NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

CHAIRMAN CAMP'S INTERNATIONAL TAX REFORM

DISCUSSION DRAFT

September 6, 2012

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Report No. 1272

New York State Bar Association Tax Section

Report on Chairman Camp's International Tax Reform Discussion Draft

I. Background

This report (the "Report")[1] of the New York State Bar Association Tax Section ("Tax Section") comments on the International Tax Reform Discussion Draft released by Representative Dave Camp, Chairman of the House Ways and Means Committee, on October 26, 2011 (the "Discussion Draft"). The Discussion Draft proposes an international tax reform plan that would (i) reduce the corporate tax rate to 25%, (ii) institute a dividend exemption system entitling domestic corporations to a 95% dividends-received-deduction ("DRD") with respect to dividends received from foreign subsidiaries, (iii) make various simplifying changes to the existing foreign tax credit regime, (iv) implement a base erosion proposal that would subject certain types of foreign income to full, current U.S. taxation, and (v) impose an interest deduction limitation that would limit the interest expense that could be deducted by a domestic corporation based on its relative leverage vis-à-vis its foreign affiliates and its interest expenses as a percentage of its adjusted taxable income.[2]

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[2] *See* Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System, available at http://waysandmeans.house.gov/UploadedFiles/Summary_of_Ways_and_Means_Draft_Option.pdf.

The Discussion Draft, while offering a detailed outline of an international tax reform proposal, including proposed legislative language, left certain items open and requested feedback from taxpayers and practitioners. In particular, the Discussion Draft requested feedback on the proposal's three "base erosion" options, its thin capitalization rule, its treatment of foreign branches as corporations, and the 95% DRD.[3] Our approach in this Report is to summarize the provisions of the Discussion Draft, and to discuss certain issues and considerations relevant to those provisions, with the aim of responding, in that process, to the questions posed by Chairman Camp in connection with the release of the Discussion Draft. We understand that one of the goals of the Discussion Draft is maintaining revenue neutrality vis-à-vis the current corporate tax system. The revenue implications of several of the suggestions raised in this Report could undermine that goal. The suggestions in this Report should therefore be considered in light of their projected revenue impact, with appropriate consideration given to whether the benefits of any particular suggestion that is inconsistent with the goal of revenue neutrality may require offsetting changes to other proposals in the Discussion Draft. For example, to maintain revenue neutrality while creating a fairer and/or more consistent approach, it may be necessary to decrease the 95% DRD.

We would also note that the international tax reform proposal in the Discussion Draft and accompanying materials leave open certain questions and proffer various alternatives. It also reflects a number of fundamental tax policy choices and premises. The preferred choice among alternative international tax systems reflects political debate and compromises. In this Report, we refrain from expressing any view on the policy

[3] *See id.*

choices underlying the proposal, and instead seek to analyze the Discussion Draft proposals solely from the perspective of internal consistency, likely consequences, administrability, practicality and susceptibility to abuse and evasion. We thus do not comment more generally on the benefits or detriments of a territorial, quasi-territorial or other international tax system relative to current law. Nevertheless, in evaluating the specific elements of the Discussion Draft, it is important to consider whether the objective of the Discussion Draft is to implement an international tax system that generally exempts all foreign income (i.e., a "territorial system"), only exempts foreign income subject to foreign tax (an "exemption system") or some hybrid of the two. Although the Discussion Draft appears to reflect a hybrid system, we believe the type of international tax system the Discussion Draft seeks to implement should inform how many of the issues discussed in this Report should be resolved.

II. Transition to and Implementation of the Participation Exemption

A. Participation Exemption for Foreign Dividends

1. Overview

DD section 301[4] would add to the Internal Revenue Code (the "Code") a New IRC section 245A that would grant a 95% DRD to domestic corporations that are U.S. shareholder (within the meaning of section 951(b)) with respect to the foreign source portion of the dividends received from a controlled foreign corporation ("CFC").[5] The

[4] References in this Report to "DD section X" or "DD § X" are to provisions of the Discussion Draft. References to "section X" or "IRC § X" are to the Internal Revenue Code of 1986, as amended (the "Code"). References to "New IRC section X" "New IRC § X" are to new sections that the Discussion Draft would add to the existing Code.

[5] As discussed further below, these rules also apply to noncontrolled 10/50 corporations with respect to which an election is made to treat them as CFCs for these purposes.

95% DRD would only be available for dividends paid with respect to stock of a CFC held by the U.S. shareholder for at least one year (365 days) during the two-year period (731 days) beginning one year (365 days) before the ex-dividend date.[6] To satisfy that requirement, the foreign corporation must be a CFC at all times during that holding period and the domestic corporation must be a U.S. shareholder with respect to the CFC throughout such holding period.[7] As long as this holding period requirement is met, dividends from one CFC to another within a tiered CFC structure will not be taxable under subpart F.[8]

The 95% DRD is limited to the foreign source portion of any dividend paid by a CFC.[9] For this purpose, the foreign source portion of a dividend is equal to the ratio of the undistributed *foreign* earnings of the CFC to the total undistributed earnings of the CFC. The foreign earnings of a CFC are those earnings other than income effectively connected with the conduct of a U.S. trade or business or dividends received from an 80%-owned domestic corporation.[10] Given the retention of subpart F of the Code and its expansion to include one or more of the anti-base erosion proposals discussed in this Report, the 95% DRD will generally have the effect of exempting only the active foreign income of foreign affiliates of domestic corporations from U.S. taxation.

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[6] DD § 301(b); New IRC § 246(c)(5).

[7] *Id.*

[8] New IRC § 245A(f).

[9] DD § 301(a); New IRC § 245A(a).

[10] New IRC § 245A(c)(3).

We note in this regard that the 95% DRD may only be claimed by domestic corporations. Dividends received by a U.S. individual or by a domestic partnership from a CFC will not qualify for the 95% DRD and thus will remain fully subject to U.S. tax. It is unclear whether a dividend paid to a domestic partnership by a CFC will qualify for the 95% DRD to the extent it is allocable to one or more domestic corporate partners of the partnership. We believe that such a dividend should qualify for the 95% DRD to the same extent it would have qualified had the domestic corporate partner received the dividend directly from the CFC. Additionally, only dividends paid by CFCs (or electing noncontrolled 10/50 corporations, as discussed further below) will qualify for the 95% DRD. Dividends received from foreign corporations that are not CFCs or by less-than-10% domestic corporate shareholders of CFCs will not be eligible for the 95% DRD and will therefore remain fully subject to U.S. tax.

Under the Discussion Draft, no foreign tax credit will be allowed for any taxes paid or accrued with respect to any dividend entitled to the 95% DRD. The disallowance of the foreign tax credit will apply to the direct foreign tax credit under section 901, such as any foreign withholding taxes on a dividend to a U.S. shareholder that is eligible for the 95% DRD.[11] The Discussion Draft would also eliminate the indirect foreign tax credit under section 902 of the Code. As a result, a foreign tax credit cannot be claimed for foreign taxes paid by the foreign corporation on income eligible for the 95% DRD.[12]

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[11] New IRC § 245A(e)(1). The Discussion Draft also disallows any deduction for such foreign taxes. New IRC § 245A(e)(2).

[12] DD § 311(a). The Discussion Draft would retain the indirect foreign tax credit for foreign taxes paid with respect to income that is taxable under subpart F. *See* DD § 311(b).

Finally, consistent with the near-complete exemption from U.S. taxation of foreign income of a CFC, the Discussion Draft would eliminate section 959 of the Code and its separate categories of earnings – previously-taxed and non-previously-taxed – that domestic corporations are currently required to track with respect to their foreign affiliates in order to determine whether dividends paid by such foreign affiliates are subject to U.S. taxation.

2. Discussion

The 95% DRD, when combined with the Discussion Draft's proposed 25% corporate tax rate, results in the general exemption of the active foreign income of CFC's from U.S. taxation, subject only to the imposition of a 1.25% residual tax upon the repatriation of CFC earnings. This residual tax may be understood to accomplish one or more functions. First, it may be designed simply to raise additional revenue that allows the proposal to remain revenue neutral while accomplishing its objectives, including removing the disincentive for domestic corporations to repatriate foreign earnings. We understand that in light of past experience, it is anticipated that a 1.25% residual tax would not meaningfully discourage domestic corporations from repatriating foreign earnings that they otherwise wish to repatriate.

