

**TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014,  
A DISCUSSION DRAFT OF THE CHAIRMAN OF  
THE HOUSE COMMITTEE ON WAYS AND MEANS  
TO REFORM THE INTERNAL REVENUE CODE:  
TITLE IV – PARTICIPATION EXEMPTION  
SYSTEM FOR THE TAXATION OF FOREIGN INCOME**

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## INTRODUCTION

This document<sup>1</sup> provides a technical explanation of Title IV of the Tax Reform Act of 2014, a discussion draft<sup>2</sup> prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. Title IV of the proposal addresses a participation exemption system for the taxation of foreign income.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV — Participation Exemption System for the Taxation of Foreign Income* (JCX-15-14), February 26, 2014. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

<sup>2</sup> Statutory draft version Camp\_041.XML.

## **TITLE IV – 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<sup>3</sup> 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.<sup>4</sup> 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<sup>5</sup> and the passive foreign investment company rules.<sup>6</sup> Taxation of income earned from foreign operations may differ depending upon the classification of the foreign entity conducting the foreign operations.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid.<sup>7</sup> 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

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<sup>3</sup> 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).

<sup>4</sup> 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.

<sup>5</sup> Secs. 951-964.

<sup>6</sup> Secs. 1291-1298.

<sup>7</sup> In lieu of the foreign tax credit, foreign income, war profits, and excess profits taxes are allowed as deductions under section 164(a)(3).

available for foreign taxes paid. The foreign tax credit generally is available to offset, in whole 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.<sup>8</sup> 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.

### **Taxation of nonresident aliens and foreign corporations**

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.<sup>9</sup>

FDAP income includes U.S.-source portfolio interest, which means any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.<sup>10</sup> For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.<sup>11</sup> Portfolio interest, however,

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<sup>8</sup> Secs. 901, 902, 960, 1291(g).

<sup>9</sup> *E.g.*, the portfolio interest exception in section 871(h) (discussed below).

<sup>10</sup> Sec. 871(h)(2).

<sup>11</sup> Sec. 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest

does not include interest received by a 10-percent shareholder,<sup>12</sup> certain contingent interest,<sup>13</sup> interest received by a controlled foreign corporation from a related person,<sup>14</sup> or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.<sup>15</sup>

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,<sup>16</sup> or aggressive intercompany pricing practices, particularly with respect to intangible property.

The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)<sup>17</sup> generally treats a foreign person’s gain or loss from the disposition of a U.S. real property interest (“USRPI”) as ECI and, therefore, as taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.<sup>18</sup> In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI (“FIRPTA income”) is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership, real estate investment trust (“REIT”) or regulated investment company (“RIC”).<sup>19</sup>

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exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Pub. L. No. 111-147, sec. 502(b).

<sup>12</sup> Sec. 871(h)(3).

<sup>13</sup> Sec. 871(h)(4).

<sup>14</sup> Sec. 881(c)(3)(C).

<sup>15</sup> Sec. 881(c)(3)(A).

<sup>16</sup> 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.

<sup>17</sup> Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, 6652(f).

<sup>18</sup> Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

<sup>19</sup> Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that reduce the 35-percent withholding on distributions to 20-percent withholding during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.<sup>20</sup> The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Certain U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Switzerland, and the United Kingdom.<sup>21</sup> To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).<sup>22</sup>

### **Entity classification**

A business entity is generally eligible to choose how it is classified for Federal tax law purposes, under the "check-the-box" regulations adopted in 1997.<sup>23</sup> Those regulations simplified the entity classification process for both taxpayers and the Internal Revenue Service ("IRS"), by making the entity classification of unincorporated entities explicitly elective in most instances.<sup>24</sup>

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<sup>20</sup> Secs. 4371-4374.

<sup>21</sup> Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.

<sup>22</sup> In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the revenue ruling provides that the excise tax still applies to both payments to the extent that the transaction violates an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the revenue ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

<sup>23</sup> Treas. Reg. sec. 301.7701-1, *et seq.*

<sup>24</sup> The check-the-box regulations replaced Treas. Reg. sec. 301.7701-2, as in effect prior to 1997, (the "Kintner regulations") under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and

Whether an entity is eligible and the breadth of its choices depends upon whether it is a “*per se* corporation” and the number of beneficial owners.

Certain entities are treated as “*per se* corporations” for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute. A number of specific types of foreign business entities are identified in the regulations as *per se* corporations. These entities are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.<sup>25</sup>

An eligible entity with two or more members may elect, however, to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules apply. A domestic entity with multiple members is treated as a partnership. A foreign entity with multiple members is treated as a partnership, if at least one member does not have limited liability, but is treated as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity owned by an individual is treated in the same manner as a sole proprietorship. In the case of an entity owned by a corporation or partnership, the disregarded entity is treated in the same manner as a branch or division. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment is as a corporation, if the single owner has limited liability, and as a disregarded entity if the owner does not have limited liability.

The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. As a result, it is possible for an entity that operates cross-border to elect into a hybrid status. “Hybrid entities” refers to entities that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes; for “reverse hybrid entities,” the opposite is true. The existence of hybrid and reverse hybrid entities can affect whether the taxpayer can use foreign tax credits attributable to deferred foreign-source income or income that is not taxable in the United States, as well as whether income is currently includible under subpart F.

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proliferation of limited liability companies (“LLCs”) under State laws allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.

<sup>25</sup> For domestic entities, the State corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions as *per se* corporations.

## 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 generate the income. If a payor or recipient is an entity that is eligible to elect its classification for Federal tax purposes, its choice of whether to be recognized as legally separate from its owner in another jurisdiction can affect the determination of the source of the income and other tax attributes, if the hybrid entity is disregarded in one jurisdiction, but recognized in the other.<sup>26</sup> To the extent that the source of income is not specified by statute, the Treasury 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.<sup>27</sup>

### 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.<sup>28</sup> 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.<sup>29</sup> Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.<sup>30</sup>

### Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.<sup>31</sup> 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

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<sup>26</sup> See Treas. Reg. sec. 301-7701-1 through 301.7701-3.

<sup>27</sup> See, e.g., *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

<sup>28</sup> Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1).

<sup>29</sup> Secs. 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations 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).

