TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

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TITLE II – TAX REFORM FOR BUSINESS

A. Corporate Income Tax Rate Reduction

1. Corporate income tax rate reduction (sec. 201 of the discussion draft and sec. 11 of the Code)

Present Law

Corporate taxable income is subject to tax under a four-step graduated rate structure. The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below:

Taxable Income	Tax Rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

An additional five-percent tax is imposed on a corporation's taxable income in excess of $1 million. The maximum additional tax is $11,750. Also, a second additional three-percent tax is imposed on a corporation's taxable income in excess of $15 million. The maximum second additional tax is $100,000.

Certain personal service corporations pay tax on their entire taxable income at the rate of 35 percent.

Present law provides if the top corporate rate exceeds 35 percent, the maximum rate on a corporation's net capital gain will not exceed 35 percent.

Explanation of Provision

The provision reduces the maximum corporate tax rate from 35 percent to 25 percent.

The provision maintains the present law 15-percent corporate tax rate for taxable income not in excess of $50,000. For a corporation with taxable income in excess of $100,000, the benefit of the 15-percent rate is recaptured by increasing the tax of that corporation by the lesser of (1) five percent of the excess over $100,000 or (2) $5,000. The benefit of the 15-percent rate is thereby fully recaptured when a corporation's taxable income reaches $200,000.

The provision reduces the tax rate on certain personal service corporations to 25 percent.

The provision repeals as no longer necessary the rules relating to the corporate tax rate on net capital gain.

Effective Date

The provision generally applies to taxable years beginning after December 31, 2012.

TITLE III – PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

PRESENT LAW

Overview of the U.S. international tax system

Present law combines the worldwide taxation of all U.S. persons[1] on all income, whether derived in the United States or abroad, with limited deferral for foreign income earned by foreign subsidiaries of U.S. companies, and provides territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities. This combination is sometimes described as the U.S. hybrid system. Under this system, the application of the Code to outbound investment (the foreign activities of U.S. persons) differs somewhat from its rules applicable to inbound investment (foreign persons with investment in U.S. assets or activities).

As stated above, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether derived in the United States or abroad.[2] Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain U.S. anti-deferral regimes may cause the domestic parent corporation to be taxed currently in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[3] and the passive foreign investment company rules.[4]

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid.[5] As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. The foreign tax credit generally is available to offset, in whole

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). Section 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates, and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).

[2] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under section 911. For a description of this exclusion, see *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

[3] Secs. 951-964.

[4] Secs. 1291-1298.

[5] In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes are allowed as deductions under section 164(a)(3).

or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[6] In addition to the statutory relief afforded by the credit, the U.S. network of bilateral income tax treaties provides a system for removing double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

Category-by-category rules determine whether income has a U.S. source or a foreign source. Additionally, present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation.

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") or income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income generally is subject to a 30-percent gross-basis withholding tax, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from withholding tax or is subject to a reduced rate of tax under the Code or a bilateral income tax treaty.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions,[7] or aggressive intercompany pricing practices, particularly with respect to intangible property.

Source of income rules

The rules for determining the source of certain types of income are specified in the Code and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the situs of the assets that

[6] Secs. 901, 902, 960, 1291(g).

[7] See sec. 7874. For a description of provisions designed to curtail inversion transactions, see Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 50.

generate the income. To the extent that the source of income is not specified by statute, the Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the Code or Treasury regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[8]

Interest

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[9] Special rules apply to treat as foreign source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[10] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[11]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[12] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[13]

Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.[14] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or

[8] See, e.g., *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

[9] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

[10] Sec. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations (discussed *infra*, in part II.B.2), the source rule in section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution, resulting in treating the payment as a withholdable payment. Sec. 1473(1)(C).

[11] Sec. 884(f)(1).

[12] Secs. 861(a)(2), 862(a)(2).

[13] Sec. 861(a)(2)(B).

[14] Sec. 861(a)(4).

from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[15] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from sales of personal property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[16] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[17] while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a foreign country or a nonresident alien with a tax home in the United States.[18] As a result, nonresident includes any foreign corporation.[19]

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[20] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as U.S. source without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[21] Income from the sale of inventory property produced by a taxpayer in the United States and sold outside the United States (or produced outside the United States and sold in the United States) is treated as partly U.S. source and partly foreign source.[22]

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[15] *Ibid.*

[16] Sec. 865(a).

[17] Sec. 865(g)(1)(B).

[18] Sec. 865(g)(1)(A).

[19] Sec. 865(g).

[20] Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

[21] Sec. 865(e)(2).

[22] Sec. 863(b). Generally, 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities. Treas. Reg. sec. 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treas. Reg. sec. 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treas. Reg. secs. 1.863-3(c)(2), 1.861-7(c).

Gain on the sale of depreciable property is divided between U.S. source and foreign source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[23] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[24]

Personal services income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain de minimis criteria.[25] Compensation for services performed both within and without the United States is allocated between U.S. and foreign source.[26]

Insurance income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[27]

Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.[28] Fifty percent of other income attributable to transportation that begins or ends in the United States is treated as U.S.-source income.

Income from space or ocean activities or international communications

In the case of a foreign person, generally no income from a space or ocean activity is treated as U.S.-source income.[29] The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United

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[23] Sec. 865(c).

[24] Sec. 865(d).

[25] Sec. 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.

[26] Treas. Reg. sec. 1.861-4(b).

[27] Sec. 861(a)(7).

[28] Sec. 863(c).

[29] Sec. 863(d).

States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.[30]

Amounts received with respect to guarantees of indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[31] This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as U.S. source.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under section 861(a)(9).

Subpart F

Generally

Subpart F,[32] applicable to controlled foreign corporations ("CFC") and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[33] Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as

[30] Sec. 863(e).