The 1.25% residual tax may also be seen as a proxy for the lack of expense allocation to exempt foreign income (other than with respect to interest). Under the Discussion Draft, other than the deduction for interest expense, which is subject to a specific disallowance regime, a domestic corporation would not be required to allocate

domestic expenses, such as G&A or R&D expenses, to foreign source income.[13] Absent such allocation, the portion of a domestic corporation's tax deductible expenses properly allocable to largely exempt foreign income would remain fully deductible. The 1.25% residual tax on such foreign income may serve as a rough proxy for the additional U.S. tax that would be paid if such expenses were allocated to exempt foreign income. If this is the intended purpose of the 1.25% residual tax, it would apparently represent a deliberate trade-off between accuracy and simplicity. In our view, any actual expense allocation regime would add too much complexity to the system, would result in double taxation if the allocated expenses are also not deductible under the tax rules of the relevant foreign jurisdiction and would depart from international norms. It could also create perverse incentives for domestic corporations to move their expense generating operations outside the United States merely to avoid disadvantageous expense allocation.

Other than the anti-base erosion proposals that are discussed below, the Discussion Draft leaves subpart F of the Code largely unchanged. Subpart F income will therefore remain subject to current U.S. taxation at regular rates (net of any available foreign tax credit),[14] with such tax imposed on the U.S. shareholders of the CFC as if the income had been currently distributed. Under current law, subpart F income is not again subject to U.S. tax upon repatriation.[15] By repealing Section 959 and its categories of

[13] The absence of expense allocation under the Discussion Draft is consistent with current law. We note, however, that the failure to require any allocation of expenses to foreign source income may take on greater significance in a tax system that exempts active foreign income from U.S. tax.

[14] As discussed further below, while the Discussion Draft eliminates the indirect foreign tax credit under section 902, under a revised section 960, a U.S. shareholder would still be able to claim an indirect foreign tax credit with respect to foreign taxes imposes on CFC income that is subject to full, current U.S. taxation under subpart F.

[15] IRC § 959(a).

previously-taxed income, however, the Discussion Draft will subject all dividends paid by a CFC, including those attributable to previously-taxed subpart F income, to a 1.25% residual tax at the time of repatriation. Subpart F income will therefore be subject to an effective tax rate of 26.25%,[16] and not simply the U.S. statutory rate of 25%. Like the 1.25% residual tax itself, this double taxation due to the elimination of section 959 may represent a trade-off between simplicity and accuracy. Given the low 1.25% residual tax rate, the drafters of the Discussion Draft may have considered the added benefit of eliminating the complexity of section 959, which requires CFCs to track different earnings pools, as outweighing the additional 1.25% tax that is due on subpart F income upon repatriation.

Perhaps more importantly, any changes to section 959 should ensure that income of a passive foreign investment company ("PFIC") that is subject to current taxation as a result of a qualified electing fund election or a mark-to-market election should not again be subject to tax when distributed. Under section 1293 of the Code, a U.S. owner of the stock of a PFIC may elect to be subject to tax currently on its pro rata share of the income of the PFIC. Section 1293(c) is intended to ensure that such income is not then subject to tax again when actually distributed. The elimination of the previously-taxed income rules of section 959 risks exposing previously-taxed PFIC income to full U.S. taxation again at the time of its distribution. If such a dividend from the PFIC to its domestic corporate shareholder is not eligible for the 95% DRD because it is not a CFC or because the recipient is not a domestic corporation, it would be subject to tax twice at the full 25%

[16] The 26.25% rate is an approximation. The residual 1.25% tax is only imposed on the net income of the CFC after foreign taxes, and thus the effective rate of tax on the subpart F income, assuming it is in fact subject to foreign tax, would actually fall somewhere between 26.25% and the 25% U.S. statutory rate.

rate. We assume that this was unintended and therefore recommend that rules be written under section 1293(c) to ensure that PFIC income is not subject to double taxation.

In addition, the elimination of section 959 will subject individuals who are U.S. shareholders (within the meaning of section 951(b)) to full taxation upon the distribution of previously-taxed income of a CFC. Under current law, an individual who is a U.S. shareholder with respect to a CFC must include in income his pro rata share of the subpart F income earned by the CFC. Under section 959, the earnings are not again subject to taxation when distributed to such individual shareholder. Due to the elimination of section 959, however, an individual shareholder would be subject to taxation upon the distribution of previously-taxed earnings. Given the proposal's overall focus on domestic corporate shareholders of CFC's, the impact of the elimination of section 959 on individual shareholders may not have been intended. We therefore recommend that further consideration be given to the treatment of individual and other non-corporate shareholders of CFCs under the proposal.

Finally, we note that due to the elimination of the indirect foreign tax credit under section 902, the ability of domestic corporations to cross-credit foreign income taxes would be diminished. Under current law, domestic corporations that are eligible to claim section 902 credits with respect to dividends paid by a CFC may often use any excess credits on such income to offset the U.S. tax due on other lower-taxed foreign source income, such as foreign source royalty income or income earned on the export of U.S. manufactured goods. The elimination of the section 902 indirect foreign tax credit on CFC dividends will eliminate any credit that can be claimed on a CFC's income, other than subpart F income, and thus diminish the ability of domestic corporations to use

foreign tax credits to reduce their U.S. tax liability on other forms of foreign source income.[17]

B. Gains and Losses on the Disposition of Certain Foreign Stock

1. Overview

DD section 302 would add a New section 1247 to the Code that would exclude from gross income 95% of the gain realized by a domestic corporation that is a 10% shareholder of a "qualified foreign corporation" upon the sale of stock in such corporation provided the domestic corporation held such stock for at least one year prior to its sale.[18] No loss may be claimed with respect to the sale of such stock.[19] A "qualified foreign corporation" is any CFC at least 70% of the assets of which are active assets, measured at the time of the sale and at the close of each quarter in the three-year period preceding the sale or during the existence of the CFC, whichever is shorter.[20] If New section 1247 applies to the sale of any CFC stock, section 1248 will not apply.[21]

2. Discussion

This provision is generally consistent with a participation exemption regime. If 95% of the income of a CFC is exempt from tax upon repatriation, a U.S. shareholder should enjoy a similar 95% exemption when it realizes gain upon a sale that is attributable to appreciated assets that generate exempt income. Alternatively, if the goal of the Discussion Draft is to exempt only the actual accumulated earnings of a foreign

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[17] *See infra* at pp. 21-22 for further discussion regarding cross-crediting under the Discussion Draft.

[18] DD § 302; New IRC § 1247(a)(1).

[19] New IRC § 1247(a)(2).

[20] New IRC § 1247(b).

[21] New IRC § 1247(c).

subsidiary from U.S. taxation to reduce the disincentive to repatriate such earnings, New section 1247 could, in a manner analogous to section 1248, exempt from taxation only the portion of the gain equal to the accumulated earnings, and subject the remaining gain to U.S. taxation. For example, if a CFC has $100 of retained earnings, and its U.S. shareholder realizes $200 of gain upon the sale of the CFC stock, $100 of that gain would be treated as a dividend and thus be 95% exempt from tax, while the remaining $100 of gain would be fully taxable in the United States.[22]

The appropriate approach to the taxation of gain on the sale of CFC stock depends in part on the underlying objectives of the Discussion Draft proposal. If the objective is to exempt all active foreign income from U.S. taxation, then it makes sense to exempt all (or 95% to parallel the treatment of actual dividends) the gain realized on the sale of stock. If, however, the goal is to exempt only active foreign income that has been subject to foreign tax, arguably only gain to the extent of the retained foreign earnings (which have already been taxed) should be exempt, while all other gain should be taxable.[23]

Consideration should also be given to the treatment of losses under New section 1247, and whether such treatment should be parallel to the treatment of gains. For example, the provision could be revised to disallow 95% – rather than 100% – of losses just as 95% of gains are exempt for U.S. taxation. Again, the disparity between the treatment of losses and gains may be driven either by revenue estimates or by the goal of simplicity. In addition, the disparate treatment of gain and loss on CFC stock parallels

[22] If such an approach were adopted, anti-abuse rules may be necessary to address transactions designed to increase the exempt E&P so as to maximize the exempt gain.

[23] In many cases, the gain from the disposition of stock in a foreign corporation would not be subject to tax in that foreign jurisdiction.

the disparate treatment of CFC income and losses more generally, since repatriated earnings of a CFC remain subject to a 1.25% residual tax, while losses of a CFC cannot be claimed at all.

Further consideration should also be given to the definition of "qualified foreign corporation" in the Discussion Draft. Under the provision, gain realized on the sale of CFC stock will only be eligible for the 95% exemption if at least 70% of the CFC's assets are "active assets," measured as and when provided in the Discussion Draft. If more than 30% of the assets of a CFC are passive assets, therefore, *all* of the gain realized upon the sale of its stock will be fully taxable.