<sup>30</sup> Sec. 884(f)(1).

<sup>31</sup> Secs. 861(a)(2), 862(a)(2).

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.<sup>32</sup>

### Rents and royalties

Rental income is sourced by reference to the location or place of use of the leased property.<sup>33</sup> 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 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.<sup>34</sup> 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.<sup>35</sup> 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,<sup>36</sup> 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.<sup>37</sup> As a result, nonresident includes any foreign corporation.<sup>38</sup>

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.<sup>39</sup> 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

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<sup>32</sup> Sec. 861(a)(2)(B).

<sup>33</sup> Sec. 861(a)(4).

<sup>34</sup> *Ibid.*

<sup>35</sup> Sec. 865(a).

<sup>36</sup> Sec. 865(g)(1)(B).

<sup>37</sup> Sec. 865(g)(1)(A).

<sup>38</sup> Sec. 865(g).

<sup>39</sup> Secs. 865(b), 861(a)(6), 862(a)(6); Treas. Reg. sec. 1.861-7(c).

foreign office materially participates in the sale.<sup>40</sup> Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States is treated as partly U.S.-source and partly foreign-source.<sup>41</sup>

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applies the asset-use test and business activities test at the partnership level to determine whether there is a U.S. business and, if so, the extent to which income derived is effectively connected with that U.S. business. To the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.<sup>42</sup>

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.<sup>43</sup> 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.<sup>44</sup>

#### 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

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<sup>40</sup> Sec. 865(e)(2).

<sup>41</sup> Sec. 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.- or foreign-source: (1) 50-50 method under which 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; (2) IFP method under which, in certain circumstances, an independent factory price ("IFP") may be established by the taxpayer to determine income from production activities; (3) books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales 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).

<sup>42</sup> Rev. Rul. 91-32, 1991-1 C.B. 107.

<sup>43</sup> Sec. 865(c).

<sup>44</sup> Sec. 865(d).

*de minimis* criteria.<sup>45</sup> Compensation for services performed both within and without the United States is allocated between U.S.- and foreign-source.<sup>46</sup>

#### 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.<sup>47</sup>

#### Transportation income

Generally, income from furnishing transportation that begins and ends in the United States is U.S.-source income.<sup>48</sup> 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.<sup>49</sup> The same holds true for international communications income unless the foreign person maintains an office or other fixed place of business in the United States, in which case the income attributable to such fixed place of business is treated as U.S.-source income.<sup>50</sup>

#### 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.<sup>51</sup> This includes payments that are made indirectly for the provision of a guarantee. For

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<sup>45</sup> 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.

<sup>46</sup> Treas. Reg. sec. 1.861-4(b).

<sup>47</sup> Sec. 861(a)(7).

<sup>48</sup> Sec. 863(c).

<sup>49</sup> Sec. 863(d).

<sup>50</sup> Sec. 863(e).

<sup>51</sup> Sec. 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner*, 134 T.C. 122 (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.

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,<sup>52</sup> 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).<sup>53</sup> 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 "subpart F income"), without regard to whether the income is distributed to the shareholders.<sup>54</sup> 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,<sup>55</sup> insurance income,<sup>56</sup> and certain income relating to international boycotts and other violations of public policy.<sup>57</sup>

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<sup>52</sup> Secs. 951-964.

<sup>53</sup> Secs. 951(b), 957, 958.

<sup>54</sup> Sec. 951(a).

<sup>55</sup> Sec. 954.

<sup>56</sup> Sec. 953.

<sup>57</sup> Sec. 952(a)(3)-(5).

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.<sup>58</sup>

Prior to 2005, subpart F income included foreign base company shipping income.<sup>59</sup> Foreign base company shipping income generally included income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities. However, for taxable years beginning after 1975 and before 1987, subpart F income did not include foreign base company shipping income to the extent that such shipping income was reinvested during the taxable year in certain qualified shipping investments.<sup>60</sup> To the extent that, in a subsequent year, a net decrease in qualified shipping investments occurred, however, the amount of previously excluded subpart F income equal to such decrease is itself considered subpart F income under section 955. Therefore, withdrawal of previously excluded subpart F income from qualified shipping investments triggers an equivalent increase in the subpart F income of the CFC.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.<sup>61</sup>

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life

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<sup>58</sup> Sec. 954.

<sup>59</sup> Sec. 954(f) prior to its repeal by The American Jobs Creation Act of 2004, Pub. L. No. 108-357.

<sup>60</sup> Former sec. 954(b)(2).

<sup>61</sup> Prop. Treas. Reg. sec. 1.953-1(a).

insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Special rules apply under subpart F with respect to related person insurance income.<sup>62</sup> Enacted in 1986, these rules address the concern that “the related person insurance income of many offshore ‘captive’ insurance companies avoided current taxation under the subpart F rules of prior law because, for example, the company’s U.S. ownership was relatively dispersed.”<sup>63</sup> For purposes of these rules, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns or is considered to own any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation’s related person insurance income. Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.

#### 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.<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup> 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.

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<sup>62</sup> Sec. 953(c).

<sup>63</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987, p. 968.

<sup>64</sup> Secs. 951(a)(1)(B), 956.

<sup>65</sup> Sec. 956(c)(1).

<sup>66</sup> Sec. 956(c)(2).

## 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 control) to the extent attributable or properly allocable to non-subpart-F income of the payor.<sup>67</sup> 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 2014.<sup>68</sup>

Under a provision enacted in 1997 and originally applicable only for one taxable year,<sup>69</sup> 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”).<sup>70</sup> Congress has extended the application of section 954(h) several times, most recently in 2013.<sup>71</sup> The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2014 (and to taxable years of 10-percent U.S. shareholders with or within which those corporate taxable years end). With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country’s tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer’s trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU

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<sup>67</sup> Sec. 954(c)(6).

<sup>68</sup> Sec. 954(c)(6)(C). Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, sec. 751(a).

<sup>69</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1175.

<sup>70</sup> Sec. 954(h).

