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Insurance industry impact — Senator Baucus' discussion draft on changes to international tax rules

On November 19, 2013, Senate Finance Committee Chairman Max Baucus, D-Mont., released a "staff discussion draft" of a proposal to fundamentally change the way that U.S.-based multinationals avoid international double taxation of foreign income, and to make other changes to the U.S. international tax rules.

Although it has not been introduced as a bill, the draft does contain statutory language indicating one or more directions that Baucus may contemplate in a large-scale rewrite of the Internal Revenue Code. The text of the proposals and supporting materials (summaries prepared by Senate Finance Committee staff and a technical explanation prepared by the staff of the Joint Committee on Taxation (JCT) are available on the Finance Committee website. Baucus has indicated that the draft is intended to be revenue neutral beyond the 10-year budget window.

Some of the key provisions of the Baucus staff discussion draft, particularly affecting U.S.-based multinationals and other outbound investors, would:

- Impose a 20% tax, less applicable foreign tax credits, on previously deferred controlled foreign corporation (CFC) earnings for years beginning before 2015, with an election to pay the tax in installments over eight years;
- Eliminate deferral for newly defined classes of CFC income and exempt all CFC income from tax upon repatriation;
- Redefine "exempt insurance income";
- Deny U.S. shareholder interest deductions to the extent attributable to exempt CFC income;
- Eliminate check-the-box rules for CFC-owned entities;
- Repeal the dual consolidated loss rules;
- Expand the definition of intangible property for purposes of Section 367[1] and modify the methods for valuing of intangibles under Sections 367(d) and 482; and
- Impose tax on U.S. shareholders of existing interest-charge passive foreign investment companies (PFICs) as of the end of the shareholders' last years beginning before 2015, with an election to pay the tax in installments over eight years; for future years, repeal and replace the "interest charge" and "QEF election" regimes, eliminate the PFIC asset test, and modify the income test.

Some of the key provisions of the Baucus staff discussion draft that would also affect foreign-based multinationals and other inbound investors would:

- Eliminate the "portfolio interest" exception from U.S. gross-basis tax in the case of corporate debt;
- Eliminate the deduction for reinsurance premiums paid, directly or indirectly, to an affiliate when such premiums are not subject to U.S. tax at the assuming company level;
- Eliminate deductions for related-party payments that reduce foreign taxes and involve hybrid transactions, instruments, or entities; conduit financing arrangements; or foreign-law exemptions from income taxes;
- Generally impose 10% withholding tax on transfers by foreign persons of interests in partnerships engaged in U.S. trade or business; and
- Modify the "FIRPTA" rules.

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

Taxation of CFC income

The Baucus staff discussion draft contains two alternative proposals (referred to as "Option Y" and "Option Z") to end U.S. tax deferral on some types of income earned by CFCs, and permanently exempt the remaining types, regardless of whether the earnings are repatriated. As under present law, the type of income taxed currently in U.S. shareholders' hands would be defined as "subpart F income."

1. Option Y

A. General Information

Option Y would create a new category of subpart F income called "Low Taxed Income." Low Taxed Income would be any item of a CFC's income that does not fall within another category of subpart F income (which would no longer include "foreign base company income" but in whose place *would* include foreign personal holding company income, somewhat modified relative to present law, plus the new category of "U.S. related income") *and* that is subject to an effective foreign income tax rate of less than 80% of the maximum U.S. corporate tax rate. (The percentage is bracketed in the discussion draft, meaning that it is not a "hard target" and can be changed.) At the U.S. shareholder level, "Low Taxed Income" inclusions would be favored relative to *other* subpart F income inclusions, because the shareholder would be allowed a deduction of 20% (again, a bracketed number in the discussion draft) of the shareholder's inclusion attributable to Low Taxed Income.

Thus Option Y (similar to the proposal mentioned in the President's Framework for Business Tax Reform (2012)) would result in a minimum worldwide tax rate on CFC income based on a percentage of the U.S. domestic corporate tax rate. (The discussion draft does not specify what the post-tax reform domestic rate should be.)