Given the continued taxation of passive income under subpart F in the Discussion Draft, it is appropriate to ensure parallel treatment for gain realized upon the sale of stock of a corporation the assets of which generate passive income. We believe it is appropriate to limit the 95% exemption under New section 1247 in a manner that accounts for a CFC's passive assets. The adoption of a 70% cut-off in New section 1247, however, would create a "cliff effect" that is both under- and over-inclusive. Under the rule, if 30% of a CFC's assets are passive, its shareholder would still enjoy the full 95% exemption for gain on the sale of the CFC's stock; conversely, if 69% of a CFC's assets are active, its shareholder would be fully taxed on all the gain realized on the sale of the CFC stock even though most of the assets of the CFC are active. As an alternative, the Discussion Draft could adopt a look-through approach, subjecting gain attributable to the passive assets of a CFC to full U.S. taxation while exempting 95% of the gain attributable to the active assets. For example, a pro rata approach could be adopted whereby a portion of the gain is subject to full U.S. tax based on the relative values of the CFC's

passive and active assets or the relative built-in gain in the CFC's passive and active assets.

C. Transition Tax

1. Overview

DD section 303 would amend section 965 of the Code to provide that in the last taxable year of a 10%-owned foreign corporation prior to the implementation of the proposal,[24] the subpart F income of the foreign corporation shall be increased by the "accumulated deferred foreign income" of the corporation.[25] U.S. shareholders would be subject to tax on their pro rata share of such income, subject to an 85% DRD – yielding an effective tax rate of 5.25% on such income. For purposes of this provision, a noncontrolled 10/50 corporation would be treated as a CFC, and its 10% shareholders would be required to include in income their pro rata share of the accumulated deferred foreign income of the foreign corporation.[26] For these purposes, "accumulated deferred foreign income" is defined as the undistributed earnings of the foreign corporation other than those earnings that are effectively connected with the conduct of a U.S. trade or business or undistributed subpart F income that was included in income of a U.S. shareholder under section 951. Under the proposal, 85% of the section 901 foreign tax credit that could otherwise be claimed with respect to such distribution would be

[24] The Discussion Draft provides that the revised section 965 would apply with respect to the taxable year of the foreign corporation that ends before January 1, 2013. We assume this date would be extended as appropriate to reflect any delayed enactment of the proposal.

[25] DD § 303; IRC § 965(a).

[26] IRC § 965(d).

disallowed.[27] In summary, therefore, the proposal would generally create a deemed distribution of the accumulated earnings of CFCs and noncontrolled 10/50 corporations, all of which would be subject to tax at a 5.25% rate.

The proposal also includes an installment payment provision that would allow taxpayers to elect to pay the liability due under section 965 in up to eight equal annual installments. Any deferred tax payments would accrue interest at the rate specified in section 6601. In addition, any remaining deferred tax payments would become immediately payable upon a liquidation or sale of substantially all the assets of the taxpayer, a cessation of business by the taxpayer, or "any similar circumstance."[28]

2. Discussion

The amendments to section 965 under the Discussion Draft raise several issues that require clarification:

First, the proposal should clarify that previously-taxed income under section 956 or 1248 should not be subject to the transition tax. While previously-taxed "subpart F" income is currently excluded from the transition tax, previously-taxed income under section 1248 and section 956 does not meet the technical definition of subpart F income under section 952. Any ultimate legislation should confirm that these other categories of previously-taxed income are not subject to the section 965 transition tax.

Second, the proposal should clarify whether the deemed inclusion under the transition rule results in a basis step-up under section 961, and if so, whether such step-up

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[27] *See* New IRC § 965(e)(1).

[28] New IRC § 965(f)(3).

is reduced to reflect the 85% DRD. While the Discussion Draft eliminates section 961,[29] it appears that the repeal of section 961 is only effective after the transition tax is imposed. The Discussion Draft does not specify, however, whether the basis step-up is adjusted to reflect the 85% DRD. We recognize that the basis step-up may be of limited significance in light of the 95% exclusion of gain from the sale of CFC stock and the nonrecognition of losses. The basis step-up could, however, still be significant in measuring gain from the sale of stock of a CFC that does not meet the definition of "qualified foreign corporation" and whose stock is therefore not eligible for the 95% exclusion. In addition, the basis of a U.S. shareholder in the stock of a CFC will remain significant if the look-through rule suggested above regarding taxation of gain on the sale of CFC stock, or some variant thereof, is adopted.

Third, the proposal should clarify that an indirect foreign tax credit can be claimed under section 902 and 960 with respect to income included or deemed included in income under the New section 965, and that such foreign tax credits are subject to the same limitation imposed on section 901 credits claimed with respect to such income.[30]

Fourth, the interaction between the transition tax and the PFIC rules should be clarified. For a PFIC that elects to be treated as a CFC under the proposal or that is otherwise subject to the transition tax, rules should clarify that the transition tax will not apply either to the extent a mark-to-market election has been made with respect to the PFIC under section 1296, or to the extent the income of the PFIC has already been

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[29] DD § 322(b).

[30] *Cf.* DD § 303(a); New IRC § 965(e)(1) (disallowing a credit for 85% of any taxes paid on the income deemed included to reflect the 85% DRD on such income).

included in income under section 1293. Although we assume that the election to treat a PFIC as a CFC is for all purposes of the Code, including for purposes of taxing its previously-taxed income, this should be clarified in any future legislation.

In addition to these clarifications, we believe certain other items merit further consideration with regard to the transition tax. First, consideration should be given to the question of whether the section 965 transition tax should be calculated on a corporation-by-corporation basis or whether netting of income and deficits should be allowed. If netting is allowed, consideration would have to be given to whether netting is done only within a chain of ownership, across an affiliated group of corporations, or with respect to all CFC's in which a domestic corporation that is a U.S. shareholder owns stock. Further, if netting is allowed, an anti-abuse or holding period rule might be required to prevent a domestic corporation from acquiring loss corporations to offset accumulated earnings.

Second, as discussed above in the context of distributions of subpart F income, due to the repeal of section 959 under the Discussion Draft, any earnings included in income under section 965 and not actually distributed will again be subject to a 1.25% residual tax at the time of distribution. As discussed above, this double taxation may be the unavoidable result of the simplification attributable to the repeal of section 959. Alternatively – or in addition – it may be an intentional means of encouraging taxpayers to repatriate accumulated earnings prior to the effective date of the proposal to avoid the additional 1.25% tax that would be payable on earnings that are retained and distributed at a later date. In either event, we support this approach.

This in turn raises another question – whether the 85% DRD should be available for earnings that are actually repatriated in the final taxable year before the proposal takes

effect. Under the Discussion Draft, the 85% DRD is only available for the deemed inclusion of the accumulated *undistributed* earnings of a CFC. It would therefore appear that an actual distribution by a CFC in that year would be subject to full U.S. tax, and would not be eligible for the 85% DRD. We would recommend that the 85% DRD in the final year be made available for both actual and deemed distributions in the final year.

Further consideration should also be given to whether accumulated earnings is the proper measure for the transition tax imposed under section 965. From an administrative perspective, some taxpayers may not have accurate measures of their historic accumulated earnings and profits, in particular if no time limit is placed on the years to which this applies. One approach to alleviate this burden is to limit the transition tax to post-1986 accumulated earnings, which would simplify the calculation and data gathering necessary to comply with this provision while presumably not meaningfully reducing the revenue raised thereby.

In addition, in many cases, accumulated earnings will not be a very accurate proxy for the earnings that are actually available for repatriation. CFCs that have reinvested a substantial portion of their earnings may lack the liquid assets to distribute a significant portion of their earnings. For CFCs that have invested in assets that have declined in value, they may never generate distributable income corresponding to their accumulated unrepatriated earnings. These concerns may already be adequately addressed by the reduced rate of tax applicable to these accumulated earnings and the installment payment plan provided in the Discussion Draft. Alternatively, the proposal could provide for an increase in basis of the stock of the subsidiary whose earnings are deemed distributed (as appears to be the case under the Discussion Draft) and permit loss

on the sale of such stock to be recognized for U.S. tax purposes to the extent of the lesser of the prior inclusions or the built in loss in the stock immediately after the deemed distribution.[31] Another possible approach is to permit netting of CFC income and losses as discussed above.

Although the issues noted above should be considered, on balance, we believe that the substantially reduced rate of the transition tax, coupled with the election to pay it in installments, adequately address these potential problems.

