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International Tax

# United States Tax Alert

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# The International Tax Provisions of the Tax Reform Act of 2014


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On February 26, 2014, Ways and Means Committee Chairman Dave Camp (R-MI) released a discussion draft of a proposed comprehensive overhaul of the Internal Revenue Code, including its international tax rules (the 2014 Draft). The international tax provisions of the 2014 Draft generally follow the territorial regime discussion draft that Chairman Camp released in October 2011 (the 2011 Draft), but with significant changes. The amendments proposed by the 2014 Draft include proposed effective dates that would generally make them effective for taxable years beginning after December 31, 2014.

The purpose of this alert is to provide a brief overview of the international tax provisions of the 2014 Draft, as well as their similarities to, and differences from, the 2011 Draft.

## Outbound provisions

The 2014 Draft would generally change the way that U.S. law prevents double taxation of U.S. corporations' foreign income, by adopting a participation exemption for certain foreign dividends, and it would expand subpart F income to include a new category of "intangible income" similar to that found in Option C of the 2011 Draft.

The similarities between the 2014 Draft and the 2011 Draft include:

- A transition tax on deferred foreign earnings upon conversion to the new system
- A 95% dividends received deduction (DRD) for dividends received from certain foreign corporations
- Eliminating deemed-paid credits with respect to dividends
- Eliminating pooling to determine deemed-paid credits with respect to subpart F inclusions
- Eliminating the allocation and apportionment of indirect expenses in computing the foreign tax credit limitation
- Limiting the U.S. interest deductions of U.S.-based multinationals with disproportionate domestic group (vs. worldwide group) leverage

However, the 2014 Draft varies some of the provisions it shares with the 2011

Draft; includes new provisions not found in the 2011 Draft; and lacks some of the provisions included in the 2011 Draft

## Transition tax

Like the 2011 Draft, the 2014 Draft requires a U.S. shareholder in a CFC or a noncontrolled section 902 corporation (10/50 corporation) to include in the shareholder's income a pro-rata share of non-previously taxed foreign earnings of a foreign corporation as of the end of its last year that begins before 2015. The resulting tax can be paid in installments over eight years. However, the 2014 Draft makes of number of changes including:

- The shareholder's shares of earnings and profits (E&P) deficits of foreign corporations may be netted against the shareholder's inclusions of positive E&P balances from other foreign corporations
- Accumulated pre-1987 E&P is not subject to the inclusion
- Rather than imposing a flat 5.25% tax rate, the 2014 Draft imposes a 3.5% rate on E&P reinvested in business operations and an 8.75% rate on E&P held in the form of cash or cash equivalents
- No interest would be charged on deferred installments of the tax on the inclusion. The installments would cover 8% of the total tax liability per year for the first five years, and then 15, 20, and 25% of the total liability in years 6, 7 and 8, respectively
- Shareholders of an S corporation that must include the deferred foreign earnings in its income can elect to defer tax liability on their shares of the S corporation's inclusion until the occurrence of a "triggering event" (e.g., conversion of the S corporation to a C corporation, or certain dispositions of the S corporation stock)

## Participation exemption

Unlike the 2011 Draft, the 2014 Draft—

- Affords a 95% DRD for dividends received from a "specified 10-percent owned foreign corporation" by a domestic corporation that is a U.S. shareholder in the foreign corporation *without regard to* whether the foreign corporation is, or is treated as, a CFC; thus, the U.S. shareholder need not elect to have the 10/50 corporation treated as a CFC in order to obtain this benefit
- Does not provide a 95% exemption from gains on stock in specified 10-percent owned foreign corporations, except insofar as the gains are deemed to be dividends under section 1248
- Reduces the basis of stock in specified 10-percent owned foreign corporations by the amount of the DRD derived from dividends with respect to such stock, but only for purposes of computing any loss realized on such stock
- Does not change the present-law treatment of branches, and imposes an additional branch-loss recapture rule in the case of a specified 10-percent owned foreign corporation that pays deductible dividends after having acquired the assets of a branch that had previously generated losses deducted by the recipient of the deductible dividends

## Foreign tax credits

The 2014 Draft follows the 2011 Draft with respect to the repeal of the indirect credit for dividends (section 902), the repeal of "pooling" to determine deemed-paid taxes with respect to subpart F inclusions (section 960), and the computation of foreign source taxable income (for section 904 purposes) without regard to indirect expenses.

