PRESIDENT'S LEGISLATIVE PROPOSALS

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On September 29, 2015, various changes to the current tax law were proposed in the Obama Administration's Fiscal Year 2016 Budget Proposal (the "Proposal"). The Proposal is designed to provide additional revenue increases and spending cuts. These changes are designed to provide deficit reduction measures. In many respects, the Proposal is a continuation of proposals that have been made, but not enacted, in prior years.

If enacted, the changes described in the Proposal could influence global patterns of investment and employment by U.S. multinationals. The likelihood that the Proposal will be enacted is not high. However, in the U.S., unenacted legislative proposals develop a patina that often make them attractive in later years for budgetary reasons. Tax reductions for some taxpayers must be offset by revenue raised from other sources. Hence, unenacted proposals serve as a resource for those favoring future tax reductions. Additionally, the winner of next year's presidential election may in turn look for revenue raisers – with the Proposal being an easy resource to tap by a future president sharing the same views as Mr. Obama.

The Joint Committee on Taxation ("J.C.T.") published a description and analysis of the Proposal's provisions. However, the magnitude of the consequences of the Proposal is not clear. This article addresses several of the provisions intended to affect U.S. taxation of global operations.

RESTRICT DEDUCTIONS FOR EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS

The Proposal would modify deductions for excessive interest costs of members of a "financial reporting group," which is defined as a group that prepares consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles ("G.A.A.P."), International Financial Reporting Standards ("I.F.R.S."), or another method authorized by the Secretary of Treasury under the regulations.

When first proposed several years ago, the interest expense deduction for a member of a financial reporting group generally would be limited to the member's interest income plus its proportionate share of the financial reporting group's net interest expense computed under U.S. tax principles. The interest deduction rule under the original proposal does not apply to financial services entities.

This year's Proposal changes the calculation of the limitation and relies more heavily on data reported on financial statements when computing interest expense. A member's deduction for interest expense generally would be limited if the member has net interest expense for tax purposes and the member has "excess financial statement net interest expense." Excess financial statement net interest expense is the amount by which the member's net interest expense for financial reporting purposes, computed on a separate company basis, exceeds the member's proportionate share of the net interest expense reported on the financial reporting group's consolidated financial statements. A member's proportionate share is a function of its share of the group's E.B.I.T.D.A. (*i.e.*, earnings computed by adding back net interest expense, taxes, depreciation, and amortization) as reflected in the group's financial statements.

When a member has excess financial statement net interest expense, it will have excess net interest expense for tax purposes, for which a current deduction is disallowed in the same proportion that its net interest expense for financial reporting purposes is excess financial statement net interest expense. If there is no excess financial statement net interest expense and the member's net interest expense for financial reporting purposes is less than its proportionate share of the financial reporting group's net interest expense, such excess limitation is converted into a proportionate amount of excess limitation for tax purposes and can be carried forward to the three subsequent tax years.

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If a U.S. member of a U.S. subgroup owns stock in one or more foreign corporations, this proposal applies before the Administration's minimum tax proposal. The U.S. subgroup's interest expense that remains deductible after application of this proposal is subject to the limitations on deductibility outlined in the Administration's minimum tax proposal (discussed below).

The goal of this provision is similar to existing legislation in the U.K. and to the B.E.P.S. action on interest deductions and other financial payments. Governments in high tax countries, such as the U.S., become upset when operations in those countries are financed by too much debt. Of course, the point at which debt becomes *too much* is in the eye of the beholder.

REPEAL DELAY IN THE IMPLEMENTATION OF WORLDWIDE INTEREST EXPENSE ALLOCATION

For the purpose of computing the foreign tax credit limitation of Code §904, present law provides detailed rules on how to allocate deductible expenses between U.S.-source income and foreign-source income. The foreign tax credit limitation measures the maximum amount of U.S. tax that can be offset by credits for foreign income taxes. Only U.S. tax on foreign-source income can be reduced by the credit. Since foreign-source taxable income is determined by identifying the source of all items of gross income and the expenses allocated to foreign-source gross income, the allocation of expenses affects a taxpayer's potential exposure to double taxation. As more expenses are allocated to foreign-source income, the limitation is reduced and the exposure to double taxation grows.