Finally, further consideration should be given to whether it is appropriate to impose the transition tax on noncontrolled 10/50 corporations that do not otherwise elect to be treated as CFC's under the new proposal. The Discussion Draft gives domestic corporations the option to treat noncontrolled 10/50 corporations – i.e., foreign corporations in which a domestic corporation owns a 10% interest but which do not otherwise qualify as CFCs – as CFCs such that dividends from such foreign corporations would be entitled to the 95% DRD. Nevertheless, the Discussion Draft's transition tax applies to the accumulated earnings of a noncontrolled 10/50 corporation whether or not this election is made. The imposition of the transition tax may well compel 10% shareholders of noncontrolled 10/50 corporations to make the election, lest they be subject to the transition tax without thereafter enjoying the benefits of the 95% DRD.

[31] This could function like the inverse of section 1374's treatment of built in gains recognized by S corporations.

III. Modifications of the Foreign Tax Credit System and Certain other Changes to Existing Law

A. Changes to the Indirect Foreign Tax Credit

1. Overview

The Discussion Draft would repeal the section 902 indirect foreign tax credit for non-subpart F income.[32] As a result, U.S. shareholders in CFCs and 10% shareholders in noncontrolled 10/50 corporations will not be able to claim a foreign tax credit for foreign taxes paid by the foreign corporation on earnings to which the dividends are attributable. This applies to noncontrolled 10/50 corporations regardless of whether the 10% shareholder in such corporation elects to treat the foreign corporation as a CFC. While generally eliminating the indirect foreign tax credit under section 902, the Discussion Draft would amend section 960 of the Code to permit such a credit with respect to subpart F income. The Discussion Draft thus effectively eliminates the indirect foreign tax credit for "exempt" income under the proposal, while preserving the credit for subpart F income that continues to be fully taxable in the United States.

2. Discussion

The general elimination of the indirect foreign tax credit for non-subpart F income is consistent with the general exemption of such income from U.S. taxation. The technical explanation to the proposal does, however, clarify that "a foreign tax credit is allowed . . . for foreign tax paid directly by a domestic corporation on foreign source income (on, for example, income from foreign sales)." As a result of these changes, the principal types of foreign taxes eligible for foreign tax credits are likely to consist of

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[32] DD § 311(a).

foreign withholding taxes on interest, rents, and royalties received by domestic corporations, which under the proposal would remain creditable under section 901. The proposal should clarify that, as under current law, foreign taxes remain creditable to the extent they are imposed by a foreign country on a U.S. corporation where the foreign country treats the U.S. corporation as having a taxable presence in that country, whether or not the United States considers the domestic corporation to have a taxable presence in that foreign country.

Consistent with the proposal's imposition of the transition tax on the accumulated earnings of noncontrolled 10/50 corporations, the complete elimination of section 902 would mean that 10% shareholders in such corporations will not be able to claim an indirect foreign tax credit even though the dividends were subject to full U.S. tax because the shareholder did not elect to treat the noncontrolled 10/50 corporation as a CFC. As a result, the elimination of section 902, together with the scope of the transition tax, effectively compel 10% shareholders in noncontrolled 10/50 corporations to make the election. Assuming this was the intention of the drafters, we believe the treatment of noncontrolled 10/50 corporations under the Discussion Draft is likely to accomplish this goal.

B. Changes to Foreign Tax Credit Limitation and Tax Credit Splitter Rules

1. Overview

The Discussion Draft would modify section 904 of the Code by (i) providing that only directly allocable expenses may be allocated to foreign source income, and (ii) by

eliminating the separate category foreign tax credit limitation rules.[33] Foreign taxes carried forward to years following the implementation of the proposal would be subject to the new rules and would thus no longer be allocated to different limitation baskets. In addition, the Discussion Draft would repeal the recently-enacted foreign tax credit "splitter" rules under section 909, which were designed to prevent U.S. taxpayers from claiming foreign tax credits with respect to foreign income which was not yet subject to U.S. taxation.

2. Discussion

The elimination of the section 904 separate limitation categories and the section 909 foreign tax credit splitter rules represents a welcome simplification of the highly-complex foreign tax credit system. Given the reduced role of foreign tax credits in the Discussion Draft's territorial system, the need for complex rules governing and limiting the foreign tax credit should be greatly diminished. In particular, the need for the separate category foreign tax credit limitation rules is diminished under a system where the availability of cross-crediting has been reduced due to the general repeal of the section 902 indirect foreign tax credit. In addition to eliminating the separate category rules of section 904, consideration should be given to the elimination of the separate category rules of section 907, which govern foreign oil and gas income.

Nevertheless, we believe the retention of the section 901 direct foreign tax credit and the indirect foreign tax credit with respect to subpart F income will provide ongoing opportunities for cross-crediting under the proposal. Serious consideration should be given to whether rules limiting such cross-crediting – such as separate limitation

[33] DD §§ 312, 313.

categories for subpart F income, non-subpart F income, and, potentially, income subject to withholding tax – will be necessary under the foreign tax credit proposals of the Discussion Draft.

The allocation of only directly-allocable expenses to foreign source income is apparently intended to be consistent with the goal of not encouraging domestic corporations to move certain types of activities offshore. For example, allocating stewardship expenses incurred in the U.S. to foreign source income would create an incentive for companies to move such functions overseas. While the lack of allocation is not entirely consistent with a pure territorial system, and more generally is inconsistent with the principle that deductions should be allocated to the income they generate, the benefits of enhanced simplicity may outweigh the lost accuracy, in particular given the reduced import of the foreign tax credit under an exemption system. Nevertheless, expense allocation rules, in particular with respect to interest expense, may be warranted in light of the continued ability of domestic corporations to claim a tax credit under section 901 with respect to the foreign taxes imposed on foreign source income. Without such rules, for example, a domestic corporation could use debt to fund a foreign investment that generates foreign source income, such as royalty income. The tax – such as a foreign withholding tax – imposed on such income would be fully creditable, even though the investment is funded with debt the interest on which reduces U.S. source taxable income.

The same can be said for the elimination of section 909. There may remain scenarios in which creditable foreign taxes can be split from the underlying foreign income. In particular, rules will be necessary to clarify that foreign taxes imposed on the

income of a branch, which under the proposal is treated as a corporation for U.S. tax purposes, are treated as imposed on the "deemed CFC," rather than its domestic corporate shareholder, such that a credit cannot be claimed for those taxes under section 901 while the income of the branch remains exempt from U.S. taxation.[34] But assuming this is clarified, the opportunities for separating foreign taxes from the related foreign income should be greatly diminished due to the reduced role of the foreign tax credit. In particular, where the foreign tax credit can generally only be claimed with respect to subpart F income – which by definition is currently taxable in the United States – and with respect to foreign income directly earned by a domestic corporation – which again by definition is currently taxable in the United States – limited opportunities may remain for splitting creditable foreign taxes from the underlying income. If such opportunities do arise in the future, regulations addressing such scenarios would be appropriate. For example, regulations addressing the tax credit issue implicated in the case of *Guardian Industries Corp. v. United States*[35] may be necessary if section 909 is repealed.

C. Repeal of Sections 956, 959, and 961

1. Overview

The Discussion Draft would repeal current section 956, which concerns investments in U.S. property by a CFC, section 959, which concerns previously-taxed earnings and section 961, which concerns basis adjustments in CFC stock.

[34] The foreign jurisdiction in which the branch operates might treat that branch as a branch and thus the U.S. corporate owner would be the party that is liable for the tax under the law of that foreign jurisdiction.

[35] 477 F.3d 1368 (Fed. Cir. 2007).

2. **Discussion**

All of these simplifying changes are consistent with the exemption of foreign income of a CFC and of gain from the sale of the stock of such CFC. Given the 95% DRD on repatriated foreign earnings, little incentive should remain for a CFC to lend its earnings to a U.S. affiliate or invest its earnings in U.S. property. The only incentive to do so would be to avoid the 1.25% residual tax due upon repatriation. The Discussion Draft may be correct in assuming that this low rate of tax will not deter multinational enterprises from repatriating their foreign earnings if they otherwise wish to do so.

Likewise, as a result of the 95% DRD there is little reason to continue to track different pools of previously-taxed and untaxed earnings. As discussed above, the elimination of section 959 does result in the "double taxation" of subpart F income, which under the proposal is subject to full current taxation and an addition 1.25% tax upon repatriation. But that may simply represent a preference for simplicity over accuracy. The same is true of the elimination of section 961, which can result in the double taxation of gain attributable to subpart F income, as such income is taxed currently and then once again at an effective 1.25% rate when the stock of the CFC that generated the subpart F income is sold. We believe such treatment is appropriate, however, because it simply parallels the treatment of repatriated subpart F income.