Other types of subpart F income under Option Y would not benefit from the 20% deduction, and would include a new category called "U.S. related income," defined as the sum of "imported property income" and "U.S. services income." "Imported property income" would be income earned in connection with the production, sale, leasing, or licensing of property imported into the United States by a CFC or related person. "U.S. services income" would be 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.

Foreign personal holding company income (FPHCI) would be the only type of present-law "foreign base company income" to survive (in modified form) under Option Y. The active financing exception would be made permanent, with some modifications. For example, the definition of "qualified insurance income" in present-law's Section 954(i) would generally be retained, but the definition of "qualifying insurance company" in present-law's Section 953(e) would be modified (as discussed below). The CFC look-through rule exception from FPHCI would generally be eliminated, although *dividends* received by CFCs from related CFCs generally would not generate FPHCI.

The indirect foreign tax credit would be retained for a CFC's foreign income taxes on subpart F income, but deemed-paid taxes would no longer be computed on the "pooled" basis of present law. In addition to the existing separate foreign tax credit limitation "baskets" for passive income and treaty-sourced income, Option Y would create new separate "baskets" for: (1) subpart F income attributable to insurance income, (2) subpart F income attributable to "U.S. related income," (3) subpart F income attributable to "Low Taxed Income," and (4) foreign branch income.

With respect to distributions of CFC income that is not subpart F income under the staff discussion draft, 10% U.S. corporate shareholders would generally receive a 100% dividends received deduction (DRD) for the "foreign-source portion" (rather than the 95% DRD in Ways and Means Committee Chairman Dave Camp's discussion draft). Unlike the Camp draft, the Baucus draft disallows the U.S. shareholder interest expense deductions for interest expenses apportioned to the non-subpart F (i.e., U.S.-tax exempt) income of its CFCs. Also, in light of the exemption, Sections 902, 909, and 956 would be repealed. Note, however, that the repeal of Section 902 would eliminate present-law's indirect (or "deemed-paid") foreign tax credit for dividends from *non-CFCs* (as well as from CFCs), even though the proposed 100% DRD would apply only to dividends from *CFCs*.

B. Insurance Income

While "insurance income" would remain a type of subpart F income, and thus be subject to current U.S. tax, Option Y would also permanently exempt from U.S. tax an insurance CFC's "exempt insurance income." Option Y does, however, make a number of changes to the definition of "exempt insurance income" in Section 953. The proposal retains the requirements that a "qualifying insurance company" be subject to home-country regulation, and that the company be engaged in the insurance business (and that it would have been subject to tax under subchapter L if it were a domestic corporation). Further, Option Y retains the requirement that a CFC derive more than 50% of its aggregate net premiums from unrelated persons in order to be considered a qualifying insurance company; but it eliminates the requirement that more than 50% of aggregate net written premiums be from contracts covering home-country risks.

Instead, the proposal requires that for a CFC to be a qualifying insurance company, more than 50% of its gross receipts for a taxable year must consist of premiums for insurance or reinsurance in connection with property, liability, or the lives or health of individuals, that are treated as earned by such CFC in its home country under the tax law of such country. Additionally, such CFC's insurance liabilities (defined as loss and loss adjustment expenses, unearned premiums, and reserves) must constitute 35% of the CFC's total assets as reported on the CFC's financial statements under generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or local regulatory standards.

With regard to companies in a start-up or run-off phase that may have trouble meeting the 50% and 35% tests described above, Option Y provides for further regulatory authority. In the absence of such guidance, Option Y refers to Section 815, which provides that a company without adequate premiums for two successive taxable years cannot be treated as an insurance company.

Option Y would also modify the definition of "exempt contract" under Section 953(e)(2), eliminating the home-country risk prong of Section 953(e)(2)(B), and correspondingly expanding the substantial activity requirement of Section 953(e)(2)(C) to include all CFC insurance contracts rather than only those contracts covering cross-border risks.

As discussed above, Option Y would make the active financing exception of Sections 953(e) and 954(i) permanent, subject to the modification of the definition of qualifying insurance company. However, Option Y's new category of "U.S. related income," which includes U.S. services income, could result in additional tax exposure for insurance companies. U.S. services income is defined as income derived in connection with services (including insurance, reinsurance, and annuities) provided with respect to persons or property located within the United States, or with respect to U.S. risks. Presumably income from services rendered by a CFC with respect to any policy written on U.S. risk could be subpart F income.

