. For purposes of this exemption, generally, a foreign pension fund would mean a trust, corporation, or other organization or arrangement that i) is created or organized outside of the United States, ii) is exempt from income tax in the jurisdiction in which it is created or organized, and iii) substantially all the activity of which is to administer or provide pension or retirement benefits. .

Observations: The proposal is part of the Administration's "Rebuild America Partnership" aimed at encouraging private investment in U.S. infrastructure. U.S. pension funds are generally exempt from U.S. tax upon the disposition of U.S. real property investments. By exempting their gains from the disposition of U.S. real property interests, this proposal would put foreign pension funds on an approximately equal footing with U.S. pension funds and would therefore encourage foreign private investment in U.S. infrastructure. In its description of the current law, the proposal discusses the application of FIRPTA to the sale of both directly-held real property and stock in a domestic corporation. However, it is unclear whether the proposed exemption would apply to the sale of all U.S. real property interests including directly held real property, or if, similar to the exemption provided to foreign governments and international organizations under section 892, the exemption would apply only to investments in stock in domestic corporations.

Sale of a Partnership Interest on a Look-Through Basis

Proposal description: Gain or loss from the sale or exchange of a partnership interest would be effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to effectively connected income (ECI) property. In addition, the transferee of a partnership interest would be required to withhold 10% of the amount realized on the sale or exchange of the interest unless the transferor certifies that it is neither a nonresident alien individual nor a foreign corporation. Reduced withholding would apply if the transferor obtains a withholding certificate from the Internal Revenue Service (IRS) establishing that the transferor's ultimate tax liability is less than the amount otherwise required to be withheld. If the transferee fails to withhold the correct amount, the partnership would be liable for any underwithholding.

Observations: The proposal essentially codifies Rev. Rul. 91-32 and extends FIRPTA-type withholding to sales or exchanges of partnership interests. The Administration is concerned that foreign taxpayers may be taking a position contrary to Rev. Rul. 91-32 because no Internal Revenue Code provision explicitly treats gain from the sale or exchange of a partnership interest as ECI. The Administration appears to think it inappropriate for inside gain derived from ECI assets to escape taxation where, without partner-level tax on gain, that inside gain will disappear where the partnership elects under section 754 to adjust the basis of its assets upon transferring a partnership interest to reflect the transferee partner's outside basis.

While the policy for the rule may be supportable, the adoption of a FIRPTA-like withholding regime in the partnership context would create several administrative difficulties for taxpayers and the IRS. First, it is unclear how the transferor would obtain the information required to compute its tax liability, as the gain or loss "attributable to" ECI property is a partnership-level determination which would

presumably require a valuation of all of the partnership's assets on the date of any transfer of a partnership interest. Second, there could be overwithholding in many circumstances, which would either require the processing of withholding certificates or refund claims by the IRS. Obtaining a withholding certificate from the IRS to reduce withholding would presumably require the partnership to produce a detailed computation of the unrealized gain or loss in each of its assets, which may not be possible prior to the transfer in many cases. FIRPTA has similar issues in the partnership context that create significant uncertainty for taxpayers and with respect to which regulations have never been issued.

Prevent Use of Leveraged Distributions

Proposal description: Section 301(c) provides that a distribution of property to a shareholder is characterized first as a dividend to the extent of the distributing corporation's E&P, then as a return of basis, and last as gain from the sale or exchange of property. The proposal would prevent return of basis treatment under section 301 to the extent a related corporation (the "funding corporation") funds a second, related corporation (the "distributing corporation") in a transaction with a principal purpose of avoiding dividend treatment on distributions from the funding corporation.

Observations: While one might wonder why the proposal has any purpose in the context of a 100% dividend exemption regime, it is important to note that the current regime only applies to corporate shareholders of CFCs. Thus, for individual shareholders or corporate shareholders of non-controlled foreign corporations the proposal continues to have potential effect.

Extend Section 338(h)(16) to Certain Asset Acquisitions

Proposal description: A "section 338 election" allows a corporation that makes a "qualified stock purchase" of another corporation's stock to step up the tax basis of the target corporation's assets to fair market value. Section 338(h)(16) prevents use of this election to increase allowable foreign tax credits by providing that the deemed sale is ignored when sourcing and characterizing items for purposes of computing the foreign tax credit limitation.