[31] Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *aff'd* 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). The Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

[32] Secs. 951-964.

[33] Secs. 951(b), 957, 958.

"subpart F income"), without regard to whether the income is distributed to the shareholders.[34] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income.

With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[35] insurance income,[36] and certain income relating to international boycotts and other violations of public policy.[37] Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[38]

Investments in U.S. property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[39] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[40] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[41] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Subpart F exceptions

A temporary provision enacted in 2006 (colloquially referred to as the "CFC look-through" rule) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on

[34] Sec. 951(a).

[35] Sec. 954.

[36] Sec. 953.

[37] Sec. 952(a)(3)-(5).

[38] Sec. 954. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, eliminated the category of foreign base company shipping income.

[39] Secs. 951(a)(1)(B), 956.

[40] Sec. 956(c)(1).

[41] Sec. 956(c)(2).

control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[42] The exclusion originally applied for taxable years beginning after 2005 and before 2009 and has been extended most recently to apply for taxable years of the foreign corporation beginning before 2012.[43]

Under a provision enacted in 1997 and originally applicable only for one taxable year,[44] there is an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[45] Congress has extended the application of section 954(h) several times, most recently in 2010.[46] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2012 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end).

The American Jobs Creation Act of 2004 ("AJCA")[47] expanded the scope of the active financing income exclusion from subpart F. Income is treated as active financing income (and was so treated before AJCA) only if, among other requirements, it is derived by a CFC or by a qualified business unit of that CFC. After the enactment of AJCA, certain activities conducted by persons related to the CFC or its qualified business unit are treated as conducted directly by the CFC or qualified business unit.[48] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or qualified business unit; the activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excepted from subpart F income so long as the other active financing requirements are satisfied.

Other exclusions from foreign personal holding company income include exceptions for dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized and for rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is

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[42] Sec. 954(c)(6).

[43] Sec. 954(c)(6)(C). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 751(a).

[44] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1175.

[45] Sec. 954(h).

[46] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 750(a); Pub. L. No. 110-343, div. C, sec. 303(b) (2008); Pub. L. No. 109-222, sec. 103(a)(2) (2006); Pub. L. No. 107-147, sec. 614 (2002); Pub. L. No. 106-170, sec. 503 (1999); Pub. L. No. 105-277 (1998).

[47] Pub. L. No. 108-357.

[48] AJCA sec. 416; Code sec. 954(h)(3)(E).

organized.[49] These exclusions do not apply to the extent the payments reduce the subpart F income of the payor. There is an exception from foreign base company income and insurance income for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[50]

Exclusion of previously taxed earnings and profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[51] Any income inclusion (under section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income.[52] Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[53]

Basis adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.[54] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[55]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[56] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders

[49] Sec. 954(c)(3).

[50] Sec. 954(b)(4).

[51] Sec. 959(a)(1).

[52] Sec. 959(a)(2).

[53] Sec. 959(c).

[54] Sec. 961(a).

[55] Sec. 961(b).

[56] Sec. 1297.

in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[57] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[58] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[59]

Other anti-deferral rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[60] and the personal holding company rules.[61] Until the enactment of AJCA, the Code included two other sets of anti-deferral rules, those applicable to foreign personal holding companies and those for foreign investment companies.[62] Because the overlap among the various anti-deferral regimes was seen as creating complexity, often with no ultimate tax consequences, AJCA repealed the foreign personal holding company and foreign investment company rules.[63]

Rules for coordination among the anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, subpart F is allowed to trump the PFIC rules.

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[57] Secs. 1293-1295.

[58] Sec. 1291.

[59] Sec. 1296.

[60] Secs. 531-537.

[61] Secs. 541-547. The accumulated earnings tax rules and the personal holding company rules apply in respect of both U.S.-source and foreign-source income.

[62] Secs. 551-558, 1246-1247.

[63] AJCA, sec. 413.

Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under the anti-deferral rules.[64]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[65] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[66]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[67] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[68] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[69]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[70] These rules exclude

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[64] Secs. 901, 902, 960, 1295(f).

[65] Secs. 901, 904.

[66] Sec. 904(c).

[67] Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

[68] Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

[69] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[70] Secs. 864(e)(5), 1504.

foreign corporations from an affiliated group.[71] AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[72] The effective date of the modified rules has been delayed to January 1, 2021.[73] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (that is, as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."[74] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in Code section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[75] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[76]

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[71] Sec. 1504(b)(3).

[72] AJCA, sec. 401.

[73] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

[74] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[75] Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

[76] Sec. 904(d)(4).

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[77]

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[78] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[79] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[80] The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with

[77] Sec. 909.

[78] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

[79] The term "related" as used herein refers to relationships described in section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

[80] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[81]

Other special rules

Temporary dividends-received deduction for repatriated foreign earnings

AJCA section 421 added to the Code section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[82]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[83] For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax credits).[84] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[85]

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[81] H.R. Rep. No. 99-426, p. 423.

[82] Section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.

[83] Sec. 965(d)(1).

[84] Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).

[85] Sec. 965(d)(2).

Earnings stripping

A domestic corporation may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[86] Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping."

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions. In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions involving interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's "excess interest expense."[87] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[88] to unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt"); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's "net interest expense" (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

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[86] In general, for U.S.-controlled corporations, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[87] Sec. 163(j).

[88] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

A. Establishment of Exemption System

1. Deduction for dividends received by domestic corporations from certain foreign corporations (sec. 301 of the discussion draft and new sec. 245A of the Code)

Explanation of Provision

In general

The discussion draft establishes a participation exemption system for foreign business income.[89] This exemption is effectuated by means of a [95]-percent deduction for the foreign-source portion of dividends received from CFCs by domestic corporations that are 10-percent U.S. shareholders of those CFCs.[90] As under the exemption systems of some other countries, [five] percent of a dividend from a CFC remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

The dividends-received deduction is available only if a one-year holding period requirement, described below, is satisfied.

