Legislative Developments

Marc J. Gerson and Layla J. Aksakal

U.S. International Tax Reform: Potential Changes to Subpart F

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As Congress and the Administration consider fundamental tax reform, it is anticipated that changes to the current deferral regime will be evaluated, particularly given that the Joint Committee on Taxation recently identified deferral as the largest corporate tax expenditure at an estimated cost of $70.6 billion from 2010 to 2014.[1] Indeed, a number of notable tax reform proposals, as well as introduced legislation and proposals from the Obama Administration, propose significant changes to deferral. These proposals range from broad reforms, such as the adoption of a territorial system or elimination of deferral, to more targeted proposals that would limit deferral with respect to certain types of income. Each of these proposals should be scrutinized and evaluated carefully by policymakers, particularly with respect to the potential impact of these proposals on the competitiveness of U.S.-based multinationals and, more generally, on the overall U.S. economy.

Marc J. Gerson is a member of Miller & Chevalier Chartered, Washington, D.C.

Layla J. Aksakal is a counsel of Miller & Chevalier Chartered, Washington D.C.

I. Tax Reform Proposals

PERAB

On August 29, 2010, the President's Economic Recovery Advisory Board (PERAB) issued its report on tax reform options.[2] The PERAB report did not put forward a specific tax reform proposal but did identify four potential options to reform the U.S. international tax system: (1) a move to a territorial system, (2) a move to a pure worldwide system without deferral and with a lower corporate tax rate, (3) a limitation on, or the end

of, deferral with a retention of the current corporate tax rate, or (4) the retention of the current system with a lower corporate tax rate.

Subsequent Proposals

There have been a number of subsequent tax reform proposals that have been introduced that adopt one of the options identified by the PERAB report as part of a proposal to reduce the U.S. corporate tax rate. In November 2010, the Bipartisan Policy Center Debt Reduction Task Force, co-chaired by former Senator Pete Domenici and Dr. Alice Rivlin, proposed a top corporate tax rate of 27 percent and retaining the worldwide system of taxation with the current deferral rules.[3] On December 3, 2010, the President's National Commission on Fiscal Responsibility and Reform included an illustrative proposal in its report that proposed a flat 28-percent corporate tax rate, adoption of a territorial system for active foreign-source income and retention of the current subpart F rules for passive foreign-source income.[4] Under the commission's proposal, active foreign-source income would be exempt from tax (rather than only deferred as under current law), but passive foreign-source income could be subject to tax immediately (as under current law). Finally, on April 5, 2011, Senator Ron Wyden (D-OR) and Senator Dan Coats (R-IN) introduced S. 727, *The Bipartisan Tax Fairness and Simplification Act of 2011*,[5] which proposed a flat 24-percent corporate tax rate, retention of the worldwide system of taxation and repeal of deferral.

II. Introduced Legislation

In addition to *The Bipartisan Tax Fairness and Simplification Act of 2011*, other legislative proposals have been introduced that would modify subpart F. Although these proposals have not been introduced in the context of fundamental tax reform proposal, they could in fact be incorporated into a future proposal and, therefore, should be given serious consideration and analysis.

H.R. 62

On January 5, 2011, Representative Lloyd Doggett (D-TX) introduced H.R. 62, *The International Tax Competitiveness Act of 2011*, which includes a series of proposals to impose current U.S. taxation on royalties and other income from intangibles received from a controlled foreign corporation (CFC). Specifically, H.R. 62 would (1) repeal the CFC "look-through" rule of Code Sec. 954(c)(6) with respect to royalties, (2) not allow entities to be disregarded for purposes of determining royalties, and (3) provide a special rule for purposes of determining foreign base company sales income under Code Sec. 954(d) whereby personal property would be treated as having been purchased from a related party if any intangible property made available to a CFC (directly or indirectly) by a related U.S. person contributes (directly or indirectly) to the production of the personal property by the CFC.

S. 45

On January 25, 2011, Senator Sheldon Whitehouse (D-RI) introduced S. 45, *The Offshoring Prevention Act*, which would subject to current U.S. tax income of CFCs attributable to imported property. Companion legislation was introduced on June 22, 2011, as H.R. 2280 by Representative David Cicillene (D-RI). The legislation would expand the definition of "foreign base company income" to include so-called "imported property income," which is defined as income from the manufacture, producing, growing, extracting, sale, exchange, other disposition, lease, rental or licensing of property imported into the United States by a CFC, a related person or certain unrelated persons. The legislation provides an exception for certain property that is subsequently exported after being imported in the United States, as well as an exception for certain agricultural commodities. The legislation also provides that a separate foreign tax credit limitation would apply with respect to imported property income. This proposal, often referred to as the so-called "runaway plant" legislation, was introduced multiple times in previous Congresses by former Senator Byron Dorgan (D-ND).[6]