IV. Treatment of Noncontrolled 10/50 Corporations, Foreign Branches, and Partnerships as Corporations

A. Election to Apply Participation Exemption to 10/50 Corporations

1. **Overview**

Under New IRC section 245A(b)(1), a domestic corporation may elect on a group-wide basis to treat its noncontrolled 10/50 corporations as CFCs for all purposes of

the Code. A noncontrolled 10/50 corporation is a foreign corporation in respect of which a domestic corporation would be eligible for the section 902 indirect foreign tax credit under current law: a foreign corporation that is not otherwise a CFC but in which a domestic corporation owns 10% or more of the voting stock.[36]

2. Discussion

As discussed elsewhere in this Report, shareholders in 10/50 corporations may be effectively compelled to make this election since they will be subject to the transition tax whether they make the election or not and they would lose the ability to claim the indirect foreign tax credit in all events under section 902. These features of the Discussion Draft may be designed with that purpose in mind, though consideration should be given to those circumstances in which it may be difficult for a shareholder in a non-controlled 10/50 corporation to obtain the information necessary to comply with the regime envisioned by the Discussion Draft (e.g., the transition tax based on accumulated earnings and profits or the current inclusion of subpart F income).

A few other points merit clarification. First, because the definition of a noncontrolled 10/50 corporation parallels eligibility for the section 902 indirect foreign tax credit under current law, the election would only apply to the first six tiers of foreign corporations. It is not clear why the election should be so limited. In addition, the provision states that the election would apply for all purposes of the Code. It should be clarified whether the election applies for purposes of the PFIC/CFC overlap rule such that a shareholder who makes the election with respect to a noncontrolled 10/50 corporation

[36] IRC § 902(a).

that is a PFIC would be exempt from the PFIC rules with respect to the stock in that corporation.

B. Treatment of Foreign Branches as CFCs

1. Overview

Under New IRC section 245A(b)(2), all foreign branches of a domestic corporation would be treated as CFCs for all purposes of the Code. A foreign branch of a domestic corporation is any trade or business of the domestic corporation in a foreign country, determined under the same principles that govern the determination of whether a foreign corporation is engaged in a U.S. trade or business.

2. Discussion

The Discussion Draft appropriately seeks to treat foreign branches of domestic corporations in a manner consistent with foreign corporations. Such a rule may be necessary to prevent taxpayers from operating in a foreign country through a branch while generating losses that can be used in the United States, and then converting the branch to a CFC when it starts earning income that under the proposal would be largely exempt from U.S. taxation (although the branch loss recapture rules under current law may allay that concern). More fundamentally, the treatment of foreign branches as corporations may be necessary to ensure consistent treatment of foreign operations whether they are generating income or losses. Because active foreign income under the proposal is generally exempt from U.S. taxation, the proposal should treat losses consistently to ensure that losses from foreign operations cannot be used to offset domestic taxable income.

Nevertheless, we believe further clarification is necessary regarding the precise scope of the branch rule and its interaction with other provisions of the Code. First, the

precise delineation of the scope of a branch is often uncertain because many branches do not operate as a distinct juridical entities. Defining the scope of a branch's activities will assume greater significance under the deemed incorporation proposal and the rules of the Code regarding the existence of a trade or business and effectively connected income is subject to uncertainty in many cases. Second, the proposal should clarify whether the rule applies to all branches in a chain of ownership or only the top-tier branch, in particular whether foreign branches owned indirectly by a U.S. corporation are treated as CFCs. As drafted, we assume that the proposal applies only to branches owned directly by a domestic corporation.[37] We also assume that if a domestic corporation owns a vertical series of branches (e.g., a London branch which owns a disregarded entity in France, which, in turn, owns a disregarded entity in Switzerland), only the branch that is directly owned by the domestic corporation is treated as a CFC. [38] If that is the intended treatment, we recommend that the language be clarified to this effect.

The proposal will also need to clarify how this provision applies with respect to income sourcing rules and tax treaties. For example, would payments made by the branch – such as interest payments – be sourced as if the branch were a distinct entity?

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[37] *See* DD § 301(a), New IRC § 245A(b)(2)(B) (defining a foreign branch of a domestic corporation as "any trade or business of such domestic corporation in a foreign country").

[38] If the provision is intended to apply to branches owned indirectly by a domestic corporation, then the rule would represent a dramatic departure from the current elective "check-the-box" regime that allows taxpayer to select the tax treatment – association, partnership or disregarded entity –for U.S. tax purposes, of most types of foreign business entities. In addition, applying the rule to indirectly owned branches could present various complications. For example, a lower-tier entity may have multiple owners such that under current law it is treated as a partnership. If one of the direct owners was a CFC and the other a domestic corporation, would that foreign entity be treated as a corporation with respect to one owner and a partnership with respect to the other? While that inconsistent treatment might create certain administrative burdens, it would not be fundamentally different than the inconsistent treatment of foreign entities under current tax law where a foreign corporation can be a CFC or PFIC with respect to some owners but not others. Nor would it be inconsistent with the Discussion Draft itself, under which a noncontrolled 10/50 corporation may be treated as a CFC by some of its owners but not others.

Likewise, would branches treated as CFC's for U.S. tax purposes be able to claim the benefits of treaties with the jurisdictions in which they are resident? For example, if a branch located in Country X is treated as a CFC under the Discussion Draft and it derives income from Country Y, can it claim benefits under the United States treaty with Country Y? Typically, under current law, the branch in Country X would be able to claim such benefits.

Finally, the proposal should clarify the transition rules that apply to branches that are deemed to undergo an incorporation as a result of the proposal. For example, the proposal should clarify whether – and if so, how – the rules of section 351, section 367, and the dual consolidated loss rules will apply to the deemed incorporation of the branch. Further, if the section 367 rules do not fully apply such that tax is not imposed on the deemed incorporation of the branch assets, then anti-abuse rules might be warranted with respect to assets that are placed in a branch in advance of the deemed incorporation.

C. Regulatory Authority With Respect to Partnerships

1. Overview

Under DD section 245A(b)(2)(C), to the extent provided by the Secretary in regulations, rules similar to the mandatory treatment of branches as CFCs will apply to partnerships with U.S. corporate partners.

2. Discussion

This provision would allow Treasury and the IRS to implement rules that effectively prevent domestic corporations from using partnerships instead of CFCs to obtain cross-crediting and other benefits available under current law. To the extent the rules effectively prevent a U.S. corporation from obtaining benefits that it could not obtain through operating a wholly-owned foreign branch, such rules would appear to be

warranted. For example, rules could be drafted to treat foreign partnerships with active businesses and greater than 10% U.S. owners as CFCs in the same manner as wholly-owned foreign branches. Foreign partnerships that function as holding companies, however, could continue to be treated effectively on a look-through basis.

V. Prevention of Base Erosion

The adoption of a territorial system of taxation creates incentives for U.S. enterprises to earn more of their income offshore through foreign affiliates. Whereas under current law such income is generally entitled to deferral, under the new regime it would be largely exempt from U.S. tax, and thus could be repatriated without residual tax, other than the 1.25% effective tax rate imposed upon repatriated earnings. Accordingly, the Discussion Draft provides for three alternative base erosion options, each of which would exclude certain types of income from the participation exemption and include them within the subpart F regime, subjecting the income to full and current U.S. tax.[39]

We believe the base erosion option that is ultimately selected should be consistent with the overall objective of the Discussion Draft. If the objective is to implement a territorial system, then Option B (taxation of low-taxed foreign income) seems inappropriate because it focuses on whether the foreign operations are subject to a minimum level of tax in the source country. On the other hand, Option B would be consistent with an exemption system that is designed to only exempt certain types of foreign income. Options A and C are arguably more consistent with a territorial system

[39] An implicit premise of at least two of these options is that the "arm's length" standard governing transactions among related parties under the section 482 regulations and other limitations under current law governing transfer pricing will not be sufficient to police attempts at base erosion under a territorial tax system.

in that the basic goal is not to tax the foreign income of non-U.S. entities, while trying to retain taxation of income that may be more readily moved outside the United States, i.e., income from intangible property.

The Discussion Draft requested comments on the three base erosion proposals. In this section we describe the three options provided in the Discussion Draft, and provide comments on each of them.

A. Option A: Excess Income From Transfers of Intangibles to Low-Taxed Affiliates Treated as Subpart F Income

1. Overview

Under DD section 331A, subpart F of the Code would be amended to create a new category of subpart F income called "foreign base company excess intangible income."[40] If a U.S. person transfers intangible property from the United States to a related CFC (whether via sale, lease, license, or cost sharing and other development agreements), certain income attributable to the use or exploitation of that intangible property that has not been subject to a minimum effective foreign tax rate in any jurisdiction would be includible in income and subject to full U.S. taxation.