Section 901(m) denies certain foreign taxes paid or accrued after a "covered asset acquisition." Section 901(m) provides the term "covered asset acquisition" means:

A. A qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,
B. Any transaction which –
    i. is treated as an acquisition of assets for purposes of this chapter, and
    ii. is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,
C. Any acquisition of an interest in a partnership which has an election in effect under section 754, and
D. To the extent provided by the Secretary, any other similar transaction. A covered asset acquisition includes transactions that are treated as asset acquisitions for U.S. tax purposes but as the acquisition of an interest in an entity for foreign tax purposes.

Observations: The Administration believes that covered asset acquisitions not

currently subject to section 338(h)(16) pose the same ability to inappropriately increase the foreign tax credit limitation as qualified stock purchases for which a section 338 election is made. However, sourcing additional transactions under the section 865 rules for sourcing stock gains may result in double taxation as section 865 often sources stock gains as U.S.-source under the assumption that stock gains are not taxed in foreign countries. This assumption can frequently be incorrect.

This proposal may also be viewed as targeting the check-the-box regulations. Although the Administration abandoned its check-the-box proposal in the FY2010 Budget, it may be using a targeted proposal to address the application of the check-the-box regulations in the international context.

Remove Foreign Taxes from Tax Pool when Earnings are Eliminated

Proposal description: Certain transactions result in a reduction, allocation or elimination of a corporation's E&P by other means than a dividend or deemed dividend or a section 381 transaction, such that there is no corresponding reduction in the associated foreign taxes paid, e.g. a redemption of a corporation's stock that is treated as a sale or exchange under section 302(a) where there is a reduction of the company's E&P under section 312(n)(7). The proposal would reduce a foreign corporation's tax pool to the extent foreign taxes are associated with a reduction in such corporation's E&P other than by reason of a dividend, deemed dividend or a section 381 transaction.

Observations: This proposal is consistent with the policy of the 1997 final regulations under section 902, which removed from the tax pool any foreign taxes attributable to distributions to ineligible shareholders and eligible shareholders that chose to deduct foreign taxes.

Deductibility of Reinsurance Premiums

Proposal description: U.S. insurance companies would be denied a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates to the extent the foreign reinsurers are not subject to U.S. income tax with respect to premiums received. The proposal would exclude from the insurance company's income any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied. Alternatively, a foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the U.S.

Expand Definition of "Intangible Property"

Proposal description: The proposal would add "workforce in place," "goodwill" and "going concern value" to the items included in the definitions of "intangible property" for purposes of sections 367(d) and 482. The Greenbook describes these modifications as "clarifications" of existing law. In addition, the proposal would also "clarify" that, in a transfer of multiple intangible properties, the IRS may value the intangible properties on an aggregate basis "where that achieves a more reliable result." Finally, the proposal would clarify that intangible property must be valued at its highest and best use, as it would change hands between a willing buyer and a willing seller.

Observations: While this proposal may be consistent with some positions taken by the IRS in connection with section 367(d) and cost sharing, it would be inaccurate to describe the proposal as a clarification with respect to foreign goodwill and going concern value, which have long been expressly excluded from the operation of section 367(d).

Eliminating the Boot Within Gain Rule

Proposal description: "Boot" (property other than certain stock or securities) received by an exchanging shareholder in certain corporate reorganizations is generally not taxable to the recipient to the extent that it *exceeds* the gain realized by the shareholder in the exchange. The proposal would remove this "boot within gain" limitation in situations where the acquiring corporation is foreign and the exchange "has the effect of the distribution of a dividend" within the meaning of section 356(a)(2).

Observations: The proposal is the latest in the Government's effort to crack down on repatriation transactions. It would change the treatment of, for example, "all-cash D" reorganizations where the exchanging shareholder has no built-in gain in the stock of the acquired corporation.

Modify Tax Rules for Dual Capacity Taxpayers

Proposal description: Additional restrictions would be placed on the creditability of foreign taxes paid by "dual capacity taxpayers," taxpayers that pay a levy to a foreign government and also receive a specific economic benefit from that government. Under a regulatory safe harbor, if a foreign country does *not* generally impose an income tax, a dual capacity taxpayer is entitled to treat a levy by that country as a creditable tax to the extent of the product of the taxpayer's net income and the applicable U.S. federal tax rate. The proposal would convert the special foreign tax credit limitation rules of section 907 into a separate basket for foreign oil and gas income. The proposal would not override a U.S. tax treaty that allows a credit for a foreign tax paid or accrued on certain oil or gas income.