H.R. 749

On February 16, 2011, Representative Pat Tiberi (R-OH) introduced legislation to permanently extend the active financing exception of Code Secs. 954(h) and 954(i). Similar legislation has been introduced in previous Congresses.[7] In addition, it is anticipated that, similar to previous Congresses, legislation will also be introduced to extend the CFC "look-through" rule of Code Sec. 954(c)(6).[8]

III. Administration Proposals

The Obama Administration's Fiscal Year 2012 ("FY2012") budget proposal contains a number of proposals that would modify deferral or have significant implications for taxpayers that benefit from deferral.[9]

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Extension of the CFC Look-Through Rule and Active Financing Exception

As it has in prior budgets, the Administration has proposed a short-term (in this instance, one-year) extension of the CFC "look-through" rule of Code Sec. 954(c)(6), as well as the active financing exception of Code Secs. 954(h) and 954(i).[10] Both provisions have been subject to multiple, short-term extensions since their original enactment, most recently for two years through December 31, 2011, as part of *The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*.[11]

Expansion of Subpart F

The Administration's FY2012 budget also contains a proposal to expand subpart F to impose current U.S. tax on so-called "excess income" associated with the transfer of intangible assets to "low-taxed affiliates" offshore.[12] Although specific details of the proposal have not been released, the proposal would provide that if a U.S. person transfers (directly or indirectly) intangible property from the United States to a related CFC, certain undefined "excess income" from transactions related to the intangible property would be treated as subpart F income if the income is subject to an undefined low foreign effective tax rate. Further, this subpart F income will be a separate category of income for purposes of determining a taxpayer's foreign tax credit limitation under Code Sec. 904.

Other Proposals That Will Impact Deferral

Finally, the Administration's FY2012 budget contains two proposals from prior Administration budgets that, although they do not modify subpart F, would have significant implications for taxpayers that benefit from deferral under current law. First, the FY2012 budget contains a proposal to defer the deduction of interest expense related to deferred income. Specifically, the proposal would defer the deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax (*i.e.*, unrepatriated foreign earnings).[13] The FY2012 budget contains a second proposal that would determine the foreign tax credit on a "pooling" basis, such that a U.S. taxpayer would be required to determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit.[14] The deemed paid foreign tax credit for a tax year would be based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that tax year. Thus, the practical impact of both of these proposals is to deny otherwise allowable interest expense deductions and foreign tax credits based on a taxpayer's unrepatriated foreign earnings. As a result, taxpayers may be forced to voluntarily relinquish deferral and repatriate such earnings in order to access the underlying interest expense deductions and foreign tax credits.

IV. Conclusion

At the outset of the tax reform debate, there are a number of proposals that would fundamentally change the subpart F landscape. It will be important to monitor developments with respect to these proposals and future proposals. To the extent that the Congress considers proposals that would repeal, or significantly limit deferral, these proposals must be carefully evaluated on their tax policy merits, particularly with respect to their potential impact on the competitiveness of U.S.-based multinationals and, more generally, on the overall U.S. economy.

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Endnotes

1 Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates* (JCX-15-11), Feb. 28, 2011, at 25. One commentator recently suggested that deferral should not, in fact, be characterized as a tax expenditure. Kies, *Deferral Not A Tax Expenditure, Former JCT Chief Says,* 131 Tax Notes 219 (Apr. 11, 2011).

2 The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (Aug. 2010), at 89-94.

3 The Debt Reduction Task Force, Restoring America's Future (Nov. 2010), at 130, fn. 89 ("The Task Force plan leaves in place the provision that allows U.S. multinationals to defer taxation of the profits of their foreign subsidiaries until those profits are repatriated to the U.S. parent (deferral). Some view deferral as an incentive for U.S.-based companies to invest overseas, but others believe eliminating deferral would damage the ability of U.S. corporations to compete with foreign-based corporations and note that most of our major trading partners have enacted territorial systems that exempt completely the active foreign income of their corporations. While the Task Force plan does not address our complex system of taxing international income flows of corporations, the substantially lower corporate tax rate that the Task Force proposes will increase the incentive for both U.S. and foreign-based multinationals to invest in the United States").

Endnotes

[4] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (Dec. 2010), at 33.

[5] Similar legislation was introduced by Senator Wyden and former Senator Judd Gregg (R-NH) in the 111th Congress as S. 3018, *The Bipartisan Tax Fairness and Simplification Act of 2010*.

[6] *See, e.g.,* S. 260 (2009).

[7] *See, e.g.,* H.R. 1944 (2009); S. 940 (2007); H.R. 1509 (2007).

[8] *See, e.g.,* H.R. 2098 (2009).

[9] The Obama Administration, as of the date of this article, is reportedly working on a comprehensive corporate tax reform proposal. It will be interesting to see if the proposals contained in the FY2012 budget are in fact included in any tax reform proposal released by the Administration.

[10] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (Feb. 2011) (the "Greenbook"), at 32.

[11] P.L. 111-312, §§750 and 751 (2010).

[12] Greenbook, at 43-44.

[13] Greenbook, at 40-41.

[14] Greenbook, at 42.

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