In the first instance, the income from the intangible property that is included as "excess intangible income" is only that income that exceeds 150% of costs attributable to such income. Income derived from the use, disposition, or consumption of the intangible property in the same country as that in which the CFC is organized is not taken into account. The portion of the "excess intangible income" that is included under subpart F then depends on the foreign effective tax rate to which such income is subject. Income

[40] DD § 331A(a); New IRC § 954(a)(4), (f).

subject to a foreign effective tax rate equal to at least 15% is excluded from subpart F altogether. Income subject to a foreign effective tax rate between 10% and 15% is includible on a sliding scale, with the portion that is excluded from subpart F income equal to the ratio of (i) the amount by which the effective foreign tax rate exceeds 10% over (ii) 5 percentage points.[41] Thus, for example, if the income is subject to a foreign effective tax rate of 13%, only 40% of the income would be includible under subpart F as excess intangible income.

2. Discussion

Option A of the Discussion Draft would impose U.S. tax on the excess return on intangible property that has been shifted from a U.S. corporation to a foreign affiliate. The proposal resembles the excess intangible income proposal that has been included in the Administration's budget proposals.[42] The proposal presents a number of administrative and conceptual questions that would need to be addressed in greater detail if the proposal were enacted.

First, the proposal defines as "foreign base company excess intangible income" a CFC's gross income derived from the sale, lease, license of other disposition of property "in which [a] covered intangible is used," or performance of services related to such covered intangible.[43] The proposal thus includes *all* of the gross income from the sale of a good or performance of a service in which a covered intangible is used; it does not attempt to distinguish between gross income that is actually attributable to the covered

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[41] New IRC § 954(f)(2).

[42] *See* General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, 88-89 (Feb. 2012).

[43] DD 331A(b); New IRC § 954(f)(1)(A)(i).

intangible and other gross income derived from the sale of such good or provision of such service that is attributable to something other than a covered intangible. For example, a good might incorporate some intangible property that the CFC acquired from a related U.S. person, and that is therefore treated as a covered intangible, and other intangible property that the CFC developed itself or acquired from an unrelated person. If the CFC's "non-covered intangibles" are used in goods or services in which covered intangibles are also used, any "excess returns" earned by the CFC on those "non-covered intangibles" would be subject to taxation under Option A even though those intangibles were developed by the CFC or acquired in a transaction that did not involve a related U.S. person.

The lack of income allocation under Option A may reflect a desire to avoid the administrative complexity of such a system. If the intent is only to tax excess returns on the intangible income itself, however, then Option A should be revised to provide that only income attributable to a covered intangible is includible under subpart F, and not simply all income from the sale of a good or provision of a service in which a covered intangible is used. We acknowledge that such a revision would increase the administrative complexity of the proposal. Taxpayers may face considerable difficulty and uncertainty in distinguishing income and expenses properly attributable to covered intangibles from income and expenses attributable to other property. Absent such an allocation of income and expenses, the proposal would be overbroad. In evaluating the issue of base erosion, therefore, careful consideration should be given to the costs and compliance obligations associated with any proposal that would require taxpayers to distinguish between different types of income and allocate costs among them.

Clarification will also be required to specify which types of costs are entitled to the 50% mark-up provided under the proposal. The proposal subjects to taxation certain "gross income" in excess of 150% of the costs attributable to such gross income. Thus certain costs that are relevant in calculating gross income, such as costs of goods sold in the manufacturing context, presumably are not entitled to the 50% mark-up under the proposal. Other expenses, such as research and development expenses, are presumably entitled to the 50% mark-up.[44] For certain other expenses, most notably royalties paid with respect to a covered intangible, it is not clear, and should therefore be clarified, whether the 50% mark-up would apply.

The proposal also fails to take into account the likely timing mismatch between many items of income and expense. For example, although the provision allows the allocation of current year research and development expenses from the same line of business, the costs attributable to generating the intangible income may be incurred in years prior to the realization of the income. If the proposal were to be enacted, it should be modified to allow costs to be taken into account over time on some basis, such as through appropriate amortization rules. Otherwise, research and development expenses incurred in one year that give rise to income in another year would be disregarded as a cost in calculating the excess return on the intangible, generating subpart F income that does not represent a true excess economic return on the intangible.

The proposal also creates a potentially distortive cliff effect whereby income subject to an effective foreign tax rate of 15% is not subject to tax under subpart F but

[44] *See* New IRC § 954(f)(1)(C) (providing that research and developments costs allocable to the same line of business as the covered intangible are treated as allocable to gross income derived from a covered intangible for purposes of calculating excess intangible income).

income subject to an effective foreign tax rate of less than 10% is subject to full U.S. tax under subpart F, with the income included ratably as the foreign tax rate rises from 10% to 15%. Thus, excess intangible income subject to an effective foreign rate of 10% will be subject to full U.S. taxation, and thus effectively subject to tax at a 25% rate (after claiming a foreign tax credit for the foreign taxes paid by the CFC), while income subject to foreign tax of 15% will be exempt from U.S. tax and thus only subject to an effective tax rate of 16.25% (including the 1.25% residual tax due upon repatriation). This creates the undesirable incentive for a U.S. shareholder to increase the foreign effective tax rate of a CFC to 15%.

Finally, the proposal does not specify whether the foreign effective tax rate is determined based on the measurement of income under U.S. tax principles or foreign law principles. The explanation for Option B indicates that U.S. tax principles apply and we assume that this is also intended for Option A. We would recommend that the statutory language specify that the determination of the foreign effective tax rate be measured based on income of the CFC as determined under U.S. tax principles.[45]

B. Option B: Low-Taxed Cross-Border Foreign Income Treated as Subpart F Income

1. Overview

Under Option B of the Discussion Draft, income earned by a CFC that is neither derived from the active conduct of a trade of business in the home-country of the CFC (the "home-country exception") nor subject to an effective foreign tax rate of at least 10% would be includible in subpart F income as low-taxed cross-border income.

[45] This recommendation applies as well with respect to the statutory language of Option B, discussed in the following section.

The home-country exception will apply only if (i) the CFC maintains an office or fixed place of business in its country of incorporation, (ii) the income is derived in the conduct of a trade or business on the CFC's country of incorporation, and (iii) the income is derived from property sold for use in the home-country or services provided with respect to persons or property in such country. The CFC must therefore conduct a trade or business from an office in its home-country and derive its income from serving its home-country market.

For purposes of calculating a CFC's effective tax rate, the effective tax rate is determined separately for each country in which a CFC conducts business, aggregating its gross income in each such country.

2. Discussion

Relative to Option A, Option B has the advantage of administrative simplicity. Nevertheless, it does raise certain similar conceptual questions. Unlike Option A, Option B does not require taxpayers to measure intangible income or to distinguish between different types of income and costs. It should therefore be easier to determine the amount of subpart F income includible under Option B than under Options A or C.

Option B does, however, present concerns similar to those presented by Option A with respect to distortions created by its own cliff effect. Indeed, the cliff effect is even more pronounced under Option B than under Option A. Under Option B, foreign income subject to a greater than 10% rate is entitled to the full participation exemption, while foreign income subject to a rate of 10% or less is fully taxable in the United States (assuming the home-country exception is not met). As a result, foreign income subject to a local tax rate of 9% is subject to taxation at a 26.25% rate (full U.S. taxation with a credit for foreign taxes paid, plus the 1.25% residual tax upon repatriation), while foreign

income subject to an 11% foreign tax is only taxed at a 12.25% rate (including the 1.25% tax due upon repatriation). This creates an incentive for a CFC to raise its foreign effective tax rate to just over 10%, and an incentive for foreign governments to raise taxes to the detriment of the U.S. fisc.

As an alternative to mitigate this cliff effect, the portion of the CFC's income that is includible under Option B could be determined based on the ratio of the foreign effective tax rate to some "base rate", such as the 10% rate used currently in Option B. The proportion of the CFC's income that would be includible under subpart F would then equal 1 – (effective tax rate/10).[46] For example, if the CFC's foreign effective tax rate is 8%, then 20% of its income would be includible as subpart F income under Option B, while the remaining 80% would be exempt from taxation unless includible as another category of subpart F income. Once the CFC's foreign effective tax rate reaches 10%, none of its income would be subject to current inclusion under Option B. A CFC with a foreign effective tax rate of 8% would thus face an overall effective tax rate of 14.25% – an 8% local rate, a 5% U.S. rate (based on a 25% rate applied to 20% of the CFC's income), and a 1.25% residual tax upon repatriation of the earnings. No foreign tax credit would be available with respect to the income included under Option B on the theory that the income has effectively not been subject to foreign tax.[47] A CFC's

[46] Given revenue considerations, this formula could be adjusted so as to raise the effective tax rate "ceiling" on low-taxed income. For example, the portion of the CFC's income includible under subpart F could equal 1 – (effective tax rate/15), so that a portion of that CFC's income would be includible under subpart F as long as the income was subject to a foreign effective tax rate of less than 15%, rather than the 10% that is currently provided (albeit bracketed) in the proposal.