When allocating interest expense deductions to domestic-source or foreign-source income, money is treated as a fungible commodity and the interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. For interest allocation purposes, all members of an "affiliated group" of corporations generally are treated as one taxpayer, and allocations and apportionments of interest expense are made on the basis of assets rather than gross income.[1] Debt is seen as advancing all assets and activities of a corporation, and as a result, the related interest costs are not specifically allocated to any particular item of income. The term "affiliated group" in this context is generally defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[2]

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Where a taxpayer apportions interest costs based on the tax book value method of apportionment – a method that uses historic costs, adjusted for depreciation and capital contributions – the basis of stock in shares of a 10%-owned foreign corporation, such as a C.F.C., must be adjusted for its retained earnings that are not otherwise reflected in basis. As the basis increases in the shares of a C.F.C., more interest expense is apportioned to the investment in the foreign shares and a smaller portion of worldwide taxable income is considered to be foreign-source taxable income. This rule takes into account chains of foreign corporations that are owned by a first tier C.F.C.

Financial corporations are generally excluded from the affiliate group.[3] Instead, the financial corporation is a separate single corporation for interest allocation purposes. A financial corporation includes any corporation which would otherwise be a member of the affiliated group for consolidation purposes that is a financial institution (as described in Code §581 or §591), the business of which is predominantly with persons other than related persons or their customers, and which is required by state or Federal law to be operated separately from any other entity that is not a financial institution.[4] The category of financial corporations may also include bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business.[5]

The current rules for the apportionment of interest costs do not take into account the assets, debt, and interest costs of foreign subsidiaries other than in the way interest costs reduce earnings at the level of the foreign subsidiary when retained earnings increase assets for apportionment purposes. As a result, distortions occur in computing the foreign tax credit limitation because both the U.S. parent's interest expense and the foreign subsidiaries' interest expense are allocated to foreign-source income. In legislation that was enacted in 2004, this problem was addressed by a provision calling for worldwide allocation and apportionment of interest expense.

The American Jobs Creation Act of 2004 ("A.J.C.A."), among other things, modified

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1 Code §864(e)(1) and (e)(2).

2 Code §864(e)(5).

3 Treas. Reg. §1.861-11T(d)(4).

4 Code §864(e)(5)(C) and Treas. Reg. §1.861-11T(d)(4)(ii).

5 Code §864(e)(5)(D).

the interest expense allocation rule by providing a one-time election that allows the taxable income of domestic members of an affiliated group from sources outside the U.S. generally to be determined by allocating and apportioning the interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (*i.e.*, as if all members of the worldwide group were a single corporation). Philosophically, this provision shares the same view of interest costs as the excessive interest proposals discussed above, in that its premise is that interest should be apportioned globally.

If this election is utilized, the taxable income of domestic members of a worldwide affiliated group from sources outside the U.S. would be determined by apportioning interest expense on borrowings from the third parties to foreign-source income pursuant to a multi-step formula:

1. Determine the total interest expense of the worldwide affiliated group ("Global Interest").
2. Multiply Global Interest by a fraction in which the numerator consists of the foreign assets of the worldwide group and the denominator consists of the global assets of the worldwide group ("Group Foreign Interest").
3. From the Group Foreign Interest, subtract the portion attributable to the foreign members of the group, *viz.*, the amount that would be apportionable to foreign-source income if the group consisted only of the foreign members.

The remainder is the maximum amount of the U.S. group's interest expense that can be apportioned to the foreign-source gross income of the U.S. group. The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between the three broad categories of foreign-source income on a *pro rata* basis, based on assets. Broadly, these foreign-source income categories are (i) income that is subject to taxation at the full U.S. statutory tax rate, (ii) income that is entirely exempt from U.S. taxation, and (iii) income that is taxed at a variety of different tax rates under the minimum tax system. In principle, the cap will be significantly lower than the apportioned amount under typical rules.

Taxpayers are allowed to exclude certain financial institutions from the affiliated group under the bank group rules for interest allocation purposes under the worldwide fungibility approach. A one-time "financial institution group" election is also available to expand the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of

1. all corporations that are part of the bank group, and
2. all "financial corporations."

For this purpose, a corporation is a financial corporation if at least 80% of its gross income is financial services income that is derived from transactions with unrelated persons. For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

As discussed below, the Administration proposes to impose tax on foreign income at various rates, including a minimum tax of 19%, a tax at ordinary rates, and zero tax. The apportionment formula in the Proposal would be used to apportion interest expense to each of these baskets.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. Once made, the election applies to the current taxable year and all subsequent taxable years, unless revoked with the consent of the I.R.S. When enacted originally, the election was to be available for taxable years beginning after December 31, 2008. Subsequent legislation[6] deferred the availability of the election until taxable years beginning after December 31, 2020. The Proposal repeals the delay of the worldwide affiliated group election so as to make it available for taxable years beginning after December 31, 2015.