<sup>71</sup> American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, sec. 322(b); Pub. L. No. 111-312, sec. 750(a), 2010; 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.

in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

The American Jobs Creation Act of 2004 (“AJCA”)<sup>72</sup> 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.<sup>73</sup> 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 organized.<sup>74</sup> 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).<sup>75</sup>

#### 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.<sup>76</sup> 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.<sup>77</sup> Ordering rules provide that distributions from a CFC are treated as coming first out of

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<sup>72</sup> Pub. L. No. 108-357.

<sup>73</sup> AJCA sec. 416; Code sec. 954(h)(3)(E).

<sup>74</sup> Sec. 954(c)(3).

<sup>75</sup> Sec. 954(b)(4).

<sup>76</sup> Sec. 959(a)(1).

<sup>77</sup> Sec. 959(a)(2).

earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.<sup>78</sup>

### 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.<sup>79</sup> 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.<sup>80</sup>

### Passive foreign investment companies

The Tax Reform Act of 1986<sup>81</sup> 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.<sup>82</sup> Alternative sets of income inclusion rules apply to U.S. persons that are shareholders 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.<sup>83</sup> 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.<sup>84</sup> 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."<sup>85</sup>

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<sup>78</sup> Sec. 959(c).

<sup>79</sup> Sec. 961(a).

<sup>80</sup> Sec. 961(b).

<sup>81</sup> Pub. L. No. 99-514.

<sup>82</sup> Sec. 1297.

<sup>83</sup> Secs. 1293-1295.

<sup>84</sup> Sec. 1291.

<sup>85</sup> Sec. 1296.

## **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<sup>86</sup> and the personal holding company rules.<sup>87</sup> 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.<sup>88</sup> 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.<sup>89</sup>

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.

## **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 as a dividend or is included in the domestic corporation’s income under the anti-deferral rules.<sup>90</sup>

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.<sup>91</sup> 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

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<sup>86</sup> Secs. 531-537.

<sup>87</sup> 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.

<sup>88</sup> Secs. 551-558, 1246-1247.

<sup>89</sup> AJCA, sec. 413.

<sup>90</sup> Secs. 901, 902, 960, 1295(f).

<sup>91</sup> Secs. 901, 904.

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.<sup>92</sup>

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.<sup>93</sup> However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.<sup>94</sup> 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.<sup>95</sup>

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.<sup>96</sup> These rules exclude foreign corporations from an affiliated group.<sup>97</sup> AJCA modified the interest expense allocation rules for taxable years beginning after December 31, 2008.<sup>98</sup> The effective date of the modified rules has been delayed to January 1, 2021.<sup>99</sup> 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.

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<sup>92</sup> Sec. 904(c).

<sup>93</sup> Treas. Reg. sec. 1.861-8(b), Temp. Treas. Reg. sec. 1.861-8T(c).

<sup>94</sup> Temp. Treas. Reg. sec. 1.861-9T, Treas. Reg. sec. 1.861-17.

<sup>95</sup> Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

<sup>96</sup> Secs. 864(e)(5), 1504.

<sup>97</sup> Sec. 1504(b)(3).

<sup>98</sup> AJCA sec. 401.

<sup>99</sup> Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a).

The foreign tax credit limitation is applied separately to passive category income and to general category income.<sup>100</sup> 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.<sup>101</sup> 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.<sup>102</sup>

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.<sup>103</sup>

### **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

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<sup>100</sup> 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).

<sup>101</sup> Sec. 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.

<sup>102</sup> Sec. 904(d)(4).

<sup>103</sup> Sec. 909.

company through pricing that does not reflect an arm's-length result.<sup>104</sup> 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<sup>105</sup> 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.<sup>106</sup> 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 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.<sup>107</sup>

## **Other special rules**

### **Dual consolidated loss rules**

Under the rules applicable to corporations filing consolidated returns, a dual consolidated loss ("DCL") is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").<sup>108</sup> A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic

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<sup>104</sup> 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.

<sup>105</sup> 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."

<sup>106</sup> 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.

<sup>107</sup> H.R. Rep. No. 99-426, p. 423.

<sup>108</sup> Sec. 1503(d).

corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulations in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made.<sup>109</sup> Recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period.<sup>110</sup>

#### 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.<sup>111</sup>

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.<sup>112</sup> 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

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<sup>109</sup> Treas. Reg. sec. 1.1503(d)-6(d)

<sup>110</sup> See Treas. Reg. sec. 1.1503(d)-6(e)(1).

<sup>111</sup> 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.

<sup>112</sup> Sec. 965(d)(1).

credits).<sup>113</sup> Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.<sup>114</sup>

### 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.<sup>115</sup> 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.<sup>116</sup> Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;<sup>117</sup> 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

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<sup>113</sup> 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).

<sup>114</sup> Sec. 965(d)(2).

<sup>115</sup> In general, for U.S.-controlled corporations, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

<sup>116</sup> Sec. 163(j).

<sup>117</sup> 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).

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.

#### Domestic international sales corporations

A domestic international sales corporation ("DISC") is a domestic corporation that satisfies the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets;<sup>118</sup> the corporation must have no more than one class of stock, and the par or stated value of the outstanding stock must be at least \$2,500 on each day of the taxable year; and an election must be in effect to be taxed as a DISC.<sup>119</sup> In general, a DISC is not subject to corporate-level tax and offers limited deferral of tax liability to its shareholders.<sup>120</sup> DISC income attributable to a maximum of \$10 million annually of qualified export receipts is generally exempt from corporate and shareholder level income tax. Shareholders must pay interest to account for the benefit of deferring the tax liability on undistributed DISC income related to this \$10 million maximum annual amount.<sup>121</sup> Shareholders of a DISC are deemed to receive a dividend out of current earnings and profits of qualified export receipts in excess of \$10 million.<sup>122</sup> Gain on the sale of DISC stock is treated as a dividend to the extent of accumulated DISC income.<sup>123</sup> The shareholders of a corporation which is not a DISC, but was a DISC in a previous taxable year, and which has previously taxed income or accumulated DISC income, are also required to pay interest on the deferral benefit, and gain on the sale or exchange of stock in such corporation is treated as a dividend.

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<sup>118</sup> If a corporation fails to satisfy either or both of the 95-percent tests, it is deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. Sec. 992(c).

<sup>119</sup> Secs. 992(a) and (b).

<sup>120</sup> Sec. 991.