The 2014 Draft departs from the 2011 Draft in the following respects:

- The separate FTC basket for "passive" income (renamed "mobile" income) would be retained, with the separate basket expanded to include foreign base company sales income, foreign base company intangible income, and financial services income
- Section 909, relating to "foreign tax credit splitting events," would be retained
- Income from the production and sale of inventory property would be sourced solely by reference to the location of production activities (e.g., not in any part based on the "title passage rule")

## Subpart F income

The subpart F provisions of the 2014 Draft vary, in greater or lesser degrees, from those in the 2011 Draft. For example, the 2014 Draft does not repeal section 956 or section 959, and the 2014 Draft indexes for inflation the fixed dollar component of the de minimis exception from foreign base company income and subpart F insurance income (section 954(b)(3)(A)(ii)). In addition:

- *CFC look-through* - The 2014 Draft would make the temporary "CFC look-thru" rule (section 954(c)(6)) permanent, with no break from the expiration date of its last extension

- *High tax exception* - The high tax exception from foreign base company income (section 954(b)(4)) would become mandatory rather than elective, and where the newly proposed minimum worldwide rate approach (described below) does not apply, the threshold for the exception would be 100% of the U.S. rate, rather than 90%

- *Foreign Base Company Intangible Income (FBCII) and deduction for "Foreign Intangible Income"* - The 2014 Draft would create a new residual category of foreign base company income called "foreign base company intangible income" (FBCII) and an accompanying deduction for "foreign intangible income." These provisions are similar, rather than identical, to Option C in the 2011 Draft. The 2014 Draft would afford FBCII, as well as foreign base company sales income (FBCSI) and income excluded from foreign personal holding company income (FPHCI) under the active financing exception, a new "minimum worldwide tax rate" approach similar to Option Y in former Senate Finance Committee Chairman Baucus's staff discussion draft of November 2013. In the case of FBCII, the 2014 Draft is intended to have *the effect of* causing a CFC's FBCII to bear a minimum worldwide tax rate of 15%. The rate of worldwide tax on such income would be greater than 15% only if a *foreign* government imposed a rate

greater than 15%.

- *Foreign base company intangible income* - FBCII would generally be defined by reference to the excess of the CFC's "adjusted gross income" over 10% of its "qualified business asset investment" (generally the adjusted basis in certain tangible property). The "adjustment" in "*adjusted* gross income" backs out gross income from (and investment in) the production or extraction of commodities.

  This profit component of the CFC's entire gross income (other than commodities gross income)—which appears to be intended by the drafters as a proxy for a supranormal level of profit—would be apportioned among all of the types of the CFC's income (other than commodities gross income), and only the portion *not* apportioned to (other) types of foreign base company income would be treated as FBCII. Note that this definition of FBCII is free of any reference to separately identified or valued intangible property (if any) that the CFC could be said to "own" for U.S. federal tax purposes.

  To the extent that a CFC's income to which its FBCII is attributable is "foreign-derived" (i.e., is derived in connection with property sold for use, consumption, or disposition outside the United States, or services provided with respect to persons or property located outside the United States), the 2014 Draft would subject a corporate U.S. shareholder's subpart F inclusion of the CFC's FBCII to a reduced rate of U.S. tax: not the 2014 Draft's fully phased-in 25% rate, but a reduced rate of 15%. (During the overall rate's five-year phase-in period, the effective rate of U.S. tax on a subpart F inclusion of FBCII would approximate 15%.)

  This is achieved by (i) the 2014 Draft's *modified* "high tax exception" specifically for FBCII (under this modification, a "high" foreign tax rate would be 15% or more) and (ii) the 2014 Draft's proposed allowance to domestic corporations of a deduction for "foreign intangible income."

- *Deduction for foreign intangible income* - The deduction for foreign intangible income would be equal to the "applicable percentage" of the lesser of (i) the domestic corporation's taxable income or (ii) the sum of:

  (a) the "foreign percentage" of *the domestic corporation's* "net imputed intangible income," plus

  (b) the domestic corporation's subpart F inclusion of any CFC's FBCII multiplied by *the CFC's* "foreign percentage"

  The "applicable percentage" would ultimately equal 40% starting in 2019 (resulting in an effective U.S. tax rate of 15% on the domestic corporation's net imputed intangible income), and would phase in during the previous four years, such that the effective U.S. tax rate on a domestic corporation's net imputed intangible income and subpart F inclusions of FBCII would approximate 15% as the U.S. corporate tax rate phases down from 35% to 25%.

  "Net imputed intangible income" would be based on the profit component described above that defines FBCII (i.e., adjusted gross income less 10%

of qualified business asset investment), and each corporation's "foreign percentage" would be based on the "foreign-derived" portion of its total adjusted gross income for the taxable year.

- *Foreign Base Company Sales Income (FBCSI)* - The 2014 Draft would modify the definition of FBCSI so as to exclude income of a CFC that is eligible for treaty benefits as a qualified resident of a country that has a "comprehensive income tax treaty" in force with the United States.