PERMANENTLY EXTEND THE EXCEPTION UNDER SUBPART F FOR ACTIVE FINANCING INCOME

Since 1997, the C.F.C. rules have contained a temporary exception for income derived in the active conduct of a banking, finance, or similar business from the scope of foreign personal holding company income ("F.P.H.C.I.").[7] The presence of F.P.H.C.I. can result in the imposition of current tax for U.S. shareholders.[8] The same temporary exception was also provided in the definition of foreign base company services income ("F.B.C.S.I.") and insurance income, which can also result in deemed dividends to U.S. shareholders.[9]

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This temporary relief for active banking and finance income expired at the end of last year, and attention has now focused on the need for a retroactive extension.[10] The Proposal includes a permanent extension of relief from the Subpart F rules for active banking and financing businesses. The permanent extension would be effective retroactively for taxable years of foreign corporations beginning on or after December 31, 2014, and for all taxable years of affected U.S. shareholders.

PERMANENTLY EXTEND LOOK-THROUGH TREATMENT FOR PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS

Under the Subpart F exception commonly referred to as the "C.F.C. Look-Through Rule," dividends, interest, rents, and royalties received or accrued by one C.F.C. from a related C.F.C. are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither Subpart F income nor treated as effectively-connected income of the payor C.F.C.

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6 Pub. L. No. 110-289 ("HERA").

7 Code §954(h).

8 Code §951(a).

9 Code §§954(e)(2), (i).

10 Code §954(h)(9).

For this purpose, a related C.F.C. is a C.F.C. that controls or is controlled by the other C.F.C., or a C.F.C. that is controlled by the same person or persons that control the other C.F.C. Ownership of more than 50% of the C.F.C.'s stock (by vote or value) constitutes control for these purposes.

The I.R.S. is authorized to prescribe regulations that are necessary or appropriate to carry out the C.F.C. Look-Through Rule, including regulations appropriate to prevent the abuse of the purposes of such rule. The C.F.C. Look-Through Rule applies to taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2015, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The C.F.C. Look-Through Rule reflects the view that the Subpart F rules burden a U.S. multinational company ("M.N.C.") more heavily than the tax laws of other countries when an entity in an M.N.C. group has used business earnings to make cross-border interest, royalty, other payments to another entity in the group. On the other hand, the Administration is concerned that by allowing a C.F.C. to make an untaxed, deductible cross-border payment to a related C.F.C., the C.F.C. Look-Through Rule may facilitate foreign tax reduction because a U.S. M.N.C. might arrange intra-group payments from entities in high-tax countries to entities in low-tax countries. This latter view is consistent with the view of tax planning held by the O.E.C.D. and is reflected in the B.E.P.S. Action Plan.

The Proposal makes the C.F.C. Look-Through Rule permanent, but only as part of its overall plan to impose a 19% minimum tax on foreign income. According to the Administration, the combination of the permanent extension and the minimum tax is an appropriate policy response to concerns of foreign governments and the O.E.C.D. regarding foreign-to-foreign payments. It ensures that such payments could not be used to shift income into entities with effective tax rates below the minimum tax rate of 19%.

IMPOSITION OF A PER-COUNTRY 19% MINIMUM TAX ON FOREIGN INCOME

The Proposal aims to significantly change the taxation of a domestic C corporation's foreign earnings by imposing a per-country minimum tax on the earnings from a C.F.C. or branch from the performances of services abroad. Under the Proposal, the foreign earnings of a C.F.C. or branch from the performance of services are subject to current U.S. taxation at a rate of 19%. This minimum tax can be reduced by a foreign tax credit of 85% of the per-country foreign effective tax rate (the "Residual Minimum Tax Rate"). As a result, if the per-country foreign effective tax rate is at least 22.35% on income that is computed under U.S. income tax principles, no tax will be imposed on the domestic C corporation's foreign income.