[47] Any disallowance of a credit for foreign taxes paid may be inconsistent with the provisions of certain income tax treaties. Consideration would have to be given to either overriding or renegotiating such treaties.

effective tax rate would thus fall ratably from 26.25% to 11.25% as its foreign effective tax rate rose from 0% to 10%;[48] it would then begin to climb again as the foreign effective tax rate rose above 10%. A CFC would thus still have an incentive to raise its foreign effective tax rate as high as (but no higher than) 10%. But the distortion created by the cliff effect would be greatly diminished.[49]

The cliff effect under Option B (as well as under Options A and C) will also heighten the significance of the effective tax rate determination for a CFC, as well as the significance of the question of whether a foreign tax qualifies as an "income tax". For example, it is possible that the actions of a third country taxing jurisdiction (e.g., a transfer pricing adjustment that is not recognized by the home jurisdiction) may reduce the foreign effective tax rate of a CFC to 10% or less, disqualifying the income of the CFC from the participation exemption. Although this is not necessarily a flaw in the proposal, any future legislation should carefully consider the potential impact of these determinations on the intended scope of the participation exemption.

Also critical to the proper functioning of Option B is the scope of its "home-country exception." The provision appears to be based on the Japanese model.[50] The Japanese model, however, does not require products to be sold within the country of incorporation in order to satisfy the home-country exception. Rather, it requires only that

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[48] Every one percentage point rise in the foreign effective tax rate up to 10% would reduce the CFC's effective tax rate by 1.5 percentage points.

[49] This "ratable inclusion" formula could be used under Options A and C to mitigate the cliff effects under those proposals as well.

[50] *See* Joint Committee on Taxation, Background on Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income, JCX-33-11, 29-30 (May 20, 2011) (describing the Japanese CFC rules).

the CFC have an active business, physical substance, and local management in its country of organization. Further consideration should be given to the scope of the home-country exception if a base erosion provision along the lines of Option B is adopted. It is not clear why a CFC with an active business and physical presence in its country of incorporation that serves other markets (including nearby regional markets) should be disadvantaged. For example, it may be economically efficient to use one company as a base from which to sell products or provide services to a regional market. Provided the presence in the home-country is substantial, it is not clear why a taxpayer should be required to duplicate functions in multiple countries to avoid the application of subpart F. Some of our members do not believe that the home-country exception should be expanded; others believe it should be eliminated altogether.

The ultimate scope of the home-country exception may also depend on how other aspects of subpart F are modified as well as the overall objectives of the Discussion Draft. If other modifications are made to subpart F income, such as the elimination of the categories of foreign base company sales income, foreign base service income, and foreign base oil income, as discussed below in Section V.D, then, consistent with such changes, an expanded home-country exception might be warranted. If, on the other hand, the goal of the proposal is to ensure a minimum level of taxation on all income, then perhaps a narrower home-country, or even no home-country exception, is warranted.

In evaluating the appropriateness of the home-country exception, it is worthwhile to consider the following example. Assume domestic corporation (USCo) forms a foreign subsidiary (IslandCo) that operates a hotel in a jurisdiction that does not impose an income tax. USCo also operates a hotel in the United States. If the home-country

exception applies under Option B, USCo would pay no tax (other than the 1.25% tax upon repatriation) on the income of the IslandCo hotel and a 25% tax on the income of the domestic hotel. This creates an apparent advantage, and potential incentive, for USCo to operate abroad. Yet, if there was no home-country exception, IslandCo would be at a disadvantage relative to other hotel operators on the island that are owned by local or other foreign corporations whose home jurisdictions have a territorial system of taxation that does not impose tax on the such "foreign" earnings. In addition, the particular business in this example is one that can only be conducted overseas in a single jurisdiction (i.e., a local hotel). These issues may be more acute in the case of business activities that could be conducted in the United States, or that by their nature are relatively mobile.

C. Option C: Foreign Intangible Income Subject to Tax at Reduced Rate; Intangible Income Treated as Subpart F Income

1. Overview

Option C of the Discussion Draft provides a combination of penalties intended to discourage the movement of intangible property and related income to foreign corporations and incentives intended to encourage the development and use of intangible property by domestic corporations. Under Option C, income earned by a CFC that is attributable to intangible property would constitute a new category of subpart F income. To the extent attributable to the exploitation of the intangible property outside the United States, however, the income includable under subpart F would be eligible for a 40% dividends-received-deduction, yielding an effective tax rate of 15%. In short, a CFC's income from the use of intangible property would be fully taxable in the United States to the extent the income is attributable to the use of that intangible property in the United

States, and would be taxable at a reduced 15% rate to the extent the income is attributable to the exploitation of the property outside the United States.

For purposes of this new category of subpart F income, the high-tax exception to subpart F under section 954(b)(4) would equal 60% of the tax rate provided under 954(b)(4), which itself is 90% of the statutory U.S. tax rate. Assuming the U.S. statutory tax rate is reduced to 25%, income of a CFC would not be taxable under subpart F if it is subject to an effective foreign tax rate greater than 13.5%.

Option C also provides a similar incentive for domestic corporations that earn income from the use of intangible property outside the United States. Such corporations could claim a deduction equal to 40% of such "foreign intangible income," resulting in a 15% effective rate of tax on such income. Thus a domestic corporation that directly earns income from the use of intangible property outside the United States would be in the same position as a domestic corporation that earned such income indirectly through a foreign subsidiary.[51]

2. Discussion

From an administrative perspective, Option C presents some of the same concerns as Option A. Specifically, it will require taxpayers to distinguish income attributable to intangible property from income attributable to other property. In addition, the proposal will need to clarify which expenses (if any) may be allocated by a CFC to its intangible income in calculating its subpart F inclusion within this category. The Discussion Draft defines intangible income as "gross income" from the use of intangible property in the

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[51] There would, in fact, be a slight benefit to earning such income directly, as such income earned through a CFC would be subject to a residual tax of 1.25% upon repatriation of such income.

sale of goods or provision of services. Presumably only *net* intangible income of the CFC will in fact be includible under subpart F,[52] and rules will be required to determine what expenses may be allocated to the intangible income in determining the net income taxable under subpart F.

Option C also creates a cliff effect similar to the one created by Option B. A U.S. corporation that owns a CFC that earns intangible income would, under this proposal, have an incentive to increase the foreign effective tax rate of that CFC to 13.5% in order to prevent the intangible income of the CFC from being subject to current tax under subpart F. CFC income taxed over that 13.5% rate would be exempt from U.S. taxation (other than the 1.25% residual tax due at the time of repatriation), whereas CFC income taxed at a slightly lower rate – e.g., a foreign effective tax rate of 12.5% – would be subject to taxation under subpart F, and if such income is attributable to the use of the intangible property in the United States, it would be subject to taxation at the full 25% statutory rate. A slight change in the foreign effective tax rate may therefore trigger a substantial increase in the overall effective tax rate imposed on the income of the CFC.

Finally, we would note that Option C, unlike the other options, distinguishes between income earned in the United States and income earned outside the United States, imposing full U.S. taxation only on the former. Arguably, to the extent these proposals are designed to protect the U.S. tax base from the incentives that might exist to erode that base under a territorial tax system, a proposal that distinguishes between income attributable to U.S. sales and services and income attributable to foreign sales and services is consistent with the overall approach in a territorial system. However, the

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[52] *See* IRC §954(b)(5).

requirement to determine the destination of goods sold may present administrative difficulties.

D. Overall Recommendation

Subject to the discussion of Option B above, we believe that Option B is the best of the three anti-base erosion proposals. Option B appears to be the simplest to administer and, by focusing mostly on income subject to a low level of tax, it has a better potential to police base erosion adequately over a broader range of activities. Although income from intangibles may be the most movable income, it is not difficult to predict whether that will always be the case.