Generally, the changes to the exempt insurance rules found in Option Y would appear to make it more difficult for insurance CFCs' income to qualify as exempt insurance income under subpart F. The requirement that an insurance CFC evaluate insurance liabilities in relation to its entire balance sheet appears to be intended to prevent companies from "stuffing" investment income into offshore insurance vehicles. In relation to the "anti-stuffing rules," the requirement that status as a qualifying insurance company be made with reference to the company's gross receipts will also cause insurance CFCs to evaluate their current cash flows to determine whether they meet the applicable thresholds from an income statement perspective. Other provisions of Option Y appear to be aimed at limiting "home country" definitions, resulting in additional insurance income that could be taxed as subpart F income.

2. Option Z

A. General Information

Under Option Z, there is generally one kind of "subpart F income": the sum of —

- The CFC's net "active foreign market income" (AFMI) of 60%; and
- All of the CFC's net "nonactive income" (which would include "passive income").

(The discussion draft refers to net AFMI as "modified active income," and net "nonactive income" as "modified nonactive income.")

AFMI would be the opposite, in some ways, of "U.S. related income": AFMI is 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" would be defined similarly to foreign personal holding company income as defined under Option Y.

The indirect foreign tax credit would be retained for CFC foreign taxes on subpart F income (thus excluding credits for the foreign taxes on the 40% of net AFMI that escapes subpart F income status), and deemed-paid taxes would no longer be computed on a "pooled" basis. Taxes on each of (1) subpart F income from AFMI, (2) passive income, and (3) other income would be separately "basketed," as would treaty-sourced income.

Distributions by a CFC would be excluded from the U.S. shareholder's gross income as "PTI" even if attributable to the 40% of a CFC's net AFMI that is excluded from the CFC's subpart F income (the "excludable portion" thereof), as well as if attributable to the portion of the CFC's income that actually *is* or *was* subpart F income. However, interest expenses of U.S. shareholders properly allocated and apportioned to income of a CFC would be disallowed based on an apportionment between the excludable portion of the CFC's subpart F income and the remainder of the CFC's earnings. In addition, Sections 902, 909, and 956 would be repealed.

B. Insurance Income
Because there is no "insurance income" category of subpart F income under Option Z, Option Z distinguishes between types of insurance company income that are, and are not, entitled to preferential treatment by including varieties of such income in, and excluding other types of such income from, "AFMI." Specifically excluded from AFMI is related-party insurance income ("RPII") of a captive insurance company. This generally corresponds to Option Y's (and present law's) treatment of RPII effectively as subpart F "insurance income." AFMI would *include* the "qualified insurance income" of a qualifying insurance company, which corresponds to Option Y's (and present law's) *exclusion* of such income from FPHCI. Finally, AFMI would *include* "exempt insurance income," which corresponds to Option Y's (and present law's) *exclusion* of such income from subpart F "insurance income." In each case, Option Z provides for modifications to the definitions of "qualifying insurance company" and "exempt insurance income" that mirror those found in Option Y.

3. Transition to either proposed new system

Under either option, the U.S. corporate shareholder of a CFC would include in income its pro rata share of the CFC's accumulated deferred foreign income as of the end of its last year beginning before 2015, but the tax rate on this inclusion would be 20%.[2] The tax could be reduced by credits for deemed-paid foreign taxes in the same proportion that the transitional 20% rate bears to the U.S. shareholder's then-current ordinary U.S. income tax rate. The shareholder could elect to pay the tax on this inclusion in installments over eight years.

Provisions to Prevent Base Erosion — Related-Party Reinsurance

The staff discussion draft contains a provision similar to those put forward numerous times in recent years that would deny an insurance company a deduction for "nontaxed reinsurance premiums" paid. Nontaxed reinsurance premiums are defined as reinsurance premiums paid to affiliated foreign reinsurers with respect to property and casualty risks to the extent that the foreign reinsurer or its parent is not subject to U.S. tax on those premiums. A deduction would also be disallowed for additional amounts paid with respect to the reinsurance for which such nontaxed reinsurance premiums are paid, to the extent they are properly allocable to such premiums.