Observations: Under the proposal a foreign tax generally would be considered creditable only if the foreign country generally imposes an income tax. A country would meet this requirement only if it imposes an income tax that applies to trade or business income from sources in the country, and the tax has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country.

FY15 Budget Proposals Excluded from FY16 Budget

Three proposals contained in the FY2015 budget proposal were removed from the current FY2016 budget. Many of the FY2016 proposals suggest a transition to a minimum tax territorial regime; therefore, the proposals below were likely removed due to inapplicability.

Defer Deductions of Interest Expense Related to Deferred Income
The FY2015 budget contained a different limitation on interest expense which required deferral of interest expense properly allocated and apportioned to stock of a foreign corporation to the extent such interest expense exceeds the taxpayer's pro-rata share of income from subsidiaries currently subject to U.S. tax.

Determine Foreign Tax Credit on a Pooling Basis

The FY2015 budget placed restrictions on foreign tax credits to reduce residual U.S. tax through "cross-crediting," by requiring taxpayers to determine deemed paid credits under section 902 on a consolidated basis, looking to aggregate foreign taxes and E&P of all foreign subsidiaries where sufficient section 902 ownership exists. Under the former proposal, total deemed paid credits would then be limited to an amount proportionate to the taxpayer's pro-rata share of the consolidated E&P of such foreign subsidiaries that are repatriated into the U.S. and subject to U.S. tax.

Current Taxation on Excess Returns Associated with Intangible Property Transfers

Restrictions on the use of intangible property by CFCs were included in the FY2015 budget. The proposal would have treated certain excess income attributable to intangibles transferred offshore to a related CFC located in a low-tax jurisdiction as Subpart F income.

Comparison of FY2015 Budget Revenue to FY2016 Budget Revenue

Treasury Budget Proposal Comparison FY 2015 vs. FY 2016		
Proposal	Administration Revenue Estimate (in $billions)	
	2015 Budget	2016 Budget
Repeal delay in the implementation of worldwide interest allocation	n/a	-12.21
Extend the exception under Subpart F for active financing income	n/a	-81.33
Extend the look-through treatment of payments between related CFCs	n/a	-9.73
Impose a 19% minimum tax on foreign income	n/a	205.98
Impose a 14% one-time tax on previously untaxed foreign income	n/a	268.13
Amend CFC attribution rules	n/a	3.40
Eliminate the 30-day grace period before subpart F inclusions	n/a	1.20
Hook stock	n/a	.06
Limit shifting of income through IP transfers	2.7	3.07
Disallow deductions for non-taxed reinsurance premiums paid to affiliates	7.57	7.39
Modify tax rules for dual capacity taxpayers	10.38	10.32
Tax gain from the sale of a partnership interest on look-through basis	2.80	2.97
Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment	3.55	0.25
Extend section 338(h)(16) to certain asset acquisitions	.96	.67
Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated	.42	.32
Exempt certain foreign pension funds from the application of FIRPTA	-2.27	-2.40
Repeal gain limitation for dividends received in reorganization exchanges	3.05	0.63
Limit earnings stripping by expatriated entities	n/a	n/a

Restrict deductions for excessive interest of members of financial reporting groups	48.6	64.13
Create new category of subpart F income for transactions involving digital goods or services	11.66	8.71
Prevent avoidance of FBCSI through manufacturing service arrangements	24.6	18.38
Restrict the use of hybrid arrangements that create stateless income	0.94	1.13
Limit the application of exceptions under subpart F to certain transactions that use reverse hybrids to create stateless income	1.34	1.40
Limit the ability of domestic entities to expatriate	17.0	12.75
Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas	-0.21	-0.25
Defer deduction of interest expense related to deferred income	43.14	n/a
Determine foreign tax credit on a pooling basis	74.67	n/a
Tax currently excess returns associated with transfer of intellectual property offshore	25.97	n/a
Total for all international proposals	**276.87**	**504.97**

Legend: New Proposals, Carryover Proposals, Excluded Proposals

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