<sup>121</sup> The rate is the average of 1-year constant maturity Treasury yields. The deferral benefit is the excess of the amount of tax the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. Sec. 995(f).

<sup>122</sup> The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of \$10 million. See sec. 955(b).

<sup>123</sup> Sec. 995(c).

## **A. Establishment of Exemption System**

### **1. Deduction for dividends received by domestic corporations from certain foreign corporations (sec. 4001 of the discussion draft and new sec. 245A of the Code)**

#### **Description of Proposal**

##### **In general**

The proposal establishes a participation exemption system for foreign income.<sup>124</sup> This exemption is effectuated by means of a 95-percent deduction for the foreign-source portion of dividends received from certain foreign corporations (“specified 10-percent owned foreign corporations”) by domestic corporations that are United States shareholders of those foreign corporations within the meaning of section 951(b).<sup>125</sup> As under the exemption systems of some other countries, five percent of an otherwise deductible dividend from a foreign corporation remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

A specified 10-percent owned foreign corporation is any foreign corporation if any domestic corporation owns directly, or indirectly through a chain of ownership described under section 958(a), 10 percent or more of the voting stock of that foreign corporation.

##### **Foreign-source portion of a dividend**

The participation exemption system is intended to be available only for foreign income, not for U.S.-source income. Some specified 10-percent owned foreign corporations, 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 from a specified 10-percent owned foreign corporation for which the 95-percent deduction is allowed represents the portion of the dividend that relates to the foreign corporation’s post-1986 undistributed foreign earnings.<sup>126</sup> The foreign-source portion of any dividend is, therefore, the amount that bears the same ratio to the dividend as the foreign corporation’s post-1986 undistributed foreign earnings bears to the corporation’s total post-1986 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-

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<sup>124</sup> The term “participation exemption,” commonly used in describing similar systems in other countries, refers to the exemption granted to a domestic corporation for earnings of a foreign corporation by virtue of the present corporation’s participation in the ownership of the subsidiary.

<sup>125</sup> Under section 951(b) a corporation is a United States shareholder of a foreign corporation if it owns (within the meaning of section 958(a)) or is considered as owning by applying the rules of section 958(b) 10 percent or more of the voting stock of the foreign corporation.

<sup>126</sup> Undistributed foreign earnings include both foreign income on which a U.S. taxpayer may be taxed under subpart F and other foreign income on which no U.S. taxpayer is taxed before receipt of the dividend.

percent owned foreign corporation. The U.S.-source portion of any dividend for which a deduction is allowed under section 245 is the amount that bears the same ratio to the dividend as the dividend-paying corporation's post-1986 undistributed U.S. earnings bears to the corporation's total post-1986 undistributed earnings. For this purpose, a corporation's post-1986 undistributed U.S. earnings are, in general, undistributed earnings attributable to (a) the corporation's income that is effectively connected with the conduct of a trade or business within the United States, or (b) any dividend received (directly or through a wholly owned foreign corporation) from an 80-percent-owned (by vote or value) domestic corporation.<sup>127</sup>

Under the proposal, a CFC's post-1986 undistributed foreign earnings are, in general terms, the portion of post-1986 undistributed earnings that is not attributable to post-1986 undistributed U.S. earnings.

The term post-1986 undistributed earnings means the amount of the earnings and profits of the specified 10-percent owned foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986 as of the close of the taxable year of the foreign corporation in which the dividend is distributed and without diminution by reason of dividends distributed during that year.

Rules similar to the rules just described apply when a dividend is paid out of earnings of a specified 10-percent owned foreign corporation accumulated in taxable years beginning before January 1, 1987. As a consequence, the participation exemption system is available for both post-1986 and pre-1987 foreign earnings. An ordering rule provides that dividends are treated as paid out of post-1986 undistributed earnings to the extent of those earnings.

As a result of the coordination with the present law section 245 dividends received deduction for dividends received from certain 10-percent owned foreign corporations, the proposal provides the 95-percent dividends-received deduction for a dividend received by a United States shareholder from a specified 10-percent owned foreign corporation 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 proposal is intended to provide an exemption from U.S. corporate tax when a domestic corporation receives a dividend from an eligible foreign corporation attributable to the corporation's foreign-source income.

### **Foreign tax credit disallowance; foreign tax credit limitation**

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

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<sup>127</sup> Section 3650 of the discussion draft, described previously, modifies the definition of a domestic corporation for purposes of the definition of post-1986 undistributed U.S. earnings so that dividends derived from RICs and REITs are ineligible for the section 245 dividends received deduction.

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

For purposes of computing its section 904(a) foreign tax credit limitation, a domestic corporation that is a United States shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income by disregarding the foreign-source portion of any dividend received from that foreign corporation and any deductions properly allocable to that foreign-source portion.

### **Six-month holding period requirement**

A domestic corporation is allowed the 95-percent deduction for a dividend it receives on stock of a specified 10-percent owned foreign corporation only if the domestic corporation satisfies a six-month 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 stock that is held by the domestic corporation for 180 days or less during the 361-day period beginning on the date that is 180 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 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 proposal 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 180-out-of-361-days test described above is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the domestic corporation is a United States shareholder of the foreign corporation at all times during the period.

### **Foreign branches**

The proposal does not change the general rules related to the taxation of foreign branches of domestic corporations. Section 4002 of the discussion draft, however (described below), provides new income recognition rules when a domestic corporation transfers a foreign branch to its specified 10-percent owned foreign corporation and coordinates those new rules with the present law branch loss recapture rules.

## **Conforming amendments and other changes**

The proposal 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 proposal'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 proposal 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 proposal extends this rule to stock on which a dividend eligible for the 95-percent dividends-received deduction is paid.

### **Effective Date**

The proposal applies to taxable years of foreign corporations beginning after December 31, 2014 and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

## **2. Limitation on losses with respect to specified 10-percent owned foreign corporations (sec. 4002 of the discussion draft, and secs. 367(a)(3)(C) and 961 and new sec. 91 of the Code)**

### **Description of Proposal**

#### **Reduction in basis of certain foreign stock**

Under the proposal, solely for the purpose of determining a loss, a domestic corporate shareholder's adjusted basis in the stock of a specified 10-percent owned foreign corporation (as defined in new section 245A and explained above) is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of a dividends received deduction allowable under section 245A in any taxable year of such domestic corporation.

