Deloitte.

International Tax

United States Tax Alert

November 20, 2013

Baucus tax reform discussion draft takes on international tax rules

Contacts

Gretchen Sierra
gretchensierra@deloitte.com

Harrison Cohen
harrisoncohen@deloitte.com

Timothy Tuerff
ttuerff@deloitte.com

James Gannon
jgannon@deloitte.com

Tax reform efforts in the Senate entered a new phase on November 19 as Finance Committee Chairman Max Baucus, D-Mont., released a staff-level discussion draft of a proposal to overhaul the tax rules governing U.S. multinational corporations.

Although it is not an introduced bill, the draft does contain legislative language and indicates what Baucus is contemplating as he undertakes a possible large-scale rewrite of the Internal Revenue Code (IRC). The text of the proposal, summaries of the proposals prepared by Finance Committee staff and a technical explanation prepared by the Joint Committee on Taxation staff were all released on November 19, 2013 (link to Finance Committee website). Baucus has indicated that the draft is intended to be revenue neutral beyond the 10-year budget window.

House Ways and Means Chairman Dave Camp, R-Mich., released his own discussion draft on international tax reform two years ago, but it differs significantly from the Baucus proposal. (For prior coverage of Camp's discussion draft, see International Tax Alert dated October 27, 2011.)

Key proposals of the Baucus discussion draft:

- Eliminate deferral for controlled foreign corporations (CFCs) on a class of gross income and exempt all other CFC earnings;
- Impose a 20% tax on previously deferred earnings, less applicable foreign tax credits, with an election to pay the tax in installments over eight years;
- Eliminate the checkthe-box rules for offshore structures;
- Deny an interest deduction to the extent attributable to exempt CFC income; and
- Expand the definition of intangible property subject to IRC section 367.

Taxation of CFCs

The Baucus draft proposes ending deferral on a class of CFC income as defined under one of two options (referred to as "Option Y" and "Option Z") and then exempting the rest, regardless of whether it is repatriated.

Option Y

- *Overview*: U.S. tax is imposed on certain CFC earnings treated as "subpart F income"; an exemption is provided with respect to the remaining earnings of the CFC through a 100% dividends received deduction (DRD) for dividends to 10% or greater U.S. corporate shareholders.

- *Scope of subpart F*: Option Y would redefine subpart F income to include "United States related income," defined as the sum of "imported property income" and "United States services income."

  - *Imported Property and Services*: "Imported property income" is income earned in connection with the production, sale, leasing or licensing of property into the United States. "United States services income" is defined as income derived in connection with services provided with respect to persons or property located within the United States, or with respect to U.S. risks.

  - *Low Taxed Income*: Option Y would also treat as subpart F income any item of a CFC's income that is subject to an effective foreign income tax rate of less than 80% of the maximum U.S. corporate tax rate ("Low Taxed Income"). The effective rate would be determined under U.S. tax principles and would generally take into account present law net operating loss rules of IRC section 172, but would not take into account any net operating loss carrybacks.

  - *Deduction for Low Taxed Income*: A U.S. shareholder of a CFC would also be allowed a deduction of 20% of the amount included in the shareholder's income as Low Taxed Income. This is intended to set a minimum worldwide tax rate for foreign income based on a percentage of the U.S. domestic corporate tax rate, but the draft does not specify what the post-tax reform domestic rate should be. Further, the percentage itself is bracketed, meaning that it is not a hard target and can be changed.

  - *Elimination of Existing Subpart F Income*: This option would repeal many present law categories of subpart F income, including:

    - foreign base company sales income,
    - foreign base company services income, and
    - foreign base company oil-related income.

    In contrast, foreign personal holding company income would survive in amended form. The active financing exception would be made permanent, with some modifications.

- *Foreign Tax Credit*: The foreign tax credit is retained only with respect to foreign taxes paid or accrued on subpart F income, not foreign earnings of CFCs exempt from U.S. tax. The foreign tax credit baskets, however, are modified to provide for the following baskets:

  - passive income,

- subpart F attributable to insurance income as defined under section 953,
- subpart F attributable to U.S. related income,
- subpart F attributable to Low Taxed Income,
- foreign branch income, and
- income other than that described in the previous five items.

Option Z

- *Overview:* Option Z generally provides for the immediate inclusion of a percentage of certain CFC income and a complete exemption from U.S. tax of certain CFC earnings.

- *Scope of Subpart F:* A U.S. shareholder is subject to current U.S. tax, subject to allowable foreign tax credits, on the shareholder's pro rata share of:

  - 60% of the CFC's net "active foreign market income" (AFMI), and
  - all of the CFC's net "non-active income," including "passive income."

- *Exemption Income*: The remaining 40% of net AFMI is treated as previously taxed income (PTI) and thus is tax-free when distributed. Similarly, a portion of gains and losses on CFC stock is exempt from U.S. tax. Present law sections 956 and 1248 would be repealed.