  The 2014 Draft would also apply a modified high tax exception to FBCSI, under which a "high" foreign tax rate would be 12.5% or more. Finally, the 2014 Draft would limit a U.S. shareholder's subpart F inclusion of FBCSI to 50% of the CFC's net FBCSI. Notwithstanding the reduced subpart F inclusion, 100% of the taxes paid or accrued by the CFC on the CFC's (unreduced) FBCSI would be deemed paid by a corporate U.S. shareholder on the shareholder's (reduced) subpart F inclusion of FBCSI. Therefore, similar to the 2014 Draft's treatment of FBCII, the 2014 Draft is intended to have *the effect of* causing a CFC's FBCSI to bear a minimum worldwide tax rate of 12.5%.

- *Active Financing Exception from Foreign Personal Holding Company Income (FPHCI)* - The 2014 Draft would generally extend for five years the temporary exception from FPHCI for certain income derived in the active conduct of a banking, financing, insurance, or similar business, *with a significant change*. The extension would only apply to income that is subject to a foreign effective tax rate of 12.5% or more. Active financing income subject to an effective foreign tax rate *less than* 12.5% would *not* be excluded from FPHCI but, like FBCSI, would be subject to a U.S. tax rate of only 12.5% before foreign tax credits.

### Interest expense deductions

With only minor modifications, the 2014 Draft includes the 2011 Draft provisions denying interest expense deductions for corporate U.S. shareholders of worldwide affiliated groups that have "excess *domestic* indebtedness." Under that provision, if the U.S. shareholders (as a group) fail *both* a relative leverage test *and* a percentage-of-adjusted-taxable-income test, their interest expense deductions would be reduced.

The relative leverage test in the 2014 Draft asks whether the U.S. group members' debt exceeds the debt they would owe if their aggregate debt-to-equity ratio were 110% of the worldwide group's ratio. (In the 2011 Draft, the corresponding benchmark was 100%, rather than 110%, of the worldwide group's debt-to-equity ratio.) Net interest expense associated with this excess leverage could potentially be disallowed. However, under the 2014 Draft, such disallowance would be limited to the amount by which the net interest expense of the U.S. group exceeds 40% of its "adjusted taxable income," as defined in present law's "earnings stripping" rules (see below). (In the 2011 Draft, the relevant percentage number was left unspecified.)

## Inbound Provisions

Unlike the 2011 Draft, the 2014 Draft contains several provisions that primarily affect foreign-based multinational enterprises with investments in the United

States.

## Earnings stripping

The 2014 Draft would amend the section 163(j) “earnings stripping” rule that defers or denies a corporate U.S. taxpayer deductions for its “disqualified interest” expense (interest that bears no U.S. tax in the hands of the recipient or that is owed with respect to debt that is guaranteed by a foreign or tax-exempt person) to the extent of the taxpayer’s “excess interest expense.” Generally, the provision would lower, from 50% to 40%, the percentage of the taxpayer’s adjusted taxable income that serves as the general benchmark for determining whether its net interest expense is “excess interest expense;” the 2014 Draft would also eliminate recourse to the taxpayer’s prior three years’ “excess limitation” to increase this threshold.

## Statutory anti-treaty shopping rule

The 2014 Draft would statutorily override treaty protection from the 30% gross-basis U.S. tax in the case of “deductible related-party payments” between members of a foreign controlled group of entities, unless the U.S. tax would have been reduced by treaty if the payment had been made directly to the common foreign parent corporation of the payer and payee. To avoid override of treaty benefits under the provision, the foreign parent corporation need not have been entitled to treaty protection equivalent to (or better than) the treaty protection to which the payee would have been entitled under the payee’s treaty; the foreign parent need only be eligible for at least some treaty protection from the 30% U.S. tax.

## Other inbound items

- *Reinsurance Premiums* **–** The 2014 Draft would deny an insurance company deductions for certain nontaxed reinsurance premiums it pays to affiliated corporations
- *Passenger Cruise Gross Income* – The 2014 Draft would deny “passenger cruise gross income” the benefits of the “reciprocal exemption” that now exempts such income from generally-imposed U.S. tax when a ship operates in U.S. territorial waters
- *“FIRPTA” (Foreign Investment in Real Property Tax Act of 1980)* – FIRPTA’s so-called “purging” rule would not apply to stock in a REIT (or RIC); such stock might thus be treated as a U.S. real property interest (USRPI) even if all of the entity’s USRPIs were disposed of in taxable transactions. As a result, the gain of a foreign corporation or nonresident alien individual from the sale or exchange of such stock following the entity’s disposition of such USRPIs might, in contrast to present law, be taxable by the United States under FIRPTA if the entity had been a “United States real property holding corporation” at any time during the final five years of the shareholder’s holding period of the stock.

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