#### **Inclusion of transferred loss amount in certain assets transfers**

Under the proposal, if a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) to a foreign corporation which, after such transfer, is a specified 10-percent owned foreign corporation with respect to which such

domestic corporation is a United States shareholder, such domestic corporation includes in gross income an amount equal to the transferred loss amount, subject to certain limitations.

For any taxable year of such domestic corporation, the amount included in gross income is limited to the aggregate amount of dividends received deductions allowable under new section 245A to such domestic corporation during such taxable year (taking into account all specified 10-percent owned foreign corporations with respect to which such domestic corporation is a United States shareholder). Transferred loss amounts not included in gross income by reason of such limitation are carried forward and included in gross income in subsequent years, subject to the application of such limitation in such subsequent taxable year.

The transferred loss amount is the excess of (1) losses incurred by the foreign branch after December 31, 2014, for which a deduction was allowed to the domestic corporation, over (2) the sum of taxable income earned by the foreign branch and gain recognized by reason of an overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer. For the purposes of (2), only taxable income of the foreign branch in taxable years after the loss is incurred through the close of the taxable year of the transfer is included.

For transfers not covered by section 367(a)(3)(C), the transferred loss amount is reduced by the amount of gain recognized by the domestic corporation on the transfer (other than gains recognized by reason of overall foreign loss recapture). For transfers covered by section 367(a)(3)(C), the transferred loss amount is reduced by the amount of gain recognized by reason of such subparagraph.

Amounts included in gross income by reason of the proposal or by reason of section 367(a)(3)(C) are treated as derived from sources within the United States.

The proposal provides authority for the Secretary to prescribe regulations or other guidance for proper adjustments to the adjusted basis of the specified 10-percent owned foreign corporation to which the transfer is made, and to the adjusted basis of the property transferred, to reflect amounts included in gross income under the proposal.

#### **Effective Date**

The proposal relating to reduction of basis in certain foreign stock for the purposes of determining a loss is effective for dividends received in taxable years beginning after December 31, 2014.

The proposal relating to transfer of loss amounts from foreign branches to certain foreign corporations is effective for transfers after December 31, 2014.

### **3. Treatment of deferred foreign income upon transition to participation exemption system of taxation (sec. 4003 of the discussion draft and secs. 965 and 9503 of the Code)**

#### **Description of Proposal**

##### **In general**

The proposal generally requires that, for the last taxable year beginning before the participation exemption takes effect, any 10-percent U.S. shareholder of a CFC or other 10-percent owned foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation. Up to 90 percent of the amount so included in income is deductible by the U.S. shareholder, depending on whether the deferred earnings are in cash or other assets. The deduction results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. In determining the increase in a 10-percent U.S. shareholder's U.S. tax liability as a result of the mandatory inclusion, the Code is applied as in effect before enactment of the discussion draft. For example, the corporate tax rate remains unchanged and the separate foreign tax credit limitation rules of present law section 904 apply. The increased tax liability generally may be paid over an eight-year period. An amount equivalent to the taxes collected under this proposal is appropriated to the Highway Trust Fund.

##### **Subpart F**

The mechanism for the mandatory inclusion of pre-effective date foreign earnings is subpart F. The proposal provides that in the last taxable year of a specified foreign corporation that ends before January 1, 2015, 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. In contrast to the participation exemption deduction available only to domestic corporations that are U.S. shareholders under subpart F, the transition rule applies to all U.S. shareholders<sup>128</sup> of a specified foreign corporation, which includes any foreign corporation in which a U.S. person owns ten percent of the voting stock. Consistent with the general operation of subpart F, each 10-percent U.S. shareholder of a specified 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.<sup>129</sup>

A 10-percent U.S. shareholder of a specified foreign corporation is allowed a deduction in an amount determined by reference to the portion of deferred earnings and profits that are held

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<sup>128</sup> Sec. 951(b), which defines United States shareholder as any U.S. person that owns 10 percent or more of the voting classes of stock of a foreign corporation.

<sup>129</sup> For purposes of taking into account its subpart F income under this rule, a noncontrolled 10/50 corporation is treated as a CFC.

in cash or liquid assets. The noncash portion is eligible for a deduction of 90 percent; the U.S. shareholder aggregate foreign cash position is eligible for a deduction of 75 percent.

**Accumulated deferred foreign income**

A specified 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 post-1986 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, (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, (3) or, for PFICs, an amount that would be treated as an excess distribution or attributable to an unreversed inclusion. 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, 2015.

The income inclusion required of a U.S. shareholder under this transition rule is reduced by the portion of aggregate foreign earnings and profits deficit allocated to that person by reason of that person’s interest in one or more E&P deficit foreign corporations. An E&P deficit foreign corporation is defined as any specified foreign corporation owned by the U.S. shareholder as of February 26, 2014 and which also has a deficit in post-1986 earnings and profits as of that date. The U.S. shareholder aggregates its pro rata share in the foreign E&P deficits of each such company and allocates it among the deferred foreign income corporations in which the shareholder is a U.S. shareholder. The aggregate foreign E & P deficit allocable to a specified foreign corporation is in same ratio as the U.S. shareholder’s pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder’s pro rata share of accumulated post-1986 deferred foreign income from all deferred income companies of such shareholder.

To illustrate, assume that a U.S. corporation is a U.S. shareholder with respect to each of four specified foreign corporations, two of which are E&P deficit foreign corporations, and that the foreign companies have the following accumulated post-1986 deferred foreign income or foreign E&P deficits as of February 26, 2014:

<b>Specified Foreign Corp.</b>	<b>Percentage Owned</b>	<b>Foreign profit/deficit</b>	<b>Pro Rata Share</b>
A	60	(1,000)	(600)
B	10	(200)	(20)
C	70	2,000	1,400
D	100	1,000	1,000

The aggregate foreign E & P deficit of the U. S. shareholder is (620), and the aggregate share of accumulated post-1986 deferred foreign income is 2400. Thus, the portion allocable to Corporation C is \$362, that is, \$620 x 1400/2400. The remainder of the aggregate foreign E&P deficit is allocable to Corporation D.