The discussion draft largely retains subpart F of the Code. Consequently, although the foreign-source portion of a dividend generally is [95]-percent deductible when received by a 10-percent U.S. shareholder from a CFC, the 10-percent U.S. shareholder remains taxable in the United States on a current basis under the discussion draft on its pro rata share of certain items of passive or highly mobile income of the CFC. Retention of subpart F is intended to ensure that the participation exemption applies only to income from the conduct of an active foreign business. The discussion draft's modifications to subpart F are described in more detail below.

No foreign tax credit is allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend for which the [95]-percent dividends-received deduction is allowed. A deduction for any foreign tax paid or accrued in respect of a deductible dividend also is denied. This foreign tax credit disallowance and deduction denial apply to foreign tax with respect to the entire amount of any deductible dividend even though a deduction is available for only [95] percent of the dividend. By contrast, a foreign tax credit is allowed for foreign tax imposed on income included under subpart F and for foreign tax paid directly by a domestic corporation on foreign-source income (on, for example, income from foreign sales). Likewise, a foreign tax credit generally is available for foreign withholding tax imposed on payments such as royalties and interest. A foreign tax credit is not, however, available for foreign withholding tax

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[89] "Participation exemption" and "dividend exemption" are used interchangeably in this technical explanation. The term "participation exemption," commonly used in describing similar systems in other countries, refers to the exemption granted to a domestic parent corporation for earnings of a foreign subsidiary by virtue of the present corporation's participation in the ownership of the subsidiary.

[90] United States shareholder has the meaning given in section 951(b), as modified by the rules for noncontrolled 10/50 corporations described below.

imposed on dividends for which the [95]-percent deduction is permitted. The discussion draft's foreign tax credit rules are described in more detail below.

Foreign-source portion of a dividend

The participation exemption system is intended to apply only to foreign business income and not to U.S-source income. Some CFCs, however, may have U.S.-source income. Consequently, the 95-percent dividends-received deduction is available only for the foreign-source portion of a dividend.

The foreign-source portion of a dividend for which the [95]-percent deduction is allowed represents the portion of the dividend that relates to the CFC's undistributed foreign earnings.[91] The foreign-source portion of any dividend is, therefore, the amount that bears the same ratio to the dividend as the CFC's undistributed foreign earnings bears to the CFC's undistributed earnings. This rule complements the present law section 245 rule allowing a deduction for the U.S.-source portion of a dividend received from a qualified 10-percent owned foreign corporation. The U.S.-source portion of any dividend for which a deduction is allowed under section 245 is (as modified by the provision) the amount that bears the same ratio to the dividend as the dividend-paying corporation's undistributed U.S. earnings bears to the corporation's undistributed earnings. For this purpose, a corporation's undistributed U.S. earnings are, in general, undistributed earnings attributable to the corporation's income that is effectively connected with the conduct of a trade or business within the United States.[92] Under the provision, a CFC's undistributed foreign earnings are undistributed earnings that are not undistributed U.S. earnings. Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the CFC's taxable year in which the dividend is distributed, without diminution for dividend distributions during that taxable year.

As a result of this coordination with section 245, the provision provides the [95]-percent dividends-received deduction for a dividend received by a 10-percent U.S. shareholder from a CFC only to the extent the dividend is not deductible under present law section 245. More broadly, present law section 245 is intended to prevent a second imposition of U.S. corporate tax when a domestic corporation receives a dividend from a foreign corporation attributable to the foreign corporation's U.S.-source effectively connected income, whereas the provision is intended to provide an exemption from U.S. corporate tax when a domestic corporation receives a dividend from a CFC attributable to the CFC's foreign-source income.

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[91] The undistributed foreign earnings include both foreign income on which the U.S. parent corporation is taxed under subpart F and other foreign income on which the U.S. parent corporation is not taxed before receipt of the dividend.

[92] Section 245(a)(5)(A).

One-year holding period requirement

A domestic corporation is allowed the [95]-percent deduction for a dividend it receives on stock of a CFC only if the domestic corporation satisfies a one-year holding period requirement in respect of the stock on which the dividend is paid. No deduction is allowed in respect of any dividend on any share of CFC stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. A deduction also is not permitted in respect of any dividend on any share of CFC stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

These holding period requirements parallel the section 246(c)(1) requirements for the dividends-received deductions available under present law sections 243, 244, and 245. The discussion draft also incorporates some, but not all, of the other present law section 246(c) holding-period-related rules (including, for example, the section 246(c)(4) rule under which holding periods are reduced in a manner provided in Treasury regulations for any period during which the taxpayer has diminished its risk of loss in respect of stock on which a dividend is paid).

The 365-out-of-731-days test described above is satisfied only if the CFC is a CFC at all times during the period and the domestic corporation is a 10-percent U.S. shareholder of the CFC at all times during the period.

Application to tiered CFC structures

The discussion draft generally exempts from U.S. tax dividends paid by one CFC to another CFC to the extent the dividends would qualify for the 95-percent dividends-received deduction if paid directly to a 10-percent U.S. shareholder.

This exemption for CFC-to-CFC dividends is effectuated by a rule that provides that a domestic corporation's pro rata share of any CFC's subpart F income is reduced by the amount of the pro rata share that is attributable to dividends received by the CFC from any other CFC with respect to which the domestic corporation is also a 10-percent U.S. shareholder.

This reduction in the domestic corporation's pro rata share of a CFC's subpart F income does not apply in respect of a dividend on any share of stock unless the holding period requirement described previously (other than the requirement that a CFC paying a dividend to a 10-percent U.S. shareholder is a CFC, and the 10-percent U.S. shareholder is a 10-percent U.S. shareholder, at all times during the required holding period) is satisfied with respect to that stock.