E. Other Changes to Subpart F

Given the base erosion and other reform proposals to the taxation of foreign income under the Discussion Draft, consideration should be given to whether other changes should be made to the subpart F regime under current law to conform to these proposals. For example, in light of the general exemption of foreign income from U.S. taxation, we believe that certain of the currently expired provisions of subpart F – sections 954(c)(6), 954(h), and 954(i) – should be reinstated and made permanent, although not necessarily in their current form. In a tax system in which the active business earnings of a CFC are generally exempt from U.S. taxation, income of a CFC that is earned in the form of a dividend, royalty, interest, etc., but that is attributable to the active income of another CFC should not be subject to taxation under subpart F. If a first-tier CFC could pay a dividend directly to its U.S. shareholder without the U.S. shareholder incurring tax (other than the 1.25% residual tax on repatriation), there does not appear to be any reason for subjecting that U.S. shareholder to full U.S. taxation when a second-tier CFC pays a dividend to its CFC shareholder. The look-through rule

of section 954(c)(6) would ensure that all active income of a CFC is subject to the same rate of taxation regardless of the form in which such income is distributed within the corporate group. Likewise, consideration should be given to extending and making permanent the active financing exceptions of section 954(h) and 954(i), although if extended and made permanent, consideration might also have to be given to the precise scope of those exceptions in light of the actual experience to date with such provisions.

Finally, consideration should be given to whether the foreign base company rules of section 954(d), (e), and (g) should continue to apply in their current form. If the base erosion proposal(s) adopted under the Discussion Draft effectively police highly mobile and/or low-taxed income of foreign affiliates, there may no longer be a compelling policy reason for having separate and additional rules for taxing foreign base company income where the income earned by such a company is either already subject to a meaningful level of foreign taxation or is subject to full U.S. taxation under one of the base erosion proposals.

F. Denial of Deduction for Certain Interest Expense (DD § 332; IRC § 163)

1. Overview

The Discussion Draft would impose a limitation on the interest expense deductions that can be claimed by a U.S. corporation that is a U.S. shareholder with respect to a CFC, both of which are members of a worldwide affiliated group, as defined under section 864(f)(1)(C) but substituting "more than 50 percent" ownership for the "80 percent" ownership test of section 1504(a). Under those circumstances, a portion of the domestic corporation's otherwise deductible interest expense will be disallowed if, and to

the extent, the domestic corporation fails both a relative leverage test and a percentage of adjusted taxable income test.

Under the relative leverage test, excess indebtedness is the amount by which the total indebtedness of the U.S. members exceeds the debt those members would have if their aggregate debt-to-equity ratio were proportionate to the debt-to-equity ratio of the overall worldwide affiliated group. The ratio of that excess indebtedness over the actual indebtedness of the domestic members of the affiliated group is then calculated to determine the "debt-to-equity differential percentage."[53] Finally, to determine the amount of interest that would be disallowed under the relative leverage test, net interest expense of the domestic corporation is multiplied by the debt-to-equity differential percentage of the worldwide affiliated group.[54]

Under the percentage of adjusted taxable income test, adjusted taxable income is calculated as taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses, and certain other items. The disallowance under this test is determined by the extent to which net interest expense exceeds a currently unspecified percentage of adjusted taxable income.

The lesser of the two amounts determined under the relative leverage test and the percentage of adjusted taxable income test is the amount by which the net interest expense of the domestic corporation is disallowed. Any interest expense disallowed may be carried forward to the following taxable year. In addition, for purposes of determining

[53] DD § 332(a); New IRC § 163(n)(3).

[54] DD § 332(a); New IRC § 163(n)(1)(A).

the debt-to-equity ratios of the domestic corporations and the overall worldwide affiliated group, intragroup debt and intragroup equity are disregarded.

2. Discussion

The "thin capitalization" proposal in the Discussion Draft is similar to those currently in place in other countries, most notably Germany.[55] The rules depend on pre-determined formulae – i.e., the relative leverage of the domestic corporation and net interest as a percentage of adjusted taxable income. As such, the rules do not account for circumstances in which there may be valid business reasons for a U.S. member of a multinational corporate group to be more highly leveraged than its foreign affiliates. Nonetheless, thin capitalization rules are appropriate in the context of a territorial tax system, and the use of an easily administrable formula to limit interest expense may represent, like other aspects of the Discussion Draft, an appropriate trade-off of accuracy for simplicity.

A few aspects of the proposal do, however, merit further consideration or clarification. First, and perhaps most notably, the Discussion Draft does not select the precise percentage to be used in the percentage of adjusted taxable income test. As a potential model, Germany uses a 30% limit.[56] In contrast, the limit that is used under current law to limit related-party interest expense incurred by a domestic corporation with respect to a foreign affiliate is set at 50%.[57] Arguably, the limit on the interest expense

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[55] *See* Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income, JCX-33-11-1, 25-27 (May 20, 2011) (discussing certain aspect of German international tax law).

[56] *See id*.

[57] IRC § 163(j).

that may be incurred by a U.S. subsidiary within a foreign-parented multinational group under section 163(j) should parallel the interest limit on interest expense that can be incurred by U.S. parent corporations that are part of a multinational group of corporations. That parallelism can be achieved either by using the 50% limitation of section 163(j) in New section 163(n), or by adopting some other limit for both section 163(j) and New section 163(n). Likewise, the debt-to-equity tests used in the Discussion Draft and under 163(j) arguably should be made consistent. Either the interest disallowance proposal of the Discussion Draft could import the current section 163(j) 1.5:1 debt-to-equity safe-harbor or the relative leverage test under the Discussion Draft could replace the current debt-to-equity safe harbor under current section 163(j). In either case, one issue is whether the complexity of section 163(j) should be imported into this proposal at all. It may be that the relative leverage test, which is easier to apply and administer than the adjustable taxable income test, is a sufficient limitation on the interest deduction. A single relative leverage test would also avoid the problems noted above, as well as the issue of whether the calculation of adjusted taxable income will have a disparate impact on taxpayers in different industries.[58]

Second, the Discussion Draft should consider treating a borrowing by a U.S. parent the proceeds of which are on-lent to a CFC in the same manner as a direct

[58] If a relative leverage test is used, it may be necessary to use the worldwide average interest rate of the group to prevent interest disallowance attributable solely to differences between short and long-term interest rates. For example, the amount of interest paid in the U.S. may exceed the amount of interest paid on a worldwide basis not only because the U.S. debt-to-equity ratio of the U.S. group exceeds the debt-to-equity ratio of the worldwide group, but because the average maturity of the U.S. debt is longer.

borrowing by the CFC. As illustrated by the following example, the relative leverage test can lead to inappropriate results in the case of these transactions:

Suppose A, a U.S. corporation, has assets worth $200, excluding the stock of its CFC subsidiary, which has assets worth $50. A borrows $100 and on-lends $25 to CFC. Under the Discussion Draft, the $25 intragroup loan would be disregarded (as would the intragroup equity). The group's overall debt-to-equity ratio would be 0.4:1 ($100 of debt and $250 of equity based on total assets of $350 consisting of the initial assets of $250 and $100 of borrowed funds). A's stand-alone debt-to-equity ratio would be 0.5:1 ($100 of debt and $200 of equity based on total assets of $300 consisting of the initial $200 of assets, the $25 note payable from the CFC, and $75 of borrowed funds).[59] A would therefore be considered over-leveraged under the relative leverage test, and a portion of its net interest expense could be disallowed if its net interest expense exceeds an as yet unspecified percentage of A's adjusted taxable income. In contrast, if in an economically identical transaction A had borrowed $75 and the CFC had borrowed $25, the debt-to-equity ratio of the overall group would remain 0.4:1 ($100 of debt and $250 of equity), while the debt-to-equity ratio of A would be 0.375:1 ($75 of debt and $200 of equity). A would thus not be over-leveraged and none of its interest expense would be subject to disallowance. This distortion derives from the fact that in an on-lending transaction, the debt and assets of the on-lender are increased on a 1:1 basis. The on-lending thus inflates

[59] The Discussion Draft excludes from the measurement of the domestic corporation's assets any "interest" of the domestic corporation in the foreign subsidiary. It is unclear whether the term "interest" refers only to an equity interest in the foreign subsidiary or includes a note payable of the foreign subsidiary held by its domestic affiliate. The numbers in this example assume the former. If the latter, the problem illustrated by this example is even more pronounced as the domestic corporation debt-to-equity ratio would rise to 0.57:1, subjecting even more of its interest expense to disallowance. *See* DD § 332(a); New IRC § 163(n)(3)(D)(iii).

the debt-to-equity ratio of that party, even though it may be functioning simply as an economic conduit for the ultimate borrower.

There are often legitimate business purposes for consolidating third-party borrowing at a single member of a multinational group. For example, often a single member, frequently the publicly-traded parent, has a credit rating or is able to access the public debt markets. The interest disallowance proposal should not treat on-lending transactions any differently than direct borrowing transactions. The proposal could be revised, or special rules could be drafted for on-lending transactions that would disregard the intermediary and treat the loan as if it had been made directly by the third-party lender to the ultimate borrower.