Specific regulatory authority is granted to permit reductions of accumulated deferred earnings and profits where appropriate to effect the intent of the drafters that U.S. persons not incur tax with respect to earnings and profits of a controlled foreign corporation allocable to stock owned by persons other than United States shareholders as deferred foreign income.

### **Foreign tax credit**

Like present law section 965, the proposal disallows a foreign tax credit for the portion of foreign taxes paid with respect to the pre-effective-date undistributed CFC earnings inclusion. The proposal 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.

The required inclusion of deferred foreign income under this provision is disregarded for purposes of determining the amount of income from foreign sources that a U.S. shareholder has for purposes of the recapture rules applicable to overall foreign losses.

### **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 eight installments, in the following amounts: installments one through five in an amount equal to eight percent of the net tax liability; a sixth installment of 15 percent of the net tax liability; the seventh is 20 percent and the eighth, 25 percent. 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.

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 income tax return of each succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment for which the due date is past must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under this proposal, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in

installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount.

The proposal 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).

### **Special rule for S corporations**

A special rule permits deferral of the transition net tax liability for shareholders of a 10-percent U.S. shareholder that is a flow-through entity known as an S corporation.<sup>130</sup> Any shareholder of the S corporation may elect to defer his portion of the net tax liability at transition to the participation exemption system until the shareholder's taxable year in which a triggering event occurs. If an election to defer tax is made, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2015.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor. Partial transfers trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, that shareholder may be eligible to elect to pay the net tax liability in installments, subject to rules similar to those generally applicable absent deferral. Whether or not a shareholder may elect to pay in installments depends upon the type of event that triggered the end of deferral. If the triggering event is liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, installment payments are not available. Instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

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<sup>130</sup> Section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with fewer than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.

If an election to defer payment of the net tax liability is in effect for a shareholder, the period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral.

### **Highway Trust Fund**

The proposal requires that income tax payments relating to the net tax liability for deemed repatriation of pre-effective date foreign earnings will be transferred to the Highway Trust Fund. The Highway Trust Fund, established in 1956, is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs.<sup>131</sup> The Highway Trust Fund is currently funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. Of the receipts received in the Treasury as a result of the deemed repatriation provision (and not otherwise appropriated), an amount equivalent to twenty percent will be transferred to the Mass Transit Account, the balance transferred to the Highway Account.

#### **Effective Date**

The proposal is effective for the last taxable year of a deferred foreign corporation that begins before January 1, 2015, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the specified foreign corporations end.

#### **4. Look-thru rule for related controlled foreign corporations made permanent (sec. 4004 of the discussion draft and sec. 954(c)(6) of the Code)**

#### **Description of Proposal**

The proposal makes the exclusion from foreign personal holding company income for certain dividends, interest, rents, and royalties received from a related controlled foreign corporation permanent.

#### **Effective Date**

The proposal applies to taxable years of foreign corporations beginning after December 31, 2013 and to taxable years of United States shareholders in which or with which those taxable years of foreign corporations end.

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<sup>131</sup> Sec. 9503(e)(1).

## **B. Modifications Related to Foreign Tax Credit System**

### **1. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis (sec. 4101 of the discussion draft and secs. 902 and 960 of the Code)**

#### **Description of Proposal**

The proposal repeals the deemed-paid credit with respect to dividends received by a domestic corporation which owns 10-percent or more of the voting stock of a foreign corporation.

A deemed-paid credit is provided with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. Foreign income taxes under the proposal 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 proposal eliminates the need for computing and tracking cumulative tax pools.

Additionally, the proposal provides rules applicable to foreign taxes attributable to distributions from previously taxed earnings and profits, including distributions made through tiered-CFCs.

The Secretary is granted authority under the proposal to provide regulations as necessary and appropriate to carry out the purposes of this proposal. It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.<sup>132</sup> Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income.

In addition to the rules described in this section, the proposal makes several conforming amendments to various other sections of the Code reflecting the repeal of section 902 and the modification of section 960. These conforming amendments include amending the section 78 gross-up provision to apply solely to taxes deemed paid under the amended section 960.

#### **Effective Date**

The proposal applies to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

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<sup>132</sup> See Treas. Reg. sec. 1.904-6(a).

## **2. Foreign tax credit limitation applied by allocating only directly allocable deductions to foreign source income (sec. 4102 of the discussion draft and sec. 904 of the Code)**

### **Description of Proposal**

The proposal 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 proposal to allocate other deductions against foreign-source income for purposes of determining the foreign tax credit limitation.

For purposes of applying this proposal, 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 proposal.

### **Effective Date**

This proposal is applicable to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

## **3. Passive category income expanded to include other mobile income (sec. 4103 of the discussion draft and sec. 904 of the Code)**

### **Description of Proposal**

The proposal generally retains the separate category rules (*i.e.*, general category and passive category) for determining the foreign tax credit limitation. The passive category is renamed mobile category income and is expanded to include a shareholder's foreign base company sales income and foreign base company intangible income. Additionally, the special rules for treating financial services income as general category income are eliminated.

Several conforming amendments are made to various sections of the Code.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

This proposal applies to taxes carried from any taxable year beginning before January 1, 2015 to any taxable year beginning on or after such date.

Treasury regulations may provide for the allocation of any carryback of taxes with respect to income from a taxable year beginning on or after January 1, 2015 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.

**4. Source of income from sales of inventory determined solely on basis of production activities (sec. 4104 of the discussion draft and sec. 863(b) of the Code)**

**Description of Proposal**

Under this proposal, income derived from the sale of inventory produced partly in, and partly outside, the United States is allocated and apportioned on the basis of the location of production activities in accordance with the regulations applicable to section 863(b). For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. Had the inventory property been produced partly in, and partly outside, the United States in this example, however, the income derived from its sale is sourced partly in the United States.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2014.

## **C. Rules Related to Passive and Mobile Income**

### **1. Subpart F income to only include low-taxed foreign income (sec. 4201 of the discussion draft and secs. 953 and 954 of the Code)**

#### **Description of Proposal**

The proposal modifies the rule excluding items of income subject to high foreign taxes from foreign base company income and from insurance income. Under the proposal, foreign base company income and insurance income do not include items of income received by a controlled foreign corporation which are subject to an effective tax rate imposed by a foreign country which is greater than or equal to the maximum U.S. corporate rate specified in section 11.