10/50 companies

The provision permits a domestic corporation to elect on a group-wide basis to treat its ownership of all noncontrolled 10/50 corporations in which it is a 10-percent shareholder as

ownership of CFCs for all purposes of the Code.[93] Consequently, a domestic corporation that makes the election is treated for all purposes of the Code as a 10-percent U.S. shareholder of each of these deemed CFCs. Principal consequences of the election are that (1) dividends received by the electing domestic corporation from its noncontrolled 10/50 corporations are eligible for the [95]-percent dividends-received deduction; (2) subpart F applies to the domestic corporation in the same manner as it would apply if the noncontrolled 10/50 corporations were actual CFCs; and (3) a foreign tax credit is allowed (under modified deemed-paid credit rules) for foreign tax imposed on income included under subpart F. By contrast, when a domestic corporation receives a dividend from a noncontrolled 10/50 corporation in respect of which an election is not in effect, the [95]-percent dividends-received deduction is not available and no deemed-paid foreign tax credit is allowed for foreign tax paid by the noncontrolled 10/50 corporation.

A domestic corporation that wishes to make an election to treat its noncontrolled 10/50 corporations as CFCs must do so by the due date for its tax return for its first taxable year for which it is a 10-percent shareholder of one or more noncontrolled 10/50 corporations. An effect of this election is that if the electing domestic corporation subsequently becomes a 10-percent shareholder of additional noncontrolled 10/50 corporations, those corporations are treated as CFCs in respect of the domestic corporation and the domestic corporation is treated as a 10-percent U.S. shareholder of those deemed CFCs. An election may be revoked only with the consent of the Treasury Secretary.

An election to treat noncontrolled 10/50 corporations as CFCs applies to all domestic members of a group of corporations that share at least 50 percent common ownership (under section 1563(a)). In other words, if one member of a controlled group makes the election, all other members of the group that are 10-percent shareholders of one or more noncontrolled 10/50 corporations are also treated as 10-percent U.S. shareholders of those deemed CFCs.

As described previously, for purposes of the provision, a noncontrolled 10/50 corporation is a foreign corporation in respect of which a domestic corporation would be eligible for the section 902 deemed-paid credit under present law by virtue of the foreign corporation's status as a noncontrolled section 902 corporation with respect to the domestic corporation. More specifically, the term noncontrolled 10/50 corporation means, with respect to any domestic corporation, any foreign corporation (other than, in the absence of the election, a CFC with respect to the domestic corporation) for which the domestic corporation satisfies certain direct or indirect ownership requirements. The direct ownership requirement is that the domestic corporation owns 10 percent or more of the voting stock of the foreign corporation. Under the

[93] As described below, a noncontrolled 10/50 corporation shares largely the same meaning as a noncontrolled section 902 corporation under present law. A noncontrolled section 902 corporation under present law is, in general, a foreign corporation that is at least 10 percent owned by one or more domestic corporations but which is not a CFC because it is not more than 50 percent owned by five or fewer 10-percent U.S. shareholders. A 10-percent domestic corporate shareholder of a noncontrolled section 902 corporation is allowed a section 902 deemed-paid credit in respect of foreign taxes paid by the noncontrolled section 902 corporation but, by definition, is not subject to the subpart F rules in respect of its ownership of that corporation. For the present law definition of noncontrolled section 902 corporation, see section 904(d)(2)(E)(i).

indirect ownership requirement, the foreign corporation must be, with respect to the domestic corporation, a member of the same qualified group as another foreign corporation for which the domestic corporation satisfies the direct ownership requirement. A qualified group means the foreign corporation for which the direct ownership requirement is satisfied and any other foreign corporation if (1) the domestic corporation owns at least five percent of the voting stock of that other foreign corporation indirectly through a chain of foreign corporations connected through ownership of at least 10 percent of their voting stock; (2) the foreign corporation for which the direct ownership test is satisfied is the first-tier corporation in the chain; and (3) the other foreign corporation is not below the third tier in the chain.

Foreign branches

The provision treats any foreign branch of a domestic corporation as a CFC for all purposes of the Code. The domestic corporation is likewise treated as a 10-percent U.S. shareholder of the deemed CFC for all purposes. Consequences of this treatment include that (1) the [95]-percent dividends-received deduction is available for payments treated as dividends from a foreign branch to its domestic parent corporation; (2) the full range of rules applicable to intercompany transactions – for example the transfer pricing rules of section 482 and the cross-border reorganization rules of section 367 – apply to transactions between a foreign branch and its domestic parent corporation; and (3) the only foreign tax credits in respect of foreign tax imposed on a foreign branch are the credits that are available in respect of foreign tax imposed on CFCs (that is, foreign tax on income included under subpart F).

A foreign branch of a domestic corporation is any trade or business of the domestic corporation in a foreign country. It is intended that the rules and principles applicable in determining whether a foreign corporation is engaged in a U.S. trade or business govern whether foreign business operations constitute a foreign branch.

[The Treasury Secretary has authority to provide guidance treating a domestic corporation's interest in a partnership with a foreign trade or business in a manner similar to the treatment of foreign branches of domestic corporations. A domestic corporation's interest in a partnership with a foreign trade or business may be treated in a manner similar to the treatment of a foreign branch only if the domestic corporation would be a 10-percent U.S. shareholder if its partnership interest were stock of a foreign corporation.]

Conforming amendments and other changes

The provision includes a number of changes that coordinate the new dividends-received deduction rules with existing Code provisions or that conform existing Code provisions to the new dividends-received deduction rules. Certain changes are described below.