These deduction disallowances would be offset by an exclusion from income for return premiums, ceding commissions, reinsurance recovered, and other amounts received to the extent they are properly allocable to the nontaxed reinsurance premiums. The exclusion from income would be allowed to the same extent that no deduction was allowed for the reinsurance premium paid, and does not apply to any greater extent. The JCT technical explanation of the proposal provides an example of this limitation, stating:

"If the amount of reinsurance premium (and any additional amount) totaling 100 for which a deduction is not allowed is 80, then 80% of the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is excluded. Thus if the total amount of the return premium, ceding commission, reinsurance recovered, and other amount received is 200, then 80%, or 160, may be excluded, and the balance is included in the company's income."

A foreign company that receives premiums that would be denied a deduction could elect to treat the premiums and associated investment income as income effectively connected with the conduct of a trade or business in the United States ("effectively connected income" or ECI) and attributable to a permanent establishment for tax treaty purposes. This provision was inserted, according to the JCT technical explanation, "to ensure that foreign affiliates are not treated less favorably than U.S. reinsurers."

Predecessors of this proposal have elicited statements that United States' treaty partners would view the provision as in conflict with their U.S. tax treaties.[3] The staff discussion draft and accompanying materials seem to contain no expression of an intent that the provision *yields* to U.S. treaty obligations, assuming that the provision did violate such obligations. This suggests the possibility that the provision is intended to override any such conflicting treaty obligations.

Other Proposed Changes to the International Tax Rules Generally

The following is a brief summary of the other international tax proposals in the Baucus staff discussion draft:

- *Entity classification*: The draft would make a significant change to the application of 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, at least one of which is a CFC. The

2 This 20% rate, as with the other rates in the staff discussion draft, is in brackets and thus subject to later revision (up or down).

3 See, e.g., letter dated February 27, 2009, to Treasury Secretary Geithner from Angelos Pangratis, Chargé d'Affaires, a.i., Delegation of the European Commission, expressing the view that a similar provision in an earlier Senate Finance Committee staff draft on related-party international reinsurance "violates the provisions of the double Tax Treaties signed by the U.S. with several Member States of the European Union."

provision would not apply to entities wholly owned by one or more domestic entities.

