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Senate Finance Chair Proposes International Business Tax Reform

On November 19, 2013, Sen. Max Baucus (D-Mont.), Chairman of the Senate Finance Committee, released a Staff Discussion Draft on International Business Tax Reform. The changes proposed in the discussion draft are far-reaching and, if enacted, likely would have a substantial — and adverse — impact on U.S. corporations with foreign operations. The proposals also could have a substantial adverse impact on the planning of many foreign corporations with U.S. operations.

Discussion Draft Overview

The discussion draft's proposals would fundamentally alter the taxation of foreign income by:

- taxing currently the accumulated unrepatriated foreign earnings of controlled foreign corporations (CFCs) at an effective rate of approximately 20 percent (based on current statutory rates);
- substantially expanding Subpart F of the Internal Revenue Code to impose full current taxation on all income attributable to U.S. sales and services, and otherwise taxing at reduced rates either low-taxed foreign income (under the discussion draft's Option Y) or all other active foreign income (under the discussion draft's Option Z);
- sharply curtailing the current check-the-box regime for foreign entities; and
- limiting the deductibility in the United States of related-party payments where the corresponding income is not subject to full, foreign taxation.

The proposal is intended to be revenue neutral in a "steady-state," excluding, most obviously, the one-time tax on accumulated, unrepatriated earnings. Additionally, the proposal likely is being considered in the context of an assumed reduction of the statutory corporate tax rate to at least 30 percent, and possibly as low as 28 percent. Even taking into account the assumed rate reduction, the proposal would substantially increase the tax burdens of many U.S. multinational corporations over the next ten years.

Proposal Highlights

Taxation of Accumulated Foreign Earnings

The discussion draft would include under Subpart F in the year prior to enactment the accumulated foreign earnings of CFCs, subjecting them to an effective U.S. tax rate of approximately 20 percent, assuming current statutory rates that would likely be in effect, as any tax rate cut would presumably be effective in the following year. A foreign tax credit would be allowed for the taxable portion of such earnings, but not for the portion that is effectively exempt from taxation. The tax would be payable in up to eight annual installments. Such earnings could be repatriated in that year or thereafter without further U.S. taxation.

Discussion Draft Option Y

Option Y, one of two legislative options contained in the discussion draft, would dramatically expand Subpart F by subjecting to full current U.S. taxation any "United

States-related income," defined as any income of a CFC that is derived in connection with property that is imported into the U.S. by the CFC or a related person, or any income derived in connection with services provided with respect to a person or property located in the United States. Property is treated as imported property if it would be "reasonable for the CFC to expect" that it would be imported into the U.S. or used as a part in or a component of property imported into the United States. Accordingly, income from sales of property to third parties outside the U.S. is not necessarily excluded from the category of U.S.-related income.

Option Y also would include under Subpart F any low-taxed CFC income, which is defined as any item of income that is subject to a foreign tax rate that is less than 80 percent of the U.S. statutory rate (with the 80 percent currently in brackets in the discussion draft). In the event that a CFC earns low-taxed income, it is subject to inclusion under subpart F, though with a 20 percent deduction that yields an effective rate equal to 80 percent of the U.S. statutory rate.

Any other income of a CFC would not be subject to U.S. taxation and would be entitled to a 100 percent dividend received deduction upon repatriation to the United States.

Option Y makes several other changes to the current Subpart F regime, including eliminating the categories of foreign base company sales, services and oil income, and making permanent the exceptions from Subpart F for active finance income and certain insurance income under current Sections 953(e), 954(h) and 954(i), albeit with significant revisions to the definitional provisions in those sections.

Option Y also would limit interest deductions claimed by U.S. corporations by disallowing a deduction in respect of any interest allocated to tax-exempt CFC income under the allocation principles of Sections 861 and 864.

Finally, Option Y would limit the foreign tax credit that can be claimed with respect to foreign income by placing such income into six limitation categories: (i) passive income, (ii) Subpart F insurance income, (iii) Subpart F U.S.-related income, (iv) Subpart F low-taxed income, (v) foreign branch income and (vi) all other income. The foreign tax credit limitation would be calculated separately with respect to each such category of income. In addition, no foreign tax credit would be allowed with respect to any exempt CFC income or exempt dividends paid by a CFC.