Like the present law dividends-received deduction rules of sections 243, 244, and 245, the provision's [95]-percent dividends-received deduction is not available for any dividend from a corporation that is exempt from taxation under section 501 or 521.

In conformity with the present law dividends-received deduction rules, deductible dividends under the provision and the stock on which deductible dividends are paid are treated as

[95]-percent tax-exempt income and [95]-percent tax-exempt assets, respectively, for purposes of allocating and apportioning deductible expenses.

Present law section 1059 generally requires that a corporation that receives an extraordinary dividend in respect of stock that the corporation has not held for more than two years before the dividend announcement date must reduce its basis in the stock by the amount of the dividends-received deduction available under section 243, 244, or 245. The provision extends this rule to stock on which a dividend eligible for the [95]-percent dividends-received deduction is paid.

The provision provides that for purposes of subpart F the term "United States shareholder" (that is, a U.S. person that owns at least 10 percent (by vote) of the foreign corporation) includes, with respect to a noncontrolled 10/50 corporation, any domestic corporation that is treated as a 10-percent U.S. shareholder of that noncontrolled 10/50 corporation as a result of an election described previously. The provision similarly provides that for purposes of subpart F the term "controlled foreign corporation" includes any entity treated as a CFC as a result of the election described previously.

Effective Date

The rules described above apply to taxable years of foreign corporations beginning after December 31, 2012 and to taxable years of 10-percent U.S. shareholders in which or with which those taxable years of foreign corporations end.

2. Treatment of gains and losses on disposition by United States shareholders of stock of certain active foreign corporations (sec. 302 of the discussion draft and new sec. 1247 of the Code)

Explanation of Provision

In general

The provision provides that when a domestic corporation that is a 10-percent U.S. shareholder of a qualified foreign corporation sells or exchanges stock of that qualified foreign corporation that the domestic corporation has held for at least one year, [95] percent of any gain from the sale or exchange is excluded from income and no deduction is allowed for any loss from the sale or exchange.

For purposes of this provision, a qualified foreign corporation is any CFC (an actual CFC or a noncontrolled 10/50 corporation treated as a CFC in respect of the selling shareholder as a result of an election) if at least [70] percent of the assets are active assets both (1) at the time of the sale or exchange and (2) at the close of each quarter of any taxable year of the selling shareholder if the quarter ends during the three-year period ending on the date of the sale or exchange. If a corporation has not been in existence for the entire three-year period, this calendar-quarter rule is applied on the basis of the period during which the corporation has been in existence. Whether a corporation is a qualified foreign corporation is determined by applying the rules just described to that corporation and to any predecessor of that corporation.

For purposes of the [70]-percent test, an active asset is any asset of a kind that does not produce foreign personal holding company income under the subpart F rules.

Section 1248

If the provision applies to gain or loss on a sale or exchange of CFC stock, present law section 1248 does not apply to that sale or exchange. Present law section 1248 generally treats gain from the sale of CFC stock as a dividend to the extent of the CFC's non-previously-taxed earnings and profits attributable to periods during which the selling shareholder held the stock and the CFC was a CFC. Section 1248 otherwise remains unchanged under the discussion draft.

Unlike section 1248, this provision has the effect of exempting from taxation [95] percent of the gain from the sale of CFC stock that represents appreciation of the CFC's assets, rather than non-previously-taxed earnings of the CFC.

Effective Date

The provision generally applies to sales and exchanges after December 31, 2012. The provision does not, however, apply to the sale or exchange of stock of a foreign corporation that takes place before the corporation's first taxable year beginning after December 31, 2012. This rule ensures that the provision does not apply before the effective date of the [95]-percent dividends-received deduction.

3. Treatment of deferred foreign income upon transition to participation exemption system of taxation (sec. 303 of the discussion draft and sec. 965 of the Code)

Explanation of Provision

In general

The provision generally requires that, before the participation exemption takes effect, a 10-percent U.S. shareholder of a CFC or a noncontrolled 10/50 corporation must include in income its pro rata share of the undistributed, non-previously-taxed foreign earnings of the CFC or noncontrolled 10/50 corporation (regardless of whether an election is made to treat the noncontrolled 10/50 corporation as a CFC). Like present law section 965, which provided a temporary reduced rate of taxation on certain dividends received by 10-percent U.S. shareholders from CFCs, the provision provides that the income from the required inclusion of pre-effective date earnings is taxed at a reduced rate, and a foreign tax credit is available in respect of the taxable portion of the included income. The Code rules in effect before enactment of the discussion draft – for example, the corporate tax rate and the separate foreign tax credit limitation rules of section 904 – apply in determining the increase in a 10-percent U.S. shareholder's U.S. tax liability as a result of the mandatory inclusion. The increased tax liability generally may be paid over an eight-year period (with interest).

Subpart F

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. The provision provides that in the last taxable year of a specified 10-percent owned

foreign corporation that ends before January 1, 2013, which is that foreign corporation's last taxable year before the participation exemption system begins, the subpart F income of the foreign corporation is increased by the accumulated deferred foreign income of the corporation determined as of the close of that taxable year. For this purpose, a specified 10-percent owned foreign corporation is a CFC and any noncontrolled 10/50 corporation. Consistent with the general operation of subpart F, each 10-percent U.S. shareholder of a specified 10-percent owned foreign corporation must include in income its pro rata share of the foreign corporation's subpart F income attributable to its accumulated deferred foreign income.[94]

A 10-percent U.S. shareholder of a specified 10-percent owned foreign corporation is allowed a deduction for an amount equal to [85] percent of the amount of income that it must include under this subpart F rule. Because the rate of tax that generally applies to the income inclusion is 35 percent, the [85]-percent deduction creates a tax rate, before foreign tax credits, of [5.25] percent.