- *Other provisions*: The draft makes several other important changes to the taxation of U.S. income of foreign persons and of taxation of foreign income of U.S. persons, including:
  - *Repeal portfolio exemption for corporate debt* — The draft would generally subject to 30% U.S. tax, the gross amount of what would now be considered "portfolio interest," received by foreign corporations and nonresident alien individuals on corporate debt issued more than one year after enactment, unless the tax is reduced or eliminated by treaty.
  - *Denial of deductions in base erosion arrangements* — The draft would deny a deduction for a related-party payment (excluding a payment included in the income of a U.S. shareholder under Section 951(a)) in a "base erosion arrangement." A base erosion arrangement is one that reduces the amount of foreign income tax paid (e.g., by the payee) and involves a hybrid transaction (e.g., a sale and repurchase agreement) or instrument, a hybrid entity, a conduit financing arrangement, or an exemption arrangement (an arrangement that reduces the generally applicable statutory rate on income derived by a person subject to the foreign income tax by 30% or more as applied to a specific item of income or to income from specified activities).
  - *Rev. Rul. 91-32* — The draft would codify the Internal Revenue Service (IRS) position in Rev. Rul. 91-32, treating gains on dispositions of partnership interests as ECI (or not) based on the nature of the assets of the partnership. The draft would generally require the transferee of a partnership interest to withhold 10% of the amount realized on the disposition unless the transferor provides an affidavit stating that it is not a foreign person, or none of the gain on such disposition would be ECI.
  - *FIRPTA* — The draft would exempt from FIRPTA (Section 897) any U.S. real property interest (USRPI) held by a "qualified foreign pension fund" or an entity wholly owned by a qualified foreign pension fund. The draft would also make the following changes to the FIRPTA rules applicable to real estate investment trusts (REITs) and regulated investment companies (RICs):
    - Increasing from 5% to 10% of the percentage ownership of a regularly traded class of REIT stock that a foreign shareholder can own without being subject to tax under FIRPTA on either a disposition of such stock, or a distribution from the REIT;
    - Providing an exception to FIRPTA taxation under Section 897(h) (which generally treats distributions by REITs and RICs, attributable to USRPI gains of the distributing REIT or RIC, as USRPI gains of the distributees) for a distribution from a REIT or RIC treated as sale or exchange under Section 301(c)(3), 302, or 331 (generally overriding Notice 2007-55);
    - Excluding REITs and RICs (and successors to such entities) from the exception in Section 897(c)(1)(B), which allows the stock of a domestic corporation to be purged of its USRPI status when the corporation has disposed of all USRPIs it held during the preceding five years in taxable transactions; and
    - Applying the attribution rules of Section 318 for determining whether a REIT or RIC is "domestically controlled" (and thus whether its stock is excluded from USRPI status).
  - *PFICs* — The draft would change the PFIC provisions by eliminating, for the future, the interest charge regime and the qualified electing fund regime, and introducing an interest imputation regime in its place; requiring all interest-charge PFICs to be marked to market on the last day of the U.S. shareholder's last tax year beginning in 2014 (subject to an election to pay the resulting tax in up to eight annual installments); repealing the asset test for PFIC status; and reducing the passive gross income threshold for PFIC status from 75% to 60%.
  - *Defining and valuing intangible property* — The draft would revise the definition of intangible property under Section 936(h) (and correspondingly, Section 367) to include goodwill, going-concern value, and workforce in place, and any other item for which the value or potential value is not attributable to tangible property or the services of any individual. The draft would also grant the IRS additional statutory authority for prescribing certain bases for valuing intangible property for purposes of Sections 367(d) and 482.
  - *Dual consolidated losses* — The draft would repeal the dual consolidated loss rules.
  - *DISCs* — The draft would terminate all domestic international sales corporation (DISC) elections effective for taxable years beginning after 2014, and impose shareholder-level taxation, without recourse to "qualified dividend income" treatment under Section 1(h)(11), on the accumulated DISC income of the former DISCs over the following 10 years.
  - *Other* — The draft would change the rules for sourcing income from sales of inventory property, and modify the interest expense allocation rules, the subpart F rules, and the DRD rules for dividends received by domestic corporations from foreign corporations.

Outlook for Passage

Although Chairman Baucus has indicated that he would like to move tax reform legislation through the Senate Finance Committee with support from both parties, ranking Republican Orrin Hatch of Utah did not attach his name to the discussion draft. (Hatch also did not sign on to two other discussion drafts — on tax administration and cost recovery — that were released within days of the international tax discussion draft.) Moreover, Senate GOP tax writers generally had urged Baucus to delay releasing *any* discussion drafts until after the House and Senate conferees reached 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 written statement issued shortly after the release of the international discussion draft, 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 statement said.

For their part, Senate leaders have been cool to the idea of taking up tax reform legislation in the near term, in part, because the parties are still far apart on some fundamental issues. Most notably, Senate Democrats have called for tax reform to generate substantial new revenue to reduce the deficit, while Senate Republicans insist that federal revenue is high enough and that tax reform should not be used to raise tax receipts.

In the House, Ways and Means Committee Chairman Dave Camp, R-Mich., and his Republican colleagues on the panel have inched closer unveiling a comprehensive reform plan. (Since 2011, Camp has released three discussion drafts addressing various issues in tax reform.) But momentum for moving a formal legislative proposal through the Ways and Means Committee slowed in late November following a meeting between senior Ways and Means Republicans and House Republican leaders, including Speaker John Boehner, R-Ohio, and Majority Leader Eric Cantor, R-Va. GOP leadership continues to publicly back Camp's efforts to overhaul the tax code, but they have been intent on keeping Congress and the public focused on issues related to the rollout of the Patient Protection and Affordable Care Act during the relatively few working days left on this year's legislative calendar.

The timing for future action by Chairman Camp in the wake of his meeting with House Republican leaders is uncertain, though he has insisted he will continue to press forward with the goal of enacting fundamental reform by the end of 2014.

Baucus seeks public comments

It is important to keep in mind that the staff discussion 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.

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