- *Foreign Tax Credit*: Foreign tax credits are allowed against U.S. tax on these subpart F inclusions, excluding credits for the foreign taxes on the 40% of net AFMI that escapes subpart F income status. Taxes on each of 1) subpart F income from AFMI, 2) passive income and 3) other income, are separately "basketed." Deemed-paid credits (allowable only under section 960) are no longer to be determined on a "pooling" basis. Interest expenses of U.S. shareholders properly allocated and apportioned to the CFC income would be disallowed to the extent of a formulary apportionment between the 40% of a CFC's net AFMI that is excluded from shareholders' income and the remainder of CFC earnings.

- *Active foreign market income:* AFMI would be defined as income attributable to "economically significant activities" with respect to a "qualified trade or business" (a foreign production or service-providing trade or business), derived in connection with property sold for use, consumption or disposition outside the United States, or services provided outside the United States with respect to persons or property located outside the United States.

- *Passive income:* "Passive income" would be defined similarly to foreign personal holding company income under present law (without the application of the "CFC look through" rule). The active financing exception would be made permanent, and somewhat modified, especially in the case of insurance income. CFC-to-CFC dividends would be spared passive income treatment under the PTI rules.

Major changes to international rules in both options

Previously deferred income: To transition to the new system, the draft would require that the U.S. shareholder of a CFC include in income its pro rata share of the accumulated deferred foreign income. A deduction from the mandatory inclusion of earnings and profits is determined by an applicable percentage which is computed under a formula to maintain a 20% rate of tax. The tax on deferred earnings may be reduced by foreign tax credits attributable to the taxable portion of the prior earnings, and the taxpayer may elect to pay the tax in installments over an eight-year period.

Entity classification: Baucus's draft would make a significant change to the application of the check-the-box rules for entity classification. Under the proposal, any business entity that could otherwise elect its tax status would be treated as a corporation if it is wholly owned by a single CFC or by two or more members of an expanded affiliated group (and one of them is a CFC). This provision would treat hybrid entities as CFCs. It would not apply to entities wholly owned by one or more domestic entities.

Other provisions: The draft makes several other important changes, including:

- Revising the definition of intangible property under IRC section 936(h) (and correspondingly, section 367) to include goodwill, going concern value, and workforce in place.
- Denying a deduction to a domestic corporation or foreign corporation with effectively connected income (ECI) for payments made to related parties in what the draft calls a "base erosion arrangement" that reduces the amount of foreign income tax paid by the payee and in which the payments are not included in the income of a U.S. shareholder under IRC section 951(a). (Base erosion arrangements include hybrid transactions—e.g. sale and repurchase agreements—or instruments, hybrid entities, conduit financing arrangements with related parties or arrangements or exemption arrangements (arrangements that reduce the foreign tax on an item of income by 30% or more below the statutory rate).
- Changing the passive foreign investment company (PFIC) provisions by eliminating the qualified electing fund and interest charge regimes, and introducing an interest imputation-like regime in their place; repealing the asset test for PFIC status; and reducing the passive gross income threshold for PFIC status from 75% to 60%.
- Repealing the rules for domestic international sales corporations (DISCs) and dual consolidated losses.
- Codifying the IRS position in Rev. Rul. 91-32 treating dispositions of partnership interests as ECI based on the nature of the assets of the partnership, and requiring the transferee of a partnership interest to withhold 10% of the sales price upon the purchase of a partnership that gives rise to ECI, unless the transferor provides an affidavit stating that it is not a foreign person.

Hatch's reaction

Although Baucus has indicated that he would like to move tax reform legislation through the Finance Committee with support from both parties, ranking Republican Orrin Hatch of Utah did not attach his name to the discussion draft; moreover,

Senate GOP taxwriters generally had urged Baucus to delay releasing a draft proposal until after the House and Senate conferees reach an agreement on a concurrent budget blueprint for fiscal year 2014. (For prior coverage of GOP concerns, see *Tax News & Views*, Vol. 14, No. 43, November 15, 2013.) In a November 19 news release, Hatch noted that there are still "significant policy differences" between Democratic and Republican Finance Committee members on tax reform but otherwise made no comment on specific provisions in the draft.

"I hope that once the budget conference negotiations have concluded that we can renew our discussions to determine whether we can find common ground to overhaul our tax code," the release said.

Baucus seeks public comments

It is important to keep in mind that the draft is not an introduced bill. Instead, Baucus wants the draft "to spur a conversation about areas where Republicans and Democrats may be able to reach agreement on how to fix the broken tax code." To that end, Baucus has issued a request for comments from stakeholders and the public on specific technical and policy issues raised in the discussion draft.

Tax administration, cost accounting drafts to follow

Baucus released a staff draft on tax administration on November 20, and reportedly may release a draft covering the cost method of accounting in the coming days. Deloitte Tax will provide details on those proposals as they become available.

Security | Legal | Privacy

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see http://www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2013 Deloitte Global Services Limited