Accumulated deferred foreign income

A specified 10-percent owned foreign corporation's accumulated deferred foreign income that must be taken into account as subpart F income is the portion of the foreign corporation's undistributed earnings that is not attributable to (1) income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax or (2) subpart F income (determined without regard to the mandatory inclusion rule) of a CFC that is included in the gross income of a 10-percent U.S. shareholder of the CFC and with respect to which the CFC has not made distributions that are excludable from gross income under section 959.[95] Undistributed earnings are the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) as of the close of the corporation's last taxable year that ends before January 1, 2013.

Foreign tax credit

Like present law section 965, the provision disallows a foreign tax credit for the [85]-percent portion of the pre-effective-date undistributed CFC earnings inclusion. The provision also denies a deduction for any foreign tax for which a credit is disallowed. A 10-percent U.S. shareholder's income is not increased under section 78 by the amount of tax for which a foreign tax credit is not allowed.

Installment payments

A 10-percent U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in up to [eight] equal

[94] For purposes of taking into account its subpart F income under this rule, a noncontrolled 10/50 corporation is treated as a CFC.

[95] By definition, subpart F income with respect to which the CFC has made excludable distributions does not constitute undistributed earnings.

installments. An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income. The Treasury Secretary has authority to prescribe the manner of making the election.

The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the tax returns for the relevant years. In addition to the prorated net tax liability, the succeeding installments must be accompanied by payment of interest from the date on which the tax attributable to the mandatory repatriation would have been due but for the election, determined at the rate applicable to underpayments of tax. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among the remaining installment payments, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax.

The net tax liability that may be paid in installments is the excess of the 10-percent U.S. shareholder's net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

The provision also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the 10-percent U.S. shareholder's assets (including in a bankruptcy case), (3) the 10-percent U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 or similar case, the day before the petition is filed).

Effective Date

The subpart F inclusion required by the provision occurs in the last taxable year of a specified 10-percent owned foreign corporation that ends before January 1, 2013.

B. Modifications Related to Foreign Tax Credit System

1. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on basis of foreign corporation's current year earnings (sec. 311 of the discussion draft and secs. 902 and 960 of the Code)

Explanation of Provision

The provision repeals the deemed-paid foreign tax credit with respect to actual dividends received by a 10-percent United States shareholder of a foreign corporation.[96] Under the provision, a deemed-paid foreign tax credit is denied for taxes paid by a noncontrolled 10/50 corporation regardless of whether or not an election is made to treat such corporation as a CFC.

A deemed-paid foreign tax credit is provided with respect to any income inclusion under subpart F. The deemed-paid foreign tax credit is restricted to the amount of foreign income taxes attributable to the subpart F inclusion. Foreign income taxes under the provision include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States. The provision eliminates the need for computing and tracking cumulative tax pools.

The Secretary is granted authority under the provision to provide regulations as necessary and appropriate to carry out the purposes of this provision.

In addition to the rules described in this section, the provision makes several conforming amendments to various other sections of the Code reflecting the repeal of section 902 and the modification of section 960.

Effective Date

The repeal of the deemed paid section 902 credit and the amendments to the computation of the deemed paid section 960 credit are applicable to taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

2. Foreign tax credit limitation applied by allocating only directly allocable deductions to foreign source income (sec. 312 of the discussion draft and sec. 904 of the Code)

Explanation of Provision

The provision provides that for purposes of computing the foreign tax credit limitation, only directly allocable deductions are subtracted from gross foreign-source income to compute foreign-source taxable income. Taxpayers are not required under the provision to allocate other

[96] However, a [95]-percent dividends-received deduction is allowed under a separate provision of the discussion draft.

deductions against foreign-source income for purposes of determining the foreign tax credit limitation.

For purposes of applying this provision, directly allocable deductions are deductions that are directly incurred as a result of the activities that produce the related foreign-source income. Directly allocable deductions could include items such as salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign-source income. Deductions such as stewardship expenses, general and administrative expenses, and interest expenses are not considered directly allocable deductions for purposes of the provision.

Effective Date

This provision is applicable to taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

3. Elimination of foreign tax credit baskets (sec. 313 of the discussion draft and sec. 904 of the Code)

Explanation of Provision

The provision eliminates the separate category rules (i.e., general category and passive category) for determining the foreign tax credit limitation. Under the provision a single foreign tax credit limitation applies to all foreign-source income without regard to its present law limitation category.

In addition, several conforming amendments are made to various sections of the Code. In general, these conforming amendments amend sections of the Code to replace references to section 904(d) with references reflecting the elimination of foreign tax credit limitation categories.

This provision applies to taxes carried from any taxable year beginning before January 1, 2013 to any taxable year beginning on or after such date.

Treasury regulations or other guidance may provide for the allocation of any carryback of taxes with respect to income from a taxable year beginning on or after January 1, 2013 to a taxable year beginning before such date for purposes of allocating income among separate foreign tax credit limitation categories in effect for the taxable year to which such taxes are carried.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

4. Repeal rule suspending taxes and credits until related income is taken into account (sec. 314 of the discussion draft and sec. 909 of the Code)

Explanation of Provision

The provision eliminates the rule providing that in certain circumstances foreign income taxes are not taken into account for Federal income tax purposes before the taxable year in which the related income is taken into account for Federal income tax purposes. Due to other changes made in the discussion draft, including the repeal of section 902 indirect foreign tax credits, this rule is no longer necessary.

Effective Date

The provision is applicable to taxable years of foreign corporations beginning after December 31, 2012, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

C. Rules Related to Passive Income

1. Termination of current year inclusion based on investments in United States property (sec. 321 of the discussion draft)

Explanation of Provision

The provision repeals the requirement that a U.S. shareholder include in income the amount of deferred earnings and profits that are invested in U.S. property. Because the earnings and profits of a CFC will generally be eligible for the [95] percent deduction under the dividend exemption provisions of section 301, without regard to whether such earnings are invested in the United States or abroad, the complex rules that determine whether certain uses of earnings and profits constitute investments in U.S. property are no longer necessary.