The proposal creates special rules for certain categories of foreign base company income. Under the proposal, foreign base company income does not include items of foreign base company sales income which are subject to an effective tax rate of tax imposed by a foreign country which is greater than or equal to 50-percent of the maximum U.S. corporate rate specified in section 11.

Further, foreign base company income does not include the foreign percentage (as determined under new section 250(c) with respect to the controlled foreign corporation) of foreign base company intangible income if such foreign base company intangible income is subject to an effective tax rate imposed by a foreign country which is greater than the applicable percentage. For the purpose of the tax rate test, the applicable percentage for any taxable year beginning in 2015 is 45 percent, 2016 is 48 percent, 2017 is 52 percent, 2018 is 56 percent and 2019 and thereafter is 60 percent.<sup>133</sup> All foreign personal holding company intangible income is treated as a single item of income for purposes of the tax rate test.

#### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

### **2. Foreign base company sales income (sec. 4202 of the discussion draft and secs. 954 and 960 of the Code)**

#### **Description of Proposal**

The proposal permits an exclusion of 50 percent of all foreign base company sales income ("FBCSI"). The taxes paid by the controlled foreign corporation with respect to such income remain creditable as deemed paid taxes, notwithstanding the exclusion of income.

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<sup>133</sup> The applicable percentage corresponds to the phase-down of the corporate income tax rate under section 3001 of the discussion draft.

Furthermore, FBCSI income of a controlled foreign corporation is excluded in full if the foreign corporation is eligible for benefits as a qualified resident under a comprehensive income tax treaty with the United States. The phrase "comprehensive income tax treaty" refers to any bilateral treaty for the elimination of double income taxation. By limiting the provision to companies that are eligible as qualified resident for all benefits of such a treaty, the scope of the provision is intended to be limited to those companies that satisfy the robust limitation on benefits provisions of income tax treaties. Such rules are intended to prevent the inappropriate claims of treaty benefits by third-country residents, and are generally standard provisions in treaties that have entered into force since January 1, 1990.

#### **Effective date**

The exception described above applies to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which those taxable years of foreign corporations end.

### **3. Inflation adjustment of *de minimis* exception for foreign base company income (sec. 4203 of the discussion draft and sec. 954(b) of the Code)**

#### **Description of Proposal**

In the case of any taxable year beginning after 2015, the proposal indexes for inflation the \$1,000,000 *de minimis* amount for foreign base company income, with all increases rounded to the nearest multiple of \$50,000.

#### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

### **4. Active financing exception extended with limitation for low-taxed income (sec. 4204 of the discussion draft and secs. 953, 954, and 960 of the Code)**

#### **Description of Proposal**

The proposal modifies and extends for five years (for taxable years beginning before January 1, 2020) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Under the proposal, foreign personal holding company income does not include any item of qualified banking or financing income of an eligible controlled foreign corporation (as determined under 954(h)), or qualifying insurance income of a qualifying insurance company (as determined under 954(i)), which is subject to an effective foreign income tax rate of at least 50 percent of the maximum U.S. corporate rate under section 11.

The proposal also excludes from foreign personal holding income fifty percent of any item of qualified banking or financing income of an eligible controlled foreign corporation, or qualifying insurance income of a qualifying insurance company, which are subject to an effective foreign income tax rate of at least 50 percent of the maximum U.S. corporate rate under section 11.

Under the proposal, with respect to such items of income subject to the 50-percent exclusion from foreign personal holding company income, the determination of taxes deemed paid by a United States shareholder under section 960(a) is made as if no 50-percent exclusion were allowed. In other words, a United States shareholder is deemed to pay the pro rata share of the full amount of tax paid by the controlled foreign corporation on such item of income.

#### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2013, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

### **5. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment (sec. 4205 of the discussion draft and sec. 955 of the Code)**

#### **Description of Proposal**

The proposal repeals section 955.

#### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2013, and to taxable years of U.S. shareholders within which or with which such taxable years of foreign corporations end.

## **D. Prevention of Base Erosion**

### **1. Foreign intangible income subject to taxation at reduced rate; intangible income treated as subpart F income (sec. 4211 of the discussion draft and sec. 954 of the Code)**

#### **Description of Proposal**

##### **In general**

The proposal addresses erosion of the U.S. tax base through shifting intangible income by creating a new category of subpart F income for intangible income derived by CFCs and providing a phased deduction for a domestic corporation for income from its foreign exploitation of intangibles. As a result, the proposal 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 intangibles in foreign markets. When fully phased in, the deduction from the gross income of the domestic corporation results in a reduced tax rate of 15 percent for income from the foreign exploitation of intangible property.

##### **Foreign base company intangible income**

The proposal adds a new category of subpart F income, foreign base company intangible income. Foreign base company intangible income is the excess of the corporation's adjusted gross income over 10 percent of the corporation's qualified business asset investment. This amount is reduced by the applicable percentage of the corporation's foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil related income. The applicable percentage is the excess of the corporation's adjusted gross income over 10 percent of the corporation's qualified business asset investment divided by the total adjusted gross income of the corporation. Adjusted gross income means the gross income of the corporation reduced by commodities gross income.

A corporation's qualified business asset investment is the aggregate of the corporation's adjusted bases in specified tangible property. A corporation's aggregate basis in specified tangible property is determined as of the close of any taxable year after any adjustments made for the taxable year. Specified tangible property is any tangible property unless the property is used in the production of commodities gross income. The specified tangible property is property used in a trade or business of the corporation, and is of a type with respect to which a deduction is allowable under section 168. The basis of any property is determined in accordance with the new rules provided elsewhere in the discussion draft, and without regard to any provisions enacted after the enactment of these rules. The proposal includes authority for the Secretary to issue guidance appropriate to prevent the avoidance of the application of the tangible property rules, including guidance providing for the treatment of property if the property is transferred or held temporarily or if avoiding the purpose of the proposal is a factor in the transfer or holding of property.