The foreign effective tax rate under the Proposal is computed on an aggregate basis over a 60-month period ending on the date the domestic corporation's current taxable year ends or, in the case of a C.F.C., on the date on which the C.F.C.'s current taxable year ends. The foreign taxes taken into account are those taxes that, absent the Proposal, would be eligible to be claimed as a foreign tax credit during the

60-month period. The foreign earnings taken into account for the 60-month period are determined using U.S. tax principles, but would include disregarded payments deductible elsewhere, such as disregarded intra-C.F.C. interest or royalties, and would exclude dividends from related parties.

In addition, the tax base would be reduced by a risk-free return on equity invested in active assets within the country. Active assets generally would include assets that do not generate foreign personal holding company income, determined without regard to both the C.F.C. Look-Through Rule (discussed above) and any election to disregard an entity as separate from its owner.

The minimum tax proposal includes rules for assigning foreign earnings and taxes to a specific foreign country. The basic rule assigns earnings and taxes to the country based on the tax residence determined under foreign law. Thus, for example, if a C.F.C. is incorporated in Country X but is tax-resident in Country Y under both the Country X and Country Y place of management tests for tax residence, the earnings and associated foreign taxes are assigned to Country Y. On the other hand, if instead of a place of management test Country Y uses the place of incorporation test, Country X sees the C.F.C. as a tax resident of Country Y while Country Y sees the C.F.C. as a tax resident of Country X. In this case, the C.F.C. may not be subject to foreign tax anywhere and the C.F.C.'s earnings are therefore subject to the full 19% minimum tax under the proposal. If a C.F.C. is subject to tax in multiple countries, the earnings and all of the taxes associated with those earnings are taxed to the highest-tax country.

Special rules would be implemented under the proposal to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country. So, for example, no deduction would be allowed for a payment from a disregarded entity based in a low-tax country to its sole shareholder based in a high-tax country if the dividend is eligible for a participation exemption in the high-tax country. The earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

"Under the Proposal, no U.S. tax would be imposed on the sale by a U.S. shareholder of stock of a C.F.C. to the extent that any gain reflects the undistributed earnings of a C.F.C."

The minimum tax would be imposed on current foreign earnings even if repatriated to the U.S. As a result, tax management of a U.S.-based M.N.C. would face the following choices: (i) pay tax abroad at a rate of at least 22.35%, in which case there would be no further tax upon repatriation, or (ii) pay tax in the U.S. under Subpart F at the statutory rate of 35% for C corporations with taxable income in excess of $10 million.

C corporations would no longer be taxed on increased investment in U.S. property.[11] An accompanying provision would exclude C corporations from the benefit of the previously taxed income rules of Code §959.

Under the Proposal, no U.S. tax would be imposed on the sale by a U.S. shareholder of stock of a C.F.C. to the extent that any gain reflects the undistributed earnings of a C.F.C. This is because these undistributed earnings would generally have already been subject to tax under the Subpart F rules, the 19% minimum tax rule, or the 14%

[11] Code §956.

one-time tax rule (discussed below). Also, the Proposal would tax any stock gain attributable to unrealized gain in the C.F.C.'s assets in the same manner as would apply to the future earnings from the C.F.C.'s assets. That is, the stock gain would be subject to the minimum tax or to tax at the full U.S. tax rate to the extent that the gain reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or Subpart F, respectively.

The Proposal would not change the present law on the taxation of foreign-source royalty and interest payments received by a U.S. corporate taxpayer. These payments would be subject to the full U.S. tax rate. To the extent a foreign branch of a U.S. corporation uses intangible assets owned by its U.S. parent, the branch would be treated as making royalty payments to its owner that are recognized for U.S. tax purposes.

As mentioned above regarding the apportionment of interest expense, interest expense incurred by a U.S. corporation must be apportioned to a C corporation's income as part of the full tax basket, the minimum tax basket, and/or the tax-free basket. For interest expense allocated to the last basket, no deduction would be permitted.

This provision would be effective for taxable years beginning after December 31, 2015.

MANDATORY DEEMED REPATRIATION: IMPOSITION OF A ONE-TIME 14% TAX ON PREVIOUSLY UNTAXED FOREIGN INCOME

The above-described 19% minimum tax on foreign income generated after the effective date of the provision would be accompanied by a one-time 14% tax on a C.F.C.'s deferred earnings accumulated for tax years beginning before January 1, 2016. Thus, this proposal has been described as a mandatory deemed repatriation.[12] The 14% tax would be paid over five years. A credit would be available for foreign taxes on the deferred earnings. However, the amount of the creditable tax would be reduced to reflect the fact that the taxable income under the deemed repatriation provision will be subject to U.S. corporate tax at a rate that is much less than the standard tax rate of 35%. Only 40% of creditable foreign taxes will be available for credit.