Discussion Draft Option Z

Option Z, the other legislative option, would likewise dramatically expand Subpart F by eliminating deferral for all CFC income and instead placing CFC income into two Subpart F categories: (i) modified active income and (ii) modified non-active income. The former is defined as income that is attributable to economically significant activities with respect to a qualified trade or business and derived in connection with property or services sold or provided outside the United States. For the income to so qualify, the CFC must perform through its officers and employees outside the U.S. activities that make a "substantial contribution" to the production of the income. Passive income cannot qualify as modified active income unless it meets the requirements for active banking, financing or insurance income. Any income that is not modified active income is by default treated as modified non-active income. Modified active income is subject to current U.S. taxation at a rate equal to 60 percent of the current U.S. rate. All other CFC income — *i.e.*, modified non-active income — is subject to full, current U.S. taxation.

Like Option Y, Option Z provides a foreign tax credit for taxes paid with respect to these categories of income, subject to limitations that are determined by dividing foreign income into three categories:

(i) active foreign market income, (ii) passive income and (iii) all other income. No credit is permitted with respect to foreign taxes paid on the excluded portion of modified active income. As with Option Y, Option Z also disallows a deduction in respect of interest that is allocable to the exempt portion of modified active income under the principles of Sections 861 and 864.

Comparison of Options Y and Z

Options Y and Z contain a number of common features, but also differ in significant respects. Both share the feature that CFC income that is attributable to U.S.-destined sales and services would be subject to full, current U.S. taxation. In that respect, the provisions share a common feature with base erosion Option C in the international tax reform discussion draft released by Rep. Dave Camp (R-Mich.), chairman of the House Ways & Means Committee, in October 2011.

However, Options Y and Z differ considerably in their treatment of all other CFC income. Option Y would effectively adopt a foreign minimum tax at a rate of 24 percent (assuming a statutory rate of 30 percent; 28 percent under current statutory rates) on all other items of CFC income, with such tax representing a "final tax" on such income. Any CFC income subject to a lower rate of foreign tax would be subject to a current U.S. residual tax that brings the rate to 24 percent; any CFC income subject to a higher rate of local tax would be exempt from further U.S. taxation. Because a foreign tax credit is not available with respect to "high-taxed" CFC income, such income would not give rise to excess credits that could be used to offset the U.S. tax due with respect to low-taxed CFC income.

Option Z, in contrast, represents a partial exemption and partial full inclusion system under which CFC income (other than income subject to full current taxation) is effectively divided into two segments — 60 percent of the income is subject to U.S. taxation with a credit for the foreign tax paid on such income, yielding an effective rate equal to the U.S. tax rate (assuming the local tax rate is not higher than the U.S. tax rate); the remaining 40 percent of the income is subject only to the local tax rate, with no further U.S. tax on such income and no U.S. tax credit for the foreign taxes paid thereon. Whether Option Y or Option Z is preferable to any given corporation would depend in large part on the rate of local tax applicable to the CFC income, as well as the types of income earned by the CFCs.

Elimination of Check-the-Box With Respect to Foreign Entities

Foreign entities that are owned by CFCs, and that would otherwise be eligible entities under the current check-the-box regulations, would be treated as corporations for U.S. tax purposes if such entities are wholly owned by one or more members of an expanded affiliated group, and at least one such owner is a CFC. To the extent this provision results in a change of status of any foreign entity, such change would be treated as a deemed incorporation of the entity.

General Changes to Subpart F

In addition to the more sweeping changes to Subpart F under the discussion draft's Options Y and Z, the discussion draft would:

- eliminate the requirement that a foreign corporation be a CFC for 30 days before a U.S. shareholder can be subject to an income inclusion under Subpart F;
- treat as a U.S. shareholder any U.S. person who holds 10 percent of the stock of the foreign corporation, measured by vote *or* value; and
- remove the look-through rules of Section 954(c)(6) that exempt from Subpart F certain types of passive income received by one CFC from another.