A series of conforming amendments removes cross-references to the repealed provisions. However, a reference to the definition of certain securities deposits that were excepted from the deemed repatriation rule of section 956 is retained for purposes of determining the availability of the dealer exception under section 954(c)(2)(C).

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2012, and for taxable years of U.S. shareholders in which or with which such taxable year of foreign corporation end.

2. Repeal of exclusion of previously taxed earnings and profits (sec. 322 of the discussion draft and secs. 959 and 961 of the Code)

Explanation of Provision

The provision eliminates the rules providing for the exclusion from income of a 10-percent U.S. shareholder of a CFC of distributions from the CFC's earnings and profits that were previously included in the 10-percent U.S. shareholder's income under subpart F. Consequently, all distributions by a CFC to a 10-percent U.S. shareholder out of earnings and profits, including amounts previously included in the 10-percent U.S. shareholder's income under subpart F, are taxed as dividends potentially eligible for the [95]-percent dividends-received deduction described above.

The provision also eliminates the rules requiring adjustments to the 10-percent U.S. shareholder's basis in the stock of the CFC when the 10-percent U.S. shareholder has an income inclusion under subpart F or when the 10-percent U.S. shareholder receives a distribution from the CFC of earnings and profits that were previously taxed under subpart F. In addition, several conforming amendments are made to various other sections of the Code. In general, these conforming amendments amend sections of the Code to replace references to sections 959 and 961 with references reflecting the elimination of the exclusion of previously taxed earnings and profits.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2012, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

D. Prevention of Base Erosion

Restrictions on the opportunities available to multinational corporations to erode the U.S. tax base by shifting highly mobile income or excessive borrowing are provided in the discussion draft. With respect to shifting highly mobile income, the discussion draft offers three distinct alternatives to address base erosion caused by shifting of intangible property and its related income. The use of excessive debt in a U.S. member of a worldwide group is constrained by new limitations on the deductibility of interest with respect to such debt.

1. [Option A] Excess income from transfers of intangibles to low-taxed affiliates treated as subpart F income (sec. 331A of the discussion draft and sec. 954 of the Code)

Explanation of Provision

The first of the three alternative options was first outlined by the Obama Administration in its budget recommendations for fiscal years 2011and 2012, and supplemented with legislative language and analysis in conjunction with its recommendations to the Joint Select Committee on Deficit Reduction, in "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction."[97] This option provides that income attributable to use or exploitation of intangibles that has not been subject to a specified minimum income tax in any jurisdiction is included in U.S. income to the extent that such income exceeds 150 percent of costs attributable to such income. Under the provision, if a U.S. person transfers intangible property from the United States to a related CFC, certain excess income from transactions benefiting from or connected with the transferred intangible property is includible in income as a new category of subpart F income, foreign base company excess intangible income.

Identifying income within this new category of subpart F income depends upon three elements: (1) existence of a covered intangible (i.e. an intangible transferred by a U.S. person (directly or indirectly) from the United States to a related CFC); (2) excess income from transactions connected with or benefiting from a covered intangible; and (3) a low foreign effective tax rate of 10 percent or less. If each of the elements is present, the taxpayer is subject to tax currently on subpart F income from the excess return.

A covered intangible includes intangible property, as broadly defined in section 936(h)(3)(B), which enumerates specific types of property that are within the meaning of the statute, including any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) any similar item which has substantial value independent of the services of any individual. Such intangible property is a covered intangible if it is transferred to a CFC by a related U.S. person (including sales, leases, licenses, or other means of transfer) or is the subject of a shared risk or development agreement

[97] Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," p. 269 (September 2011). Available at www.BUDGET.GOV.

(including any cost sharing arrangement) between the CFC and one or more related parties. The provision does not require that the intangible property be originally developed in the United States, only that it is transferred from the United States. The provision applies to both direct and indirect transfers.

Excess intangible income is the amount of gross income from transactions connected with or benefitting from the transferred intangible property that exceeds 150 percent of the costs (excluding interest and taxes) properly allocated and apportioned to the income, including research and development costs that are properly allocable to the line of business in which such income is earned. In computing excess intangible income, the income derived from 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. In addition, a percentage of the income from transactions connected with transferred intangible property may be excluded to the extent that it has been subject to an effective rate of income tax imposed by a foreign country in excess of 10 percent.

In determining the applicable percentage of intangible income that may be excluded because it was subject to a foreign income tax at an effective rate in excess of 10 percent, a sliding scale is applied. Under the sliding scale, 100 percent of the excess income would be subpart F income if the effective tax rate with respect to the intangible income was below 10, and none of the income would be treated as subpart F if the effective tax rate were above 15 percent. To determine the effective tax rate, U.S. tax principles apply, in order to effectuate the policy of targeting transfers of intangible property to low-tax jurisdictions.

Effective Date

The provision is effective for income received in taxable years beginning on or after January 1, 2013, from transactions connected with or benefitting from covered intangibles.

2. [Option B] Low-taxed cross-border foreign income treated as subpart F income (sec. 331B of the discussion draft and sec. 954 of the Code)

Explanation of Provision

In the second of the alternative approaches proposed to address concerns about base erosion, income earned by a CFC that is neither derived from the conduct of an active trade or business in the home country of the CFC ("the home-country exception") nor subject to an effective rate of foreign tax of at least [10] percent is includible in subpart F income as low-taxed cross-border income.