To illustrate, suppose a CFC in the business of manufacturing and selling widgets has an aggregate basis in specified tangible property of \$300, and adjusted gross income of \$50 which includes \$10 of foreign personal holding company income. The amount of the CFC's adjusted gross income in excess of 10 percent of its basis in property is \$20 [\$50 - \$30]. The applicable

percentage of 40 percent [ $\$20 / \$50$ ] multiplied by the \$10 of foreign personal holding company income is \$4. The CFC's foreign base company intangible income is \$16.

Foreign base company intangible income is only subpart F income under the proposal to the extent that the income is subject to a foreign effective tax rate lower than the effective U.S. tax rate imposed after taking into account the deduction for foreign intangible income discussed below.

### **Commodities gross income**

Commodities gross income is excluded from the computation of foreign base company intangible income. A CFC's commodities gross income is the gross income derived from the sale, disposition, production or extraction of any commodity. Additionally, specified tangible property does not include property used in the production of commodities gross income. If a property is used for the production of both commodities gross income and other income, the property is treated under the proposal as specified tangible property in the same proportion as the adjusted gross income produced with respect to the property bears to the total gross income produced with respect to the property.

For purposes of the proposal, a commodity is any commodity described in section 475(e)(2)(A).

### **Deduction for foreign intangible income**

The proposal allows a domestic corporation a deduction equal to the applicable percentage of the lesser of (1) the sum of the domestic corporation's foreign percentage of its net intangible income and the domestic corporation's share of a CFC's foreign base company intangible income multiplied by the CFC's foreign percentage, and (2) the taxable income of the domestic corporation.

The applicable percentage phases in over time in accordance with the phase-in of the lower domestic corporate tax rate. The applicable percentage is 55 percent for 2015, 52 percent for 2016, 48 percent for 2017, 44 percent for 2018, and 40 percent for 2019 and thereafter.

The domestic corporation's intangible income is computed in the same manner as the foreign base company intangible income of a CFC. Intangible income of the domestic corporation is equal to the adjusted gross income in excess of 10 percent of the corporation's qualified business asset investment. Adjusted gross income and qualified business asset investment are defined the same for the domestic corporation as they are for the CFC. Net intangible income is the excess of the intangible income over deductions property allocable to that income.

Only foreign intangible income is eligible for the deduction. Foreign intangible income is computed by multiplying the foreign percentage by the domestic corporation's net intangible income and multiplying the CFC's foreign percentage by the domestic corporation's share of the CFC's foreign base company intangible income.

A corporation's foreign percentage is the ratio of the foreign-derived adjusted gross income over the corporation's total adjusted gross income for the taxable year. Under the proposal, foreign-derived adjusted gross income is gross income derived in connection with property which is sold for use, consumption, or disposition outside the United States, or services provided with respect to persons or property located outside the United States. The location of title passage is not determinative of where property is sold for use, consumption, or disposition. For example, the gross income from a foreign military sale where title is transferred first to the U.S. government for on-sale to a foreign purchaser for use, consumption, or disposition outside the United States qualifies as foreign-derived adjusted gross income.

Property is not treated as sold for use, consumption, or disposition outside the United States if the taxpayer knew, or had reason to know, that the property would ultimately be sold for use, consumption, or disposition in the United States. Property sold to a related party will not be treated as sold for use, consumption, or disposition outside the United States unless the property is ultimately sold by a related party for use, consumption, or disposition outside the United States, or if the property is resold to an unrelated party outside the United States and no related party knew or had reason to know that the property would ultimately be sold for use, consumption, or disposition in the United States. Similar rules apply with respect to services. A related party for these purposes means any member of an affiliated group defined in section 1504(a) determined by using "more than 50 percent" in place of "at least 80 percent" and by including insurance companies and foreign corporations. Any person (other than a corporation) is treated as a member of the group if the person is controlled by members of the group, or controls any member of the group. Control for these purposes is determined under the rules of section 954(d)(3).

### **Effective Date**

The proposal is generally effective for foreign corporations for taxable years beginning after December 31, 2014, and for the U.S. shareholder of such foreign corporation, for the taxable years within which or with which, such taxable years of the foreign corporations end.

The deduction provided by this proposal is applicable for taxable years of a domestic corporation beginning after December 31, 2014.

## **2. Denial of deduction for interest expense of U.S. shareholders which are members of worldwide affiliated groups with excess domestic indebtedness (sec. 4212 of the discussion draft and sec. 163 of the Code)**

### **Description of Proposal**

The proposal addresses base erosion that results from excessive and disproportionate borrowing in the United States by limiting the deductibility of net interest expense<sup>134</sup> of a U.S. corporation that is a U.S. shareholder with respect to any CFC if both the CFC and U.S.

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<sup>134</sup> 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.

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 these tests is the amount by which deductible interest is reduced. The proposal does not apply 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. First, the ownership threshold of section 1504(a)(2) is applied using 50 percent rather than 80 percent. Second, 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 as a result of a debt-to-equity differential. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. members exceeds 110 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. Intragroup debt and equity interests are disregarded for purposes of this computation.

The percentage of adjusted taxable income test computes the amount by which the net interest expense of a U.S. shareholder exceeds 40 percent of adjusted taxable income. The proposal requires that the U.S. shareholder first compute adjusted taxable income as defined in section 163(j)(6)(A), that is, taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and as prescribed under regulations. The net interest expense is the amount of interest paid or accrued in the taxable year in excess of the amount of interest includible in gross income for the same taxable year, as defined in section 163(j)(6)(B).

Several changes to section 163(j) conform its operation to the new subsection. Interest disallowed under either this rule or under section 163(j) may be carried forward to subsequent taxable years. The amount by which corporate net interest expense may exceed the adjusted taxable income of the corporation (plus any excess limitation carryforward from years beginning before January 1, 2015) is reduced to 40 percent from 50 percent. Excess limitation for years beginning after January 1, 2015 is not available to be carried forward. Finally, the amount of interest disallowed under section 163(j) is reduced to the extent that a disallowance of deduction is required by this proposal.

The Secretary is provided regulatory authority to provide anti-avoidance rules and the treatment of partnership indebtedness, allocation of partnership debt, interest, or distributive shares.

**Effective Date**

The proposal is effective for taxable years beginning after December 31, 2014.