This provision would become effective on the date of enactment, but is contingent upon the enactment of the 19% minimum tax.

CLOSE LOOPHOLES UNDER SUBPART F: EXPANDING ATTRIBUTION RULES & ELIMINATING THE 30-DAY GRACE PERIOD

12 Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal, JCS-2-15, p. 62.

The Proposal would tighten the C.F.C. rules by closing down two perceived "loopholes." These proposals expand the C.F.C. constructive ownership rules and eliminate a 30-day ownership requirement in present law. These proposals are effective for taxable years beginning after December 31, 2015.

In determining whether a foreign company is a C.F.C., Code §958(b) incorporates the constructive ownership rules of Code §318. Section 318(a)(2) provides that stock owned by a shareholder of a company may be attributed downwards to that company, which makes that company the owner of the shares. However, Code §958(b)(4) then modifies these rules by providing that constructive ownership is not to be applied to consider a U.S. person as owning stock that is owned by a non-U.S. person.

When foreign companies acquire U.S. target companies having C.F.C. subsidiaries, the post-acquisition structure is commonly referred to as a sandwich structure in which the U.S target company is the "meat" in the sandwich and the foreign acquiring company and the C.F.C.'s are the two slices of bread.

Under the current law, the C.F.C. status of the foreign subsidiaries can be eliminated if the foreign parent acquires more than half their stock. As mentioned above, ownership by the foreign parent is not attributed to the U.S. target for purposes of determining the status of the foreign corporation as a C.F.C. Consequently, the foreign company can subscribe for newly-issued stock in the C.F.C. in order to eliminate C.F.C. status. Since the C.F.C. constructive ownership rules do not attribute a foreign parent's ownership of a foreign subsidiary to a U.S. target, the foreign subsidiary is no longer a C.F.C. even though all of its stock is owned by the foreign parent group.

In Notice 2014-52, the I.R.S. issued new rules to try to halt certain inversion transactions that are the intended target of Code §7874. Section 3.02(d) of the Notice states that after an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a C.F.C. The Notice recognizes that:

> [A]fter an inversion transaction, a foreign acquiring corporation could issue a note or transfer property to an expatriated foreign subsidiary in exchange for stock representing at least 50 percent of the voting power and value of the expatriated foreign subsidiary. The expatriated foreign subsidiary would cease to be a C.F.C.

The Notice states it will stop these transactions by either preserving the C.F.C. status of the foreign subsidiary or by triggering current income inclusion under Code §956. However, the Notice does not apply to non-inversion transactions such as when the new foreign parent purchases in cash the stock of the U.S. target only. Additionally, some practitioners believe the I.R.S. Notice may extend beyond the scope of the statute and may be invalid for that reason.

The Proposal would change the statutory attribution rules to allow downward attribution from the foreign parent to its U.S. target subsidiary so that the U.S. target's foreign subsidiaries will remain C.F.C.'s. This proposal would apply to any transaction, and not just inversion transactions as addressed in the Notice.

This provision is to be applied prospectively.

The second proposed provision changes the current rule that a Subpart F deemed income inclusion can only occur if the foreign company was a C.F.C. for an uninterrupted period of 30 days. This provision eliminates this 30-day grace period. The provision addresses transactions in which a foreign corporation is acquired at the end of the relevant taxable year so that the 30-day rule is not met. During that period, restructuring can apply without recognition of income under Subpart F. An example is a check-the-box election that would otherwise result in the generation of Foreign Personal Holding Company Income. Under the proposed provision, the Foreign Personal Holding Company Income would still be realized in such cases.

ADMINISTRATION FAVORITES REPROPOSED

The Proposal contains provisions that were included in prior budgets but which have not been enacted. These include provisions to

- limit shifting of income through intangible property transfers,
- disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates,
- modify tax rules for dual capacity taxpayers,
- tax gain from the sale of a partnership interest on a look-through basis,
- modify §§338(h)(16) and 902 to limit credits when non-double taxation exists,
- restrict the use of hybrid arrangements that create stateless income,
- limit the ability of domestic entities to expatriate when group management remains in the U.S., and
- exempt foreign pension funds from the application of the Foreign Investment in Real Property Tax Act (“F.I.R.P.T.A.”).