In order to qualify for the home-country exception and thus avoid inclusion of low-taxed cross-border income, a CFC must satisfy three tests. The income in question must arise from the conduct of a trade or business by the CFC within the jurisdiction in which the CFC is organized. The CFC must maintain an office or other fixed place of business within such country. With respect to a CFC located in a home country that is a party to an income tax treaty with the United States, this element is generally met if the offices or fixed place of business would satisfy the permanent establishment provisions of such treaty. Finally, the income must be derived from activities that serve the local market of the home country, either through transactions with

respect to property used within the country or by performing services with respect to persons or property located in the country.

To ascertain whether the income was subject to an effective foreign tax rate of [10] percent or more, U.S. tax principles apply, in order to effectuate the policy of targeting transfers of highly mobile income to low-tax jurisdictions. The effective rate of foreign tax is to be determined for each country in which a CFC conducts business. To do so, the CFC must aggregate its income in each such country. For purposes of determining the effective rate of income tax imposed by a foreign country, the income is determined without reduction for any losses that are otherwise permissible in computing income of the CFC. Deductions properly allocable to the income are taken into account in determining the amount of low-taxed cross-border income.

Effective Date

The provision is effective for foreign corporations for taxable years beginning after December 31, 2012. For the U.S. shareholder of such foreign corporation, the provision is effective for the taxable years in which, or with which, such taxable years of the foreign corporations end.

3. [Option C] Foreign intangible income subject to taxation at reduced rate, intangible income treated as subpart F income (sec. 331C of the discussion draft and sec. 954 of the Code)

Explanation of Provision

The last of the three alternatives for addressing erosion of the U.S. tax base through shifting income from intangibles creates a new category of subpart F income for worldwide income derived by CFCs from intangibles and provides a deduction for a domestic corporation of [40] percent of its income from foreign exploitation of intangibles. As a result, the provision both increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC and decreases the U.S. tax on the income of a U.S. corporation from its use of its intangibles in foreign markets.

The [40] percent deduction from the gross income of the domestic corporation results in a reduced tax rate of [15] percent for the income from foreign exploitation of intangible property. The base on which the deduction is computed is the sum of all foreign intangible income earned directly by the domestic corporation and, in the case of a corporation which is a U.S. shareholder, the lesser of foreign base company intangible income, or the foreign intangible income of a CFC.

Intangible income is income from transactions in property or providing services, to the extent that such income is properly attributable to intangible property that is used in or connected with the transactions or services, whether directly or indirectly. Foreign intangible income is a subset of intangible income and consists of intangible income that is derived in connection with property sold, used, consumed or disposed of outside the United States or in connection with services provided with respect to persons or property outside the United States. The new category of subpart F income, foreign base company intangible income, is intangible income of a

CFC for the taxable year, i.e., all intangible income without regard to where the intangibles are exploited.

For purposes of this provision, intangible property is defined by cross-reference to section 936(h)(3)(B), which enumerates specific types of property that are within the meaning of the statute, including any (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item which has substantial value independent of the services of any individual.

The provision includes foreign base company intangible income as a type of income that is eligible for the exception under section 954(b)(4) for highly taxed income, that is, income that has been taxed in a foreign jurisdiction at a rate greater than 90 percent of the domestic corporate tax rate. However, the provision uses [60] percent of the maximum Federal income tax rate as the maximum specified corporate tax rate for purposes of determining whether the foreign base company intangible income was subject to a high rate of foreign tax for purposes of satisfying the exception. For purposes of the exception, the relevant foreign taxes are those imposed on the particular items of intangible income. It is intended that taxpayers not be permitted to engage in inappropriate planning, including the use of disregarded entities, to qualify for the high-tax exception.

Effective Date

The provision is generally effective for foreign corporations for taxable years beginning after December 31, 2012, and for the U.S. shareholder of such foreign corporation, for the taxable years in which, or with which, such taxable years of the foreign corporations end. The deduction provided by this provision is applicable for taxable years of a domestic corporation beginning after December 31, 2012.

4. Denial of deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness (sec. 332 of the discussion draft and sec. 163 of the Code)

Explanation of Provision

The discussion draft addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense[98] of a U.S. corporation that is a U.S. shareholder with respect to any CFC if both the CFC and U.S. corporation are part of a worldwide affiliated group. A portion of otherwise deductible interest is disallowed if the U.S. group fails to meet both a relative leverage test and a percentage of adjusted taxable income test. The lesser of the two amounts determined under

[98] Net interest for these purposes is defined in section 163(j)(6)(B) as the excess of interest paid or accrued over the interest includible in gross income for the taxable year.

these tests is the amount by which deductible interest is reduced. The new rule is inapplicable to a wholly domestic group.

A worldwide affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under section 1504, with two differences. The ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent. The restriction on inclusion of a foreign corporation under section 1504(b)(3) is disregarded for purposes of identifying the worldwide affiliated group.

In the relative leverage test, all U.S. members of the worldwide affiliated group are treated as one member in order to determine whether the group has excess domestic indebtedness. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. members exceeds [100] percent of the debt those members would hold if their aggregate debt-to-equity ratio were proportionate to the ratio of debt-to-equity in the worldwide group. The percentage of aggregate domestic debt represented by excess domestic indebtedness is the debt-to-equity differential by which net interest expense is multiplied to determine the amount of interest that would be disallowed under the relative leverage test.

The percentage of adjusted taxable income test first requires computation of adjusted taxable income, that is, taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and other items as prescribed in section 163(j)(6)(A). Whether interest expenses exceed the prescribed percentage of adjusted taxable income is determined company by company, as is the actual disallowance of deduction.

Interest disallowed under this rule may be carried forward to subsequent taxable years. To the extent that application of this provision results in a disallowance of an interest deduction, the amount of that disallowance reduces the amount of interest disallowed under section 163(j).

Effective Date

The provision is effective for taxable years beginning after December 31, 2012.