Baucus tax reform discussion draft takes on international tax rules

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

Although it is not an introduced bill, the draft does contain legislative language and indicates the direction that Baucus is contemplating as he undertakes a large-scale rewrite of the tax code. The text of the proposal, summaries prepared by Finance Committee staff, and a technical explanation prepared by the Joint Committee on Taxation staff were all released as part of this draft and are available on the Finance Committee Web site. URL: http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14

House Ways and Means Chairman Dave Camp, R-Mich., released his own discussion draft on international tax reform two years ago, but it differs significantly from the Baucus proposal. (For prior coverage of Camp’s discussion draft, see Tax News & Views, Vol. 12, No. 49, Oct. 26, 2011.) URL: http://newsletters.usdbriefs.com/2011/Tax/TNV/111026_1.html

The Baucus draft proposes ending deferral on a class of controlled foreign corporation (CFC) income as defined under one of two options — referred to as “Option Y” and “Option Z” — and then exempting the rest, regardless whether it is repatriated. Option Y aims to set a minimum tax on worldwide income; Option Z aims to partially exempt from U.S. tax “active foreign market income.” Baucus has indicated that the draft is intended to be revenue neutral on an ongoing basis.

Option Y & Option Z

Both options would change the type of controlled foreign corporation (CFC) income that is currently taxed (subpart F income) and would exempt the remainder from U.S. tax, but they do so differently. Both options would apply only to foreign income earned by CFCs. The draft does not address income earned by branches.

Option Y – With respect to distributions of CFC income that is not subpart F income under Option Y, 10 percent U.S. corporate shareholders generally receive a 100 percent dividends received deduction (DRD) for the “foreign-source portion.” “CFC” would be given the same meaning as in present law, and thus, unlike Chairman Camp’s discussion draft, CFCs would not include foreign branches or 10/50 companies. Instead of the 95 percent DRD in Camp’s discussion draft, U.S. shareholder interest expense apportioned to the non-subpart F (i.e., U.S.-tax exempt) income of its CFCs is disallowed.

Option Y would redefine subpart F income to include “United States related income,” defined as the sum of “imported property income” and “United States services income.” Imported property would be defined as property which is imported into the United States by a CFC or related person. Imported property income would be defined as income derived in connection with: (1) manufacturing, producing, growing, or extracting imported property, (2) selling, exchanging, or otherwise disposing of imported property, or (3) leasing, renting, or licensing imported property. U.S. services income would be defined as income derived in connection with services provided with respect to persons or property located within the United States, or with respect to U.S. risks.

Option Y would also treat as subpart F income any item of a CFC’s income which is subject to an effective foreign income tax rate of less than 80 percent of the maximum U.S. corporate tax rate (Low Taxed Income). The effective rate would be determined under U.S. tax principles and would generally take into account present law net operating loss rules of section 172, but would not take into account any net operating loss carrybacks. While Low Taxed Income becomes a type of “subpart F income,” the U.S. shareholder of the CFC would also be allowed a deduction of 20 percent of the amount included in the shareholder’s income as Low Taxed Income. Option Y is intended to set a minimum worldwide tax rate for foreign income based on a percentage of the U.S. domestic corporate tax rate, but the draft does not specify what the post-tax-reform domestic rate should be. Further, the percentage itself is bracketed, meaning that it is not a hard target and can be changed.

This option would repeal many present-law categories of subpart F income, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income, but not foreign personal holding company income, which would survive in an amended form. The active financing exception, for example, would be made permanent, with some modifications.
Option Y would create new foreign tax credit baskets under section 904(d) for each of: (1) passive income, (2) subpart F attributable to insurance income as defined under section 953, (3) subpart F attributable to U.S. related income, (4) subpart F attributable to Low Taxed Income, (5) foreign branch income, and (6) income other than that described in the previous five items. Foreign tax credits would be allowed against U.S. tax on subpart F inclusions.

**Option Z** – The U.S. shareholder of a CFC would owe current U.S. tax, subject to allowable foreign tax credits, on the shareholder’s pro rata share of:

- 60 percent of the CFC’s net “active foreign market income” (AFMI); and on
- All of the CFC’s net “nonactive income” (which would include “passive income).

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

Foreign tax credits would be allowed against U.S. tax on these subpart F inclusions, excluding credits for the foreign taxes on the 40 percent of net AFMI that escapes subpart F income status. Taxes on each of (1) subpart F income from AFMI, (2) passive income, and (3) other income, would be separately “basketed.” Deemed-paid credits (allowable only under section 960) would no longer be determined on a “pooling” basis.

Interest expenses of U.S. shareholders properly allocated and apportioned to CFC income would be disallowed based on a formula apportionment between the 40 percent of a CFC’s net AFMI that is excluded from shareholders’ income and the remainder of CFC earnings.

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

**Passive income** – “Passive income” would be defined similarly to foreign personal holding company income under present law (not including the CFC look-through rule), with the active financing exception made permanent, and somewhat modified, especially in the case of insurance income. CFC-to-CFC dividends would be spared passive income treatment thanks to the PTI rules.

**Major changes to international rules in both options**

**Previously deferred income** – To transition to the new system, the draft would require that the U.S. shareholder of a CFC include in income its pro rata share of the accumulated deferred foreign income. The resulting tax (at what is suggested would be a 20 percent rate) may be reduced by foreign tax credits attributable to the taxable portion of the prior earnings. This tax on deferred income could be paid in installments over an eight-year period.

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

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

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

Hatch’s reaction

Although Baucus has indicated that he would like to move tax reform legislation through the Finance Committee on a bipartisan basis, ranking Republican Orrin Hatch of Utah did not attach his name to the discussion draft; moreover, Senate GOP taxwriters generally had urged Baucus to delay releasing a draft proposal until after the House and Senate conferees reach an agreement on a concurrent budget blueprint for fiscal year 2014. (For prior coverage of GOP concerns, see Tax News & Views, Vol. 14, No. 43, Nov. 15, 2013.) In a November 19 news release, Hatch noted that there are still “significant policy differences” between Democratic and Republican Finance Committee members on tax reform but otherwise made no comment on specific provisions in the draft.

URL: http://newsletters.usdbriefs.com/2013/Tax/TNV/131115_1.html

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

Baucus seeks public comments

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

URL: http://newsletters.usdbriefs.com/2013/Tax/TNV/131119b_1suppA.pdf

Tax administration, cost accounting drafts to follow

Baucus reportedly may release staff drafts on tax administration and the cost method of accounting in the coming days. Deloitte Tax will provide details on those proposals as they become available.

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