General Changes to the Foreign Tax Credit Rules

In addition to the changes to the foreign tax credit limitation rules discussed above, the discussion draft would (i) repeal the Section 902 indirect tax credit for foreign taxes paid by CFCs, (ii) repeal the Section 909 foreign tax credit splitter rules, and (iii) repeal the dual consolidated loss rules.

Anti-Base Erosion Provisions

The discussion draft includes a number of provisions that are designed to limit the ability of U.S. corporations to shift income from the U.S. to lower-tax foreign jurisdictions. These include revisions to Sections 367(d) and 482 that would permit the IRS to value intangible assets on an aggregate basis — rather than asset by asset — and to value intangible assets based on the realistic alternative transactions available with respect to such assets.

Disallowance of Deduction on Payments Made to Related Persons in "Base Erosion Arrangements"

The discussion draft also would disallow a deduction in respect of payments made to related parties in "base erosion arrangements." "Base erosion arrangements" are defined as arrangements involving hybrid instruments, hybrid entities, conduit financing arrangements and other circumstances in which the deductible payments are exempt from or subject to a reduced rate of taxation in the foreign jurisdiction. Essentially this provision would deny a U.S. tax deduction to the extent the payments made by the U.S. person to a foreign related person are not subject to full taxation in the payee's jurisdiction. This provision could significantly limit the ability of non-U.S. parented multinationals to reduce efficiently their U.S. taxable income through intercompany leverage or other related-party transactions.

Miscellaneous Other Changes

The discussion draft contains a wide range of other proposed changes, including:

- Revising the taxation of US investors in passive foreign investment companies (PFICs) to tax shareholders either on a mark-to-market basis or based on an imputed interest charge equal to the short-term AFR plus 5 percentage points, and eliminating the asset test and reducing the gross income test to 60 percent passive income for PFIC qualification.
- Revising the inventory property sourcing rules to provide that inventory income attributable to a U.S. office or fixed place of business is treated as U.S. source income.
- Adopting worldwide allocation of interest expense under Section 864(f) effective for taxable years beginning after December 31, 2014, and disallowing the use of the fair market value method for interest expense allocation.
- Treating gain or loss from the sale of interests in a partnership as effectively connected income to the extent allocable to the effectively connected income of the partnership.

Observations

Sen. Baucus's discussion draft is further evidence of the determination of the chairmen of the tax-writing committees of the House of Representatives and the Senate to push forward with tax reform legislation. In some respects, the discussion draft resembles the 2011 international tax reform discussion draft released by Rep. Camp, in particular, base erosion Option C.

However, Sen. Baucus's discussion draft taxes foreign income attributable to foreign sales at substantially higher rates than Rep. Camp's discussion draft Option C, has no incentive for exports and imposes a substantially higher rate of tax on accumulated earnings. While Sen. Baucus's discussion draft is stated to be revenue neutral in a "steady state," it clearly raises substantial revenue over the ten year budget window taking into account its one-time 20 percent tax on unrepatriated foreign earnings. The revenue impact of the proposal will make it difficult for Sen. Baucus's approach to achieve any bipartisan support. Indeed, immediately after Sen. Baucus released the discussion draft, Sen. Orrin Hatch (R-Utah), ranking member on the Senate Finance Committee, criticized the draft, stating that, "the bipartisan desire to overhaul our tax code has become mired in the partisan desire by some to raise taxes under the guise of so-called tax reform."

Consequently, while Sen. Baucus's discussion draft may be an important step forward to the extent it offers a departure from the current international tax rules and indicates some common ground with Rep. Camp's discussion draft, it is only a very preliminary step on the long road toward tax reform. The recent fiscal crises have not produced a procedural path for considering tax reform legislation, and it is unlikely that the current budget conference will reach an agreement on a process either. Without a procedural path forward, it will be even more difficult to bridge the